

Chapter 3

ROLE OF FISCAL POLICIES IN DEVELOPING ECONOMIES

3.1. Connotation of 'Economic Development' and Characteristics of a Developing Economy

Most underdeveloped countries have low per capita incomes, widespread poverty, inadequate resources and underdeveloped infrastructure – economic and social –, as also over - population. Where certain amount of development has taken place, there exists a dual economy : a vast rural sector comprising largely agriculture with primitive equipment and low incomes; and an urban sector also steeped in poverty but with some pockets of comparative affluence and industrialized areas. Before we take up in detail the characteristics of a developing economy, we shall consider what is implied by 'economic development'.

'Economic development' is the process of sustained increase over a period of time of real per capita incomes arising out of the application of skills and technology and various factors of production for exploitation and utilization of natural resources; and induction of capital equipment, plant and machinery for augmenting agricultural and industrial production. Growth is imperative in the process but it needs to have quantitative dimensions. Development implies the 'upward movement of the entire social system' as also modernization and all that it involves: the building up and upgradation of the institutional framework – economic, political and legal; stable and efficient government, a competent bureaucracy, stable law and order, educational institutions like schools and colleges and medical and health facilities and hospitals, and above all an operationally efficient infrastructure such as power, transport, communication facilities and adequate supply of irrigation, inputs for agricultural growth

such as fertilizers, quality seeds, pesticides, tractors, pumps et al. Besides, the outlook, values and attitudes have to change. Receptivity and ability to use new techniques and modern plants and equipment are necessary to absorb, utilize and take advantage of foreign aid and capital that may flow both from aid-giving international agencies and multi-national corporate bodies. Production processes have to be modernized, skills have to be imparted and productivity improved.

Besides, financial institutions have to be built up and savings channelized into productive investment. Funds have to be provided to development banks, which deploy them for financing industrial growth. The fruits of development would however be neutralized if population continues to grow; an important element of development plans is to provide for serious efforts at control of population.

3.2. Elements of Growth: Crucial Role of Physical Capital Formation

The traditional society is characterized by low per capita income, high consumption and a low level of savings and investment. Physical capital assets in real terms such as plant and machinery and equipment are inadequate; science and technology and their application to the processes of production, hardly exist. Above all, economic, social and legal institutional framework is not developed. Without education and work-experience skilled workers are not available. Besides, feudal elements may be so powerful that the gains of development are almost entirely usurped by them, with the consequence that there is hardly any motivation for the vast number of people to take initiative and stimulate growth and incomes.

Development of underdeveloped economies implies transformation of the entire economic and social structure of the society and modernization of the institutional framework. The people must have political and economic freedom. With education and development of technical skills, there is progressive

improvement in standards of living and material wealth. As incomes increase, the proportion of income absorbed by consumption declines, and savings emerge, making investment possible. As stated elsewhere in this treatise, in order to reach the stage of take off or self-sustaining growth, the economy must increase savings and investment from 3 to 5 per cent to 20 to 25 per cent of G D P.

Capital and technology are the principal missing components of growth in underdeveloped economies. But what may be as important as capital and know-how, is the need to overcome certain inherent deficiencies: political and economic instability; lack of competent organs of public administration and infrastructure; poor literacy and inadequate trained manpower; dearth of entrepreneurial and management skills and motivation. Effective government, education, and social justice emerge as critically important factors for development.

Fiscal policy influences the rate of growth of potential output. Capital formation is constituted of the twin processes of savings and investment. Fiscal policy affects the rate of savings and inducement to invest and most tax structures improvise incentives for stimulating savings and investment. Government's budget incorporating several changes in taxes and duties constitutes one of the most potent instruments of fiscal policy and has a predominant effect upon growth of various sectors of the economy, and potential output.

We have seen that accelerating the momentum of growth postulates a high level of savings and investment in productive assets. Taxation is a principal instrument for curbing consumption and mobilizing revenues for financing state expenditure and building up of infrastructure which is vital for industrial and agricultural growth. But high taxes may prove counterproductive if they impinge upon private savings and incentives for investment.

While in totalitarian countries, forced savings may be effected through payment to factors of production below their marginal net product, thereby

diverting resources from private consumption to public investment, this is far more difficult in market economies where physical capital accumulation has to be largely financed by private savings, as also effected through public investment. In such a context, incentives have to be inbuilt in the tax system for stimulating savings and promoting investment. Corporate taxation determines the quantum of profits that corporations can retain for ploughing back for further expansion. The overall structure of taxation has to be designed to secure efficiency in resource utilization.

Public savings which normally imply excess of revenues over government consumption expenditure may be utilized for public sector investment or channelized through development banks for investment in the private sector. Expenditure policies are also of vital importance as excessive non-productive public expenditure may lead to diminution of public savings. Budgetary policy has an important role to play in maintaining a healthy investment climate, conducive to inflow of foreign investment capital which is accompanied by advanced technology and knowhow. The country's institutional framework and economic and social infrastructure has to be adequately built up in order to develop absorptive capacity in respect of both foreign capital and technology. The tax policy should also stimulate exports so as to enable foreign exchange earnings adequate to meet the needs of a developing economy for the import of vital capital goods, raw materials, oil, fertilizers and other requirements.

Taxation policy should include investment allowances and grants, which could also be on a selective basis. These are useful for stimulating investment in selected core sector and capital intensive industries. In an era of inflationary rise in prices of machinery and capital equipment the world over and depreciation on historical cost basis, these allowances have an important role in financing replacement of worn-out and obsolescent machinery.

3.3. Role of Fiscal Policy in the Improvement of Human Capital

Accumulation of both physical and human capital played important roles in the growth of East Asian economies. Primary education was by far the largest single contributor to the High Performing Asian Economies (H P A Es) growth rates. India has tremendous resources of human capital and the liberalization measures initiated by the Indian Government since June 1991, should not only aim at opening up of the economy in a market friendly atmosphere but should also concentrate upon the proper and efficient development and utilization of human capital. Productivity can be stimulated through improved education, medical facilities and social welfare leading to improvement in standards of living.

Fiscal policy has an important role to play in regard to accumulation of human capital and promotion of education and skills. Human resource development is a vital element in social welfare activities of the state; and transfer payments for purposes of development of education and skills, health and family welfare – as also housing – constitute an important part of government's social expenditure.

The modern concept of human development index (H D I) has attracted considerable attention and may be considered. The human development index is composed of three basic components: knowledge, longevity and standard of living. Knowledge is measured by adult literacy (2/3rd weight) and mean years of schooling (1/3rd weight), while longevity refers to life expectancy. Standard of living is assessed in terms of purchasing power, based on per capita G D P in real terms, adjusted for the local cost of living that is purchasing power parity.

The H D I constitutes an alternative to G N P for measurement of the 'relative socio-economic progress of nations'. It enables evaluation of progress over a period of time and determination by government of priorities for policy intervention and budget formulation. H D I also facilitates useful comparisons

of the progress and experiences of various countries of the developing and developed world.

Fiscal policy has an important role in achieving progress and improvement in regard to the parameters relating to human development index. The total quantum of allocation of budgetary funds for providing education, health facilities and the various factors that contribute to improvement in standards of living of the masses is a prime determinant for improving H D I. But perhaps of equal importance is the identification of areas and projects in these sectors on which the outlays are spent. The authorities would have to determine, *inter alia*, how much should be spent on (a) employment generation and financing self-employment schemes, (b) subsidies for food, fertilizers, clothing and other necessities of life (c) education, (d) hospitals, (e) old age pensions, sickness benefits, and other social security measures, (f) housing and (g) rural development.

It may be mentioned here that while during the first two years (1991-92 and 1992-93) of Dr. Manmohan Singh's economic reforms in India, expenditure on social infrastructure was constricted and marginally lower, there was substantial stepping up of outlays during the subsequent three years 1993-94 to 1995-96 B.E. on social infrastructure, poverty alleviation, employment generation, rural development and some degree of social security. This shift in the nature of budgetary allocations indicated a decisive policy decision to give a human face to reforms and to ensure that the benefits of the vast economic gains of reforms actually reached the under-privileged and resulted in greater employment and poverty alleviation. The above illustrates the vital importance of the budget as a powerful instrument of fiscal policy for improving human capital and human development index.

Take the case of Malaysia. Poverty was concentrated in the rural areas, and the government established rural development authorities and allocated funds for rural development – including irrigation projects, social services and rural

infrastructure. The government invested large amounts in education. Impressive results were achieved and the incidence of poverty fell considerably from 37 per cent in 1960 in case of all households to 5 per cent in 1990.

Certain guiding principles for formulation of fiscal policy in regard to human resource development may be indicated :

- (1) Since trickle down effect of increase in G N P to the poor is a slow process, fiscal policy must pursue an effective strategy to make direct budgetary allocation of funds for employment generation, poverty alleviation, building up of social infrastructure and a degree of social security depending upon the availability of funds, as also develop adequate delivery system so that wastage and leakages are minimized and money and benefits substantially reach the target groups.
- (2) There should be rational and judicious allocation of funds between defence, economic development and human resource development and cognizance in this context should be taken of the fact that improvement in human capital and skills promotes development and absorption of technology, as proved by the East Asian miracle.
- (3) Various educational, technical and vocational institutions and hospitals are established and maintained by individuals, as also corporations. Donations are also provided to such bodies. Such expenditure and grants should be allowed deductions – partly, wholly or on weighted basis – from out of income for tax purposes. Many companies provide subsidized education, medical treatment as also housing, and training in special skills and the cost of such benefits to employees should also be deductible from incomes.
- (4) Where corporations undertake development of villages and rural areas adjoining factories, tax deductions should be allowed for both capital and revenue expenditure incurred for the purpose.

- (5) Infrastructure such as roads, transport, communication facilities *et al* developed by industry should be encouraged through investment allowances for tax purposes.
- (6) Libraries, stadiums, gymnasiums, theatres, auditoriums and clubs may be built and provided to encourage sports, cultural and literary activities. They all contribute to the development of human personality. Modern fiscal policy must take cognizance of these constructive activities for human resource development and allocate funds, as also allow donation therefor as deduction from out of incomes for tax purposes.
- (7) Within the overall budgetary allocation for education, it is a public policy decision whether funds are to be allocated more for primary and secondary education or for higher education; and even in respect of the latter, choice exists with regard to the flow of resources to engineering and technology or liberal arts and humanities. Quantum of grants to research institutions and universities is also dependent upon budgetary allocation for such end use of funds. Fiscal policy has an important role to play in determining not only the overall volume of funds, but also in channelizing these funds in the manner best calculated to maximize human capital accumulation.

East Asian economies largely directed funds to primary and secondary education; they stimulated the thirst for higher education, and left it for the private sector to quench it and provide facilities for higher education on meritocratic basis. Even vocational training to a sizeable extent was provided by firms which sought to develop firm - specific technologies and skills. This is to be contrasted with many developing countries where public subsidies have been provided for university education.

It may be emphasized that the frontiers of modern fiscal policy have been considerably extended and its field of coverage enlarged; government must need take cognizance of these factors while formulating budgetary and other policies.

3.4 Role of Fiscal Policy in the Adaptation of Modern Technology

Increase in productivity is often a function of foreign technology and skills; and since developing countries have a wide choice of absorbing and adapting existing technologies available the world over, they can acquire it more cheaply and also achieve productivity based catching up with the industrial economies, who are close to the technological frontier and have to invest a larger quantum of funds to obtain newer technologies.

While growth theories have given importance to technology and skills as a factor input for triggering and accelerating the momentum of development, existing literature on fiscal policy has more or less ignored technology. However in this case practical policy has transcended theory. Governments in various countries have provided incentives for research and development. The Government of India has focussed attention upon the imperative need for modernization and upgradation of technology. Several industrial units in cement, steel, sugar, paper, textiles, and other industries were established more than 25 years ago and modernization has become urgently necessary; besides, even with regard to newer industries like electronics, computers, and telecommunications, technology is fast changing and the ability to remain internationally competitive postulates technological upgradation on a continual basis. Fiscal policy, in consonance with this objective, has emphasized the need to import appropriate technology and accelerate the development of indigenous knowhow. Various measures, including rationalization of excise and customs duties for electronics, computers and similar industries, and spreadover of knowhow fees over six years for tax purposes, have been taken by government to implement this policy. Besides, not only expenditure on research in industrial technology but plant and machinery and other capital equipment utilized in assessee's business, solar and renewed energy devices, scientific research, energy saving devices, as also for mineral oil prospecting, are entirely allowable as deduction from income for tax purposes in the form of 100 per cent write off in the year of acquisition. While donations

paid to approved scientific research association, university, college or institution are fully allowable, contribution to national laboratories for scientific research is eligible for weighted deduction of 125 per cent of the contribution.

An important aspect of budgetary formulation is the decision with regard to allocation of available funds between various areas of research: military research, nuclear and space development; scientific research; industrial, medical and other research. Advanced countries like Japan and the USA are developing science cities and when some new innovative ideas are conceived, the research complex provides incubators in the form of small laboratories to assist corporations to utilize the new ideas for commercial products.

Japan has an advantage over the USA in that less than 10 per cent of the government's research budget is spent on military technology, while in the USA, the corresponding figure is 70 per cent. Corporate R & D budgets in the USA are being starved of funds, as the objective of corporate planning is to obtain high short-term financial gains. According to *Newsweek*,¹ in mid-1988 the United States was lagging behind Japan in commercializing high temperature superconductivity, which was potentially one of the most vital technologies of the eighties. The Japanese are stealing a march over the United states in area after area, and this is a challenge that the latter must face.

It follows that if budgetary allocations in accordance with government policy give primacy and direct large funds to military research and funds for industrial or other research are inadequately provided for, it could have an impact upon development of industrial technology and competitive capacity of industry. A balanced approach in regard to allocations for different aspects of technology, is called for. East Asian countries fine-tuned their policies and placed greater emphasis on import of technology and inflow of foreign capital which was required for developing export industries, thereby providing added impetus to exports.

Certain guiding principles for formulation of fiscal policy in regard to technology for stimulating and accelerating growth may be indicated:

- There should be rational allocation of budgetary funds between military research and industrial and scientific research.
- Adequate incentives for import of state of art technology and for upgradation, modernization and adaptation of machines and technology should be improvised.
- Deductions from taxable income should be permitted for tax purposes in respect of expenditure, including capital outlay on machines, for industrial and scientific research, including adaptation of technology.
- Fiscal policy should encourage import of technology and inflow of foreign capital required for developing export industries so as to stimulate exports.
- Donations to research institutions, laboratories and universities should be wholly deductible for tax purposes.

The overall objective should be maintenance of technological excellence and competitive capacity. Fiscal policy has an important role in achieving this objective.

3.5. Role of Infrastructure and Fiscal Policy

Without power, telecommunications and transport, industrial development would be unsustainable. Similarly for agriculture also power and irrigation are absolutely necessary if production of agricultural products is to be optimized. As the World Bank² says 'Infrastructure represents, if not the engine, then the 'wheels' of economic activity. Input output tables show that in the economies of Japan and the United States, for example, telecommunications, electricity, and water are used in the production process of nearly every sector, and transport is an input for every commodity'.

While discussing the role of the state, we have observed that development of infrastructure traditionally has been regarded as one of the principal functions of the governments. The allocation of resources for development of infrastructure is usually effected through the annual budget. Obviously the quantum of allocation for infrastructure would directly vary with the size of the overall budgetary resources. Thus infrastructure and growth are linked both ways: growth depends upon infrastructure and infrastructure depends upon resources generated by growth.

Budgetary policy has an important role to play in the development of infrastructure:

- (1) The quantum of funds to be allocated every year for development and maintenance of infrastructure are decided by the finance ministry on the basis of requisition for funds from the concerned ministries. However, as stated above, the total allocation would depend upon the availability of funds in the budget.
- (2) The bulk of infrastructure in many countries is provided by the state. In many cases, there is an element of subsidy, often implicit, in the prices that are charged to consumers. This imposes a burden on the budget and deprives other sectors of the economy of resources. Actually, the government should endeavour to increase user charges to reduce the gap between cost and charges, so as to reduce budgetary deficit³.
- (3) Budgetary policy has also to determine expenditure allocation among and within infrastructure sectors: between irrigation, power, transport and communications; on new construction or maintenance of existing works; between rural and urban sectors; and between different districts and regions.
- (4) With limited resources, the government should decide as to what extent private investment – domestic and foreign – is to be associated with the development of infrastructure.

- (5) The government determines prices in respect of certain commodities such as coal, steel, petroleum and gas. Often there is an increase in administered prices of these commodities prior to the annual central budget.

It is significant that East Asian economies as a matter of policy allocated funds for investment on infrastructure in areas that encouraged exports.

Concluding, it may be observed that allocative efficiency of resources is increased provided infrastructure services are efficiently delivered. Three principal instruments for improving operational efficiency of the infrastructure sector may be indicated: commercial management, competition, and stakeholders and beneficiaries' active involvement. Part privatization of existing infrastructural works could also (a) increase efficiency output and profits and (b) contribute to reduction in budgetary deficit.

3.6. Importance of Controlling Inflation

Inflation is the most insidious form of taxation; it erodes in real terms the incomes and wealth of the people by reducing the purchasing power of money in terms of goods and services, and leaves them poorer, even though overtly no tax may have been imposed. Besides, the impact of inflation is uneven upon different sections of the society. It has a pernicious redistributive effect in society; it results in a redistribution of income and wealth in favour of the richer and affluent classes, and it adversely affects the fixed income groups, wage-earners and salaried employees, who find the real value of their incomes shrinking with rising inflation. During inflationary periods, the profits of businessmen increase; windfall profits may accrue to merchants and speculators. There exists a time-lag between the increase in price-level and rise in costs of production. But the selling prices of commodities rise immediately and industries earn higher profits. Inventories held by them also increase in value, leading to consequential gains.

Wages and salaries however do not rise in the same proportion as the prices of wage-goods; the cost of living rises and since incomes do not command the same value of goods and services as before, standards of living decline. Poverty increases, leading to widespread dissatisfaction in society. The impact of inflation upon debtors and creditors is diametrically opposite; the former gain as the money they have to repay has lost real value in terms of purchasing power. Creditors correspondingly lose as they obtain a devalued currency in real terms, although the same nominal amount may be repaid.

Farmers generally gain during inflationary periods, because while the value of their produce increases, the costs of inputs do not rise proportionately. Investors in equity gain, because of enhanced dividends consequent upon increased corporate earnings, while debenture and bondholders with fixed coupon rate of interest lose. The redistributive effects of inflation on the whole are unfair and inequitable as the poorer and middle classes with fixed incomes lose, while the business classes, who are endowed with riches, stand to gain further.

Till the 1970s, it was accepted that there was a tradeoff between inflation and unemployment. With inflation, increase in G N P, industrial output and employment took place. During the seventies, a new macro-economic phenomenon – stagflation – manifested itself. Due to supply shock and rise in oil prices in 1973, inflation increased sharply, while output and employment declined. Prices increased in response to increase in cost of crude material and fuel supplies, leading to cost-push inflation. Increase in administered prices also contributed to the price rise. Wages and prices tended to chase each other. Demand for goods declined owing to high prices, leading to decline in output and employment. Inflation manifested itself together with recession.

Samuelson⁴ observes 'today macro-economists believe that there is no necessary relationship between prices and output... We conclude with the surprising result that inflation may be associated with either a higher or a lower level of

output and employment'. But the macro economic impact of inflation upon economic efficiency is that the higher the inflation rate, the greater are the distortions of relative prices, that is, prices get out of alignment with costs and demand. It changes the level and efficiency of production. East Asian economies achieved high growth through getting fundamentals right including stable macro-economy and limiting price distortions, of which more later. (Vide Section 4.2).

Inflation is not tolerated by societies for long and anti-inflationary measures to check inflation are imperative. The monetary and fiscal measures improvised to check inflation inevitably have an adverse impact in macro-economic terms upon both growth of real output and employment. Steps to control inflation lead to stagnation, retrenchment, rising unemployment and misery. Thus the costs of controlling inflation in the form of lower G N P and increased unemployment are severe. This was observed in 1979-80 in Europe and North America, when steps to contain inflation consequent upon 1979 oil-price escalation, triggered the prolonged period of stagnation which lasted until the end of 1980s.

In India, the economy was passing through a crisis in June 1991 when the rate of inflation touched 17 per cent. With severe monetary constraints and other measures, inflation was brought down to about 7 per cent in 1992-93, but this induced recession in the economy and the rate of rise in G N P declined to 1 per cent in 1991-92 from the average of 5 per cent during the decade of eighties and growth rate in industrial production was almost nil as compared to the trend rate of about 8 per cent in the earlier decade. With good economic management, stagflation has been controlled to an extent; growth in 1994-95 is around 6 per cent, and inflation about 8 per cent (July 1995) (Vide Section 6.4)

Milton Friedman,⁵ on the basis of extensive empirical studies, argues that equilibrium between the quantity of money and aggregate output is necessary if inflation is to be controlled. He is categorical that 'Inflation is a monetary phenomenon arising from a more rapid increase in the quantity of money than

in output; there is only one cure for inflation: a slower rate of increase in the quantity of money', which modern governments can regulate. It takes a number of years for inflation to develop; naturally, the cure for inflation also takes time, and unpleasant side effects of the remedies for inflation cannot be avoided.

It is stated that on an average over the past century in the U S A, UK, and other Western countries, increased monetary growth took six to nine months in working its way and producing increased economic growth and employment. It takes between twelve to eighteen months in manifesting itself in the form of price increase and inflation.

Taking the case of Japan as a case study, Friedman says that the quantity of money in Japan continuously increased in 1971 and by mid - 1973 it was increasing at over 25 per cent a year. It took about a year for the higher money supply to have an impact on prices, and inflation rose to about 26 per cent in 1974-75. Japan changed its policy framework and monetary growth was reduced from about 25 per cent a year to between 10 to 15 per cent per annum over a period of five years. Inflation started declining within 18 months after monetary growth had been checked, and a period of about 30 months elapsed before inflation declined to a single digit figure. Inflation was constant for about two years and then it started declining towards zero in response to further reduction in growth of money supply. Figure 4.3, presented by the Japanese Economic Planning Agency, is illustrative of Friedman's thesis.

Owing to the high rate of growth of G D P in Japan, increase in monetary growth of between 10 to 15 per cent would be conducive to stable prices. The corresponding rate of growth in money supply for the U S A would be 3 to 5 per cent. Friedman's thesis that prices rise if the increase in money supply is not matched by output, is a basic proposition, the validity of which is scarcely in doubt. But his assertion that the behavior of money is the senior partner; of output, the junior partner, may be questionable. In India, since the population

is vast, adequate supply of goods and commodities of mass consumption, both of agricultural and industrial origin, is necessary to balance monetary expansion and hold inflation in check. Actually, a study of increase in money supply, agricultural and industrial production and prices over the past few years shows that the period of high price rise above 20 per cent per annum in 1973-75 and 1979-80 more or less coincided with shortfall in agricultural and industrial production. The debate between monetarists and structuralists is inconclusive. Inflation is caused by a combination of both demand and supply factors; all inflations other than hyperinflations, usually are. It hardly needs to be emphasized that coordinated fiscal and monetary policies are essential for maintenance of price stability.

Many developing countries have sizeable budgetary deficits and continuous increase in money supply, largely to finance government's overspending. Drastic measures become imperative so that inflation does not get out of control. For India the following suggestions both in regard to fiscal and monetary policy are made to control inflation :

1. A two-pronged approach is necessary to contain inflationary pressures: the aggregate money supply and consequent upsurge in demand should be reduced, and aggregate real output increased.
2. There has been an increase in money supply between 16 to 20 per cent while real output (G D P) increased by around 4 to 5 per cent in recent years (even less during certain years). The basic point that needs to be emphasized is that the Reserve Bank should limit expansion of currency on government account to the extent that the money stock is either equal to the growth of real output, or marginally higher. If under special circumstances there is expansion of currency, there should be mechanism for automatic extinction of such money by suitable surplus budgeting or open-market operations. Fiscal policy has a crucial role to play by cushioning the monetary impact of government's operations.

Greater reliance on surpluses, generated by the budget and public sector undertakings, and correspondingly diminished recourse to borrowings to finance plans is imperative to check inflation.

3. Both household and public savings should be increased substantially. It is necessary, however, to emphasize in this context that expenditure financed by deficits creates high powered money, which has a multiplier effect in the economy with consequent inflationary rise in prices. The concept of safe limit to deficit financing should be borne in mind. According to the World Bank, 'excessive fiscal deficit and the resulting financing requirements of the public sector have often been at the root of macro-economic imbalances'. Where large deficit financing becomes necessary, the extra money created should be liquidated or mopped up within a certain period of time.
4. High excise duties and wage payments contribute to cost-push inflation, particularly on account of the cascading effect of excise duty, customs duty, and sales taxes on raw materials and intermediate goods. Although MODVAT helps in reducing this effect, it is desirable to keep these duties within reasonable limits. Wage increase must be linked with productivity. Additional resource mobilization should concentrate on obtaining greater revenues and savings from the rural areas, where considerable scope exists. Increasing the ratio of taxation to G D P and taxing rural incomes will be discussed later.
5. The parallel economy, that has developed on account of generation and circulation of black money, should be controlled. An enlightened taxation policy and reasonable tax rates, besides rationalization and simplification of the income tax law and efficient administration, as also improvement in the sales tax structure in various states, would encourage voluntary compliance and reduce creation of black money. Use of such money for hoarding or creating artificial scarcities should be firmly dealt with.

6. The quality of public spending must improve, and the Government's non-plan and unproductive expenditure be drastically curtailed. Wastage and leakage of funds has to be checked, and productivity of capital stimulated. Monitoring project and plan expenditure is necessary to ensure that they yield adequate returns and production is maximized. This would reduce the inflationary potential in the economy.
7. Increase in production of foodgrains and other agricultural commodities and industrial goods and services is necessary to augment supplies and check prices. Higher production balances the effect of increased money supply.
8. The public distribution system should be widened to cover more areas and commodities of mass consumption like pulses, edible oil and cloth, and its systemic efficiency should be increased. It is an important instrument for keeping inflation under control. Where endemic shortage exists, as in the case of pulses and edible oils, there is no alternative but to maintain adequate imports till production rises to meet the demand – which keeps on rising with growth in population.
9. The manufactured products component in the aggregate supply should be substantially augmented to control prices. Infrastructural and other bottlenecks which lead to under-utilization of installed capacities operate as constraints to realization of optimum production, and the consequent loss in supply of goods adds to the inflationary potential. Improvement in power supply through increased plant-load factor and removal of other infrastructural constraints in this context would go a long way in increasing production and meeting the challenge of inflation.
10. Basically, the fiscal deficit has to be reduced by compressing expenditure and increasing revenues. The quality of fiscal adjustment also needs to be improved. Maintenance of fiscal discipline and effective economic management are imperative if inflation is to be controlled. Fiscal policy has a vital role to play in this exercise. (Vide Sec. 5.5).

Chapter 3 References

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