CHAPTER - I :: INTRODUCTION ::

The problem in developed economies like U.S.A. is to maintain steady growth whereas the problem in underdeveloped countries like India is to stimulate growth of the economy with stability and achieve full-employment. It has become fashionable to talk of the maladies in achieving economic development in underdeveloped countries. In most of them, as in India,"the road to economic development is paved with vicious circles". There is small capacity to save owing to a low level of real income, low income is reflection of low productivity which is due to lack of capital equipments and capacity to use them to the best advantage. The lack ofcapital has resulted largely from the small potential for saving. This in turn is resulted by low level of investment. Hence the poverty sequence moves like this, inadequate capital, low productivity, low real income, small purchasing power, inadequate inducement to save and invest and inadequate capital again. This justifies the ascertion that capital is a serious bottleneck in economic development underdeveloped countries, especially in those which possess a meagre amount of it in relation to their population and natural resources.

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To break this vicious circle and uplift a country with self-sustaining growth through better utilisation of human and natural resources available in the underdeveloped economies, a large amount of investment i.e. Big-Push is necessary. So, inorder to achieve sustained secular growth, in general case, it is necessary that the initial stimulant or stimulants to development be of a critical minimum size. Such an effort is necessary in order to (i) Overcome internal diseconomies of scale due to individualities in the factors of production, (ii) to overcome external diseconomies due to externalinterdependence and to achieve what has been some-times called 'balanced growth', (iii) to overcome income depressing obstacles that may be generated by the stimulants to growth.

To achieve economic growth government follows budgetory& policy. If there is full employment it follows balanced surplus budget to maintain stability in prices and employment, which was argued by classical economists because they assumed fullemployment. But no economy is there with full employment. Therefore if unemployment is there it is argued to follow deficit budget by Keynes. Because, it is now for the state tocome forward to stimulate and accelerate capital formation for economic development. It is observed that no country has made economic progress without positive stimulus from government. The state now plays a very important role in economic development. The present state is not a 'police state' of the 19th century which performed police functions like maintaining law and order, protecting nation against foreign agression and collecting revenue, but it is a Welfare State. It's role has become significant in our country since the introduction of Five Year Plans and declaration of a socialist pattern of society as the goal of our economic policy. Therefore, in recent years government expenditure has been increasing faster than their ability to raise resources. When expenditure exceeds revenue a deficit arises in the budget of the government. There are many other reasons for deficit such as (i) Failure of raising resources, (ii) Tax Exemptions, (iii) Increase in interest payment proportional to rise in GDP, (iv) Rise in subsidies. This deficit can be bridged by raising the revenue from taxation, by borrowing from public or depreciating the value of money in the hands of the people. Both in developed and developing countries there are certain limits beyond which taxation rates cannot be raised without adverse effects in the level of investment and production and consequently on the rate of economic growth. Borrowing may be used as a source of raising finance for stimulating economic growth but in developing countries people are poor so they are having low saving capacity. Therefore, there is no possibility of raising sufficient finance from this source. It may borrow from foreign countries but the borrowing from foreign countries may threatens developing economy in paying interest on debts and political interference by foreigners. Therefore deficit financing i.e. creation (printing) new money for economic development is inevitable.

SOURCES OF FINANCING ECONOMIC DEVELOPMENT

The sources of financing economic development with deficit budgets are of two types such as internal sources and external sources. Internal sources include taxation, public borrowing out of savings, market loans and deficit financing. External sources includes loans from foreign countries and grants from International institutions like World Bank.

TAXATION

As stated above modern governments collect funds for economic development from different sources. Of all the methods of raising resources taxation is the most important one in the mixed economies.

The other sources of finances for economic development are recently developed. The taxation is an old source of revenue of the government. Tax means it is a compulsory payments made by the people to the government without expectation of direct return or benefit.

Taxation is used in developing countries in order to reach the following objectives.

1) Expanding the public sector;
2) Controlling of inflationary tendency;
3) Providing incentives tothe private sector;
4) Reducing inequalities of incomes and wealth;
5) Improving allocation of resources.

Taxation has been used as an important source of financing economic development in every country. But it is well known that taxation has a narrow coverage in underdeveloped countries. This is due to low ability to pay which is caused by low money incomes. It has been found that generally in underdeveloped countries taxes make-up hardly 8 to 10 percent of total national income while in developed countries the tax-revenue/national income ratio stands at nearly 30 percent. The Planning Commission of India had reportedat the time of First Five Year Plan that, "only 7 percent of national income is realised by way of taxation in India, while in the U.K. and the USA the coverage of tax out of national income is 35 percent and 23 percent respectively." The limitations in exploiting this source to the full extent in developing countries are (i) Tax revenue cannot be raised much because of low percapita incomes; (ii) due to large non-monetised sector it is difficult to collect tax; (iii) the extent of resources that can be raised through taxation will depend on the country's taxable capacity and kinds of taxes it can levy (iv) the amount of tax revenue depends on not only a country's capacity to pay taxes but also on its willingness to pay taxes; (v) inadequate income records of the people result in tax evation and low tax collection; (vi) increasing exemptions in order to uplift poor also lead to narrow coverage of taxation.

The tax coverage in developing countries is not only low but it also has evil consequences instead of achieving its objectives. Heavy taxation may be necessary for the large development programmes, but this discourages investment and production in the private sector. For example, high income taxes may destroy the incentives which are the main spring of economic growth. Taxes which fall on the wage earner may diminish incentive to work harder and better. Taxes on profits of enterprises or on higher income groups reduce incentive to save and make new investments. Decrease in savings and investments result in decreases in employment and output.

There is every possibility that economic resources may be diverted from existing uses to other uses to avoidthe burden of taxation. If heavy income tax and profit tax are imposed, rich peopleindulge in conspicuous consumption instead of saving. They may also divert resources from one locality to other i.e. from one country to other i.e. outflow of scarce and precious resources. Thus, it reduces employment opportunities. In this connection Dalton argued that "taxation on rich increases unemployment".

Taxes in many country are imposed with a view to reducing the gap between the haves and the havenots. But whether it is a direct or an indirect tax, it gives scope for inequalities. No doubt direct taxes are progressive and much of the burden falls on rich but these can be evaded by following different ways. Indirect taxes fall more on the poor particularly if they are imposed on necessaries.

Some economists maintain that taxation may aggrevate rather than alleviate inflationary pressure. The arguments infavour of this are (i) the tendency for increase in taxes is likely to fall on saving rather than spending. This leads to low saving, low investment and low output and shortage of goods on the one hand and diversion of resources to purchase more things rather than save on the other. (ii) Commodity taxes are likely to be passed on in higher prices.

Imposition of taxes aggrevates not only inflationary pressure but also unemployment, which are the main problems in developing countries to be solved. Thus, taxation could have adverse effects on economic growth.

From this point of view we can argue that tax cut policy is best for rapid economic development in developing countries. A cut in taxation rates increases savings, investment, output and employment and thus, it leads to economic development. Keynesians formulate policies for thinning unemployment largely by means of fiscal policy such as lower taxes and increasing government expenditure. In 1964 Kennedy has suggested tax cut policy. Russia was returned at high level of employment adopting this policy.

PUBLIC BORROWING:

The other important method of financing economic development is public borrowing. In a developing country all that people save is not invested. Even rich people who are said to have high propensity to save, involve in conspicuous consumption due to demonstration effect and are not ready to invest. Therefore, scarce national resources are utilised unproductively. Because of this these (among other) the underdeveloped countries face the problems of unemployment and rising prices.

In order to solve these problems through increasing investment and production government may try to raise taxes to finance. But it has severe limitations as we have discussed above and beyond taxable capacity it is impossible to raise tax rates. So the public authority (Government) gets finance for economic development through borrowing in two ways internally and externally.

The objective of public borrowing is to finance economic development with a view to rapid expansion in the state's functions and to curb inflation by reducing conspicuous consumption. Thus, the purpose of borrowing may not always be for obtaining revenue only, it may be for influencing aggregate demand i.e. to influence investment and consumption expenditure for maintaining stability in the economy. To finance for war, for expansion of education and health resources, etc.

Public borrowing is a better method of finance than taxation - taxation being a compulsory payment for which no compensation can be claimed. If the government relies on taxation most of the development finance, public will not co-operate with the government in programmes of economic development. Public borrowing is voluntary lending by the people or the institutions. There is confidence in lenders about getting their money back with interest. Therefore, they will not distress tax payers. Thus, it is a better source to cover deficits. It helps to raise levels of income and profits. It helps to raise private investment without credit expansion. Indirectly it raises for receipts of the governments.

Public borrowing may be better than taxation in some ways but it cannot substitute taxation completely because it has certain limitations. Such as (i) Public borrowing depends on the creditworthiness of the government. Usually, there is political instability in underdeveloped countries because of this peopleare not much interested in lending to the government. (ii) People do not want to lend to the government because the rate of interest offered by the government are lower than those offered by the borrowers in the private sector. (iii) If prices are raising peoplewill not be interested in saving and lending because the value of money will be falling.

Public borrowing is divided under two heads --internal borrowing and external borrowing. Internally, government borrows from the public in these ways. Borrowing small savings under various saving schemes likeNational Savings Certificates, Funds and Deposits, Special Bearer Bonds, Market Loans etc.

SMALL SAVINGS:

The receipts under this head come in the form of voluntary saving fromn those who have little capacity to save, which consists of large proportion of population in underdeveloped countries. Savings from this class generally amounts to a net decrease in the country's consumption. That is - purchasing of government bonds, saving certificates, on which high interest is paid, reduces money in the hands of people and their consumption.

Market loans come from those who already have a reasonable saving capacity e.g. rich people and banking and non-banking institutions who purchase government securities in the capital market.

A developing economy, in the initial stage of development is characterised as having a lowsaving income ratio because of low national and percapita incomes and high propensity to consume. These economies suffer from the vicious circle of low savings as narrated by Prof. Nurkes, viz. low saving is cuase of low saving, low saving lead to low investment, low investment to low income and low income to low saving. Prof.R.J. Challaih has stated that, " the potential savings in a developing economy are more than the actual savings. It is true that rich have high propensity to save but by demonstration effect they indulge in conspicuous consumption."

The Government can also increasing savings through earning greater profits of the public enterprises, but it is not an easy task. Large number of public enterprises in the developing world are under loss.

EXTERNAL SOURCES OF FINANCE:

In a developing economy domestic sources of financing economic development like taxes, borrowing from public are sure to fall short of the huge financial requirements for rapid economic development. The main reason for underdevelopment in these countries is shortage of capital. Ifa developing economy depends on internal sources either it has to restrict developmental programmes in order to avoid adverse effects of those on the economy or it has to speed up development by raising financial resources from internal sources with adverse effects as discussed above. So, to speed up economic development without any adverse effects, external sources of finance have become almost essential.

Taking foreign assistance is not a matter of shame for any country for those that are giving assistance today had themselves received the same earlier. As Prof. Lewis had said, "Nearly every developed country has had the foreign assistance to supplement its own meagre savings during the early stages of development. England borrowed from Holland in the 17th and 18th centuries and also America in 19th century which become major leaders now.

TYPES OF EXTERNAL SOURCES OF FINANCE

Broadly, there are two types of capital inflows in a developing country such as (i) official loans and grants and (ii) private foreign investment.

Official loans and grants are from foreign governments and from international financial agencies like IMF etc. External grants to developing countries has become popular since the advent of international agencies like World Bank, International Development Association etc. In getting assistance from these agencies includes political factor. They can be received as money grants or gifts in kind (ships, shipping vessels, industrial equipments etc.) It does not carry the burden of repayment or payment of interests. It is the best form of foreign assistance. But it is difficult to get sufficient finance because politically strong or rich countries take more.

EXTERNAL BORROWING

Borrowing from abroad implies the transfer of savings generated in the advanced countries to the needs of underdeveloped countries. It always carries the burden of debt servicing i.e. interest payment. It is often said that the nation may be made bankrupt because of increasing debt. In the first place, internaldebt results in burden on persons who are taxed in order to find funds for making interest payments. This leads to greater burden on poor groups of people. In the second place the interest payment through taxes curtails production. It also leads to capital outflow.

Dalton stated that, "Externally held debt does involve some impoverishment, interest must be paid tooutsiders. Hence it should not be borrowed." Its burden can be shifted to the future generations, to repay principal debts imposition of taxes on future generations is a must.

Besides all these drawbacks of external borrowing the developed countries force the borrowing countries to follow their rules and regulations in the economic policy of developing countries at the time of giving loans.

Private foreign investment seems to be essential for economic development of underdeveloped countries because it brings technology. But investment of such type threatens a nation; through the creation of monopoly situation. In this connection India's experience with the Britishers, who came to India as merchants and started to invest in profit industries like jute industry, plantation industry, banking and ruled India for nearly 200 years. Therefore, it is important that a developing country must weigh the pros and cons before going in for external borrowings on a very large footing.

OBJECTIVES AND METHODOLOGY

The main objective of the present study is to analyse the Central Government Budget. The analysis of the budgetory positions of the Central Government is made with a view to reflect on increasing deficits, which shows insufficiency of the resources raised by the Government from various types of taxes. The study is also aimed to show defícts financed by borrowing both internally and externally and costs of the borrowing on the part of the government. The main aim of the study is to depict the role of the "Deficit Financing" in the economic development process. The analysis is made toevaluate the possible effects of the deficit financing on the various broad economic parameters.

METHODOLOGY

The analysis is mainly based on the library research and published secondary data have been used extensively.