Development Through Deficits

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DEFICIT financing has shed some of its esoteric mystery and has been brought into broad daylight by the contradictory statemerits made by one Cabinet minister after another. First it was the Minister for Education who suggested that a little deficit financing would do no harm and would be undertaken by the Government, if necessary. The Finance Minister has broken his long silence to contradict the former. Deficit financing, Shri Chintaman Deshmukh is convinced, is definitely undesirable and we have had as much of it as was good for us. More would do us positive harm. This division of opinion in a cabinet which is based on the principle of collective responsibility may be of interest to a student of political affairs but does not concern us here. A clarification of the issues raised by deficit financing is, however, very necessary, if only to clear the air.

From statements and writings in the press there does appear to exist a good deal of confusion about the meaning and significance of deficit financing. In the popular mind it seems to be inextricably wound up with printing notes and consequent inflation. This is understandable after the flood of notes and the resultant inflation during the war years. But even those who can be considered knowledgeable in such matters often make such ambiguous statements that it is difficult to be sure whether they have in mind anything different from what the common man thinks. The difficulty is not one of terminology. Everybody knows that when a State spends more than what it receives in the form of tax revenues, levies and profits of government enterprises, a ' revenue' deficit is created. It is the way that these deficits and other expenditures on its capital account are covered that causes confusion. It could be covered by borrowing for a long term at the prevailing Kites of interest in the open market. If the government does not feel confident of raising the money or does not want to issue long-term bonds, it may cover the deficit by short-term borrowing from financial institutions at very low rates of interest. , Floating treasury bills would be a way of doing it. Or the government may allow its cash balances and other liquid resources to run down as the Government of India is doing now. Finally, the government may borrow at ' zero, i.e. print notes and incur no cost whatsoever. It can be seen that printing notes is only one way of financing a deficit and there is no reason why governments should undertake it straightaway. It is only when the Government cannot borrow the current savings of the public that it has to resort to these last two devices, which, in effect, mean a fall in Government assets with the Central Bank or an increase in its liability to the Central Bank. It is this which constitutes a ' budget deficit ' in the operative sense. Usually governments resort to it only when the other means of covering the shortfall cannot be utilised.

Although budget deficits had been forced upon many governments by the declining yields of taxes during the depression it was the Keyncsian analysis which gave them an air of respectability and converted what seemed to be an inevitable evil into a powerful instrument of economic policy. Income was determined at any time by the expenditures on consumption and investment and unemployment would follow whenever there was any deficiency in the aggregate demand represented by these expenditures. Consumption was supposed to have a stable relationship with income so that it was fluctuation of investment that was primarily responsible for unemployment. Once this was known the path of public policy seemed to be clear. It had somehow to increase aggregate incomes and consequently aggregate expenditure. It could stimulate private investment by tax remission, etc., or failing that, increase consumption expenditure by transferring income from those who save a substantial portion of their incomes to those who consume. The latter policy involved transfer of incomes from the rich to the poor *via* taxation and State expenditure on social amelioration. Heavy taxation may not be feasible in certain cases as it may hamper incentives. The government may like to undertake expenditure other than of the kind mentioned above when it goes in for budget deficits. The addition to national income on account of such Government expenditures will be a multiple of these a„ given by the multiplier, which is defined as the reciprocal of the propensity to save.

Suppose the government undertakes investment with the help of a budget deficit; where will it find the resources, both real and monetary? There would be no difficulty whatsoever according to Keynes. At the bottom of a depression there would be plenty of excess capacity and output would increase very easily to the level at which, given the consumption habits of the people, real saving equal to the volume of investment undertaken would be forthcoming. There would be no question of diverting output meant for some other use to public investment. Thus, there would be no [1]forced saving ' and no need for prices to rise in order to squeeze out of people the required volume of saving. At the same time the monetary counterpart of this volume of investment will be with income recipients and the government can borrow it. This, however, is not as easy as it sounds. For, the multiplier process by which saving equal to the initial investment is generated takes time, depending upon the various lags in consumption, production and payment of incomes. To tide investment through this period the system requires what Keynes called ' finance ' which will be released later when savings catch up with investment. The process can be visualised as follows: government floats bonds which are taken up by various financial institutions and holders of cash and as saving is generated, investors take these bonds off their hands and release their funds for fresh activity. This depends, of course, on the assumption that institutional arrangements are such that savings generated flow into money and capital markets, a reasonable assumption for developed economies of the West. The only important question is the. form borrowing by government should take. There is no fear of an inflationary price rise at all.

Gould this technique be used for financing the economic development of an undeveloped country? It would appear at first sight that,

since the technique was developed to cure cyclical unemployment in a developed country, it would be unsuitable for an undeveloped economy. The problem in the latter is not one of creating sufficient aggregate demand but of increasing the stock of capital equipment. If, however, we go to the Income analysis on which the technique is based, we can see how deficit financing could he used for promoting economic development. All that the technique really means is that, if all the saving out of full employment income is not being used for private investment, the government may step in and undertake investment with borrowed funds if necessary- Similarly, even in an undeveloped economy we could say that If out of the income which can be produced with existing equipment (full employment income, though its connotation is slightly different in an undeveloped economy), savings which arise with a given propensity to consume cannot be utilised by the private sector, the State may step in and undertake investment itself. There would be nothing wrong in this. And it will be seen that the operation is identical with public investment through deficit financing in a developed economy except that the aim and scope are different. The aim there is removal of depression unemployment while here it is economic development. Again, in a developed economy where both the volume and percentage of savings are high, there is greater scope for deficit budgeting than in a poor country.

Certain factors may, however, cause an upward trend in prices when budget deficits are incurred. It is doubtful if the money and capital markets of undeveloped economies will have all the facilities to finance I udget deficits. We have seen that initially at least ' finance ' has to be provided by cash holders and it is doubtful if all the ' finance ' required for a continuous deficit financing programme can be found. ' Finance ' is essentially a revolving land but if income recipients do not release it by purchasing securities, it tends to be locked up and further investment may not Lake place. This failure is not a remote possibility as investing habits are not well developed in underdeveloped economies. Besides, the other lags involved in the multiplier process are likely to be long in an underdeveloped economy. The result is that government may be forced to find its own ' finance ' which it can do by either giving 10Us to banks or by printing notes. The former will lead to an increase in currency in circulation when the government actually disburses deposits created in its favour. Thus, means of payment tend to increase in the system and an inflationary process based on them may begin. 'This danger of the emergence of a large volume of liquid assets consequent upon deficit financing is present even in a developed economy but it is likely to appear in an aggravated form in an undeveloped economy for the reasons mentioned above.

it may be argued that these increased means of payment would not do much harm as savings generated do not find their way to the money and capital markets but tend to be held in liquid form. It really may not matter if the increase is for a short while. But if it is to take place over a number of years, one cannot be too sure that the increase in currency will have no inflationary impact. There is always the danger that private investment may be stimulated, both by the higher level of activity and greater volume of funds, and total investment may exceed the voluntary saving of society. Hence, there does appear to be a genuine need for carefully watching private investment when an undeveloped country embarks on a development programme based upon budget deficits.

Could the technique be used for financing development beyond the level mentioned above? It is often argued that since most undeveloped economies have unused resources, deficit financing could be resorted to without much harm. However, idle resources in an undeveloped country are altogether different from those in a developed economy. In the latter, these are idle equipment and unemployed skilled labour, which have only to be brought together to expand output. In an underdeveloped economy, the only unemployed resource is manpower which is very often unemployable in an industrial set-up. All other resources have to be developed before they can start yielding an output. It is one thing to have a mine which is not being worked because of a temporary decline in demand for minerals and quite another to have just ore under the ground!

Supposing that a government incurs budget deficits for building a dam or a hydro-electric project under such circumstances, what would be the effect on the economy? The deficits will necessarily have to be financed by printing notes for reasons mentioned above. Since the real saving of the community does not permit this particular piece of investment, people have to be forced to save and this is done by pumping so much more purchasing power into the system that prices will rise which, in their turn, will prevent consumption by others and release the resources necessary for the investment. This additional expenditure will set off a money income multiplier though not a real income multiplier as the elasticity of output is zero at this stage. Those whose incomes have

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Risen as a result will spend, raising the incomes of others and so on. Especially will the demand for food increase due to the expenditure by those engaged in the investment activity. From then on, expansionary forces may gather speed due to stimulation of private investment, speculation, wage rises and so on. And on account of the price rise, the deficit necessary to complete the programme will go on mounting. The inflationary rise in prices will be checked only by the increase in output following the completion of investment and tin's will naturally depend upon the period of production of the investment. Since most developmental projects require: a long time before they start production, the threat of inflation due to deficit financing will be a serious one.

The only good thing about such a policy is that it is the least troublesome. People's consumption can be restricted by merely having control over the printing press. The. same kind of limitation of consumption can be brought about by other means as well. Government can exhort people to restrain consumption voluntarily. Such a policy would yield results only if backed by a powerful propaganda machinery and enthusiastic acceptance of the development programme by the people, conditions which may not always obtain. Rationing and heavy taxation will achieve the same ends but create other problems. Control on distribution raises enormous administrative problems which many governments may not be in a position to tackle. Heavy direct taxation may not be feasible as it may have undesirable effects on private investment and heavy indirect taxation may be just as inflationary as deficit-financing. Deficit financing as described above avoids these administrative problems.

One cannot, however, be too sure that it will not raise problems of its own. The ease with which deficits can be incurred may breed carelessness in spending. Even if this were not so, the way it brings about forced saving creates problems. The manner in which consumption is restricted is through the failure of certain classes of incomes to rise when prices of commodities go up. These are not likely to be the incomes of producing classes, i.e., agriculturists and industrial producers, or "the trading classes. The sections whose incomes usually fail to rise are organised and unorganised labour and the professional and salaried classes. If they are capable of exercising pressure and the government succumbs to it, wages and salaries will rise. Then would follow a spiralling inflation which will retard the intended development. If wage and income rises are not granted, the efficiency of those on whose skill and ability development largely depends in these countries will he seriously impaired. Besides, it is doubtful if these classes will tolerate for long the demands which economic development makes only upon them.

There is a more serious argument against deficit financing which leads to an unending round of price rises. Speculation under such circumstances will be extremely profitable and there will be a tendency to hoard everything. More serious than that is that people will develop a speculative outlook. The. entire economic activity will be geared to the hope of capital appreciation and private investment may be diverted into socially undesirable channels. Wastage also will tend to be enormous because of the money illusion. Ultimately, the loss to society may be far greater than the gain from the completion of a few public investment projects.

One way out of this is to plan, as our Finance Minister has been stressing so often, deficits matched by an equal amount of foreign assistance. So much additional output is available and the effect is as if the government had undertaken investment equal to so much extra saving out of a higher income. No inflation would result. There is, however, a small catch in this which we may not notice so long as we think in terms of aggregates. We have seen above that the first effect of any act of investment is the rise in food prices due to the extra demand of the additional workers. If there is no corresponding addition to the food supply, prices of food will rise with subsequent repercussions throughout the economy. This would suggest that the path of development would be smoother if foreign assistance were; in the form of consumer' goods than anything else. Otherwise, we may have an inflationary price rise beginning in consumer goods and gradually spreading to others. The post-war imports of consumer goods in many countries to check price rises is an illustration of this proposition.

Finally, a word about the policy pursued by the Government of India regarding development. *The Report on Currency and Finance* for 1951-52 gives detailed figures of development finance. We find that for the three years from 1950-51 requirements of the development programme arc Rs 252, 317 and 35P crores respectively, whereas resources available are Rs 235, 245 and 210 crores respectively, leaving a gap of Rs 17, 72 and 140 crores respectively. These resources include not only contributions from revenues to development but also loans and foreign assistance. And each year the shortfall has been made good by drawing upon the cash balances of the Government. (Please see page 817.)

Is this way of financing development good or bad? The fact, that cash balances have gone down means that the Government is pumping currency into the system. The ultimate effect of this will depend upon whether the total investment undertaken by both the private and the public sector is greater than the volume of voluntary saving undertaken by the people out of their incomes. In view of the insufficient data on saving we cannot say anything definite. Now, the First Annual Report of the Consultative Committee of the Colombo Plan maintains that an annual volume of investment of about Rs 390 crores in the public sector and Rs 255 crores in the private sector cannot be maintained without foreign assistance of the order of Rs 130 crores every year. If we accept this view and if the Government is forced to incur the deficit because foreign aid is not forthcoming, or because it cannot mobilise as much domestic saving as it wants, we would be heading for severe inflation. There is, however, a possibility that this may not happen if private investment does not rise to Rs 255 crores. The report mentioned above estimates that private investment will not exceed Rs 180 crores in the early years of the Plan. In such a case, the resulting inflationary piessure may not be so great. One cannot be sure, however;, that with so much money floating about, private investment will always remain low. Thus we would be facing a dilemma. If private investment remains low, the rate of development, will be slow; if it is high, it will lead to an inflationary rise in prices which again will reduce the rate of growth, if we keep the rate of expenditure, fixed.

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REQUIREMENTS FOR DEVELOPMENT, RESOURCES AVAILABLE AND COVER FOR DEFICIT

(Crores of rupees)

	1950-51 (Accounts)	1951-52 Revised estimates	1952-1953 Budget estimates
1. Requirements for development expenditure	252	317	350
2. Resources Available for development	235	245	210
(*i*) Total Resources (including railways)	969	1126	993
(*ii*) *Less* (*a*) Defence outlay*	168	197	215
(*b*) Other non-development expenditure on revenue and capital accounts†	566	684	568
3. Shortfall in Resources	17	72	140
Of which			
(*i*) Centre	12	11	76
(*ii*) Part 'A' States	5	42	54
(*iii*) Part 'B' States	—	19	10
4. Cover for Deficit			
(A) Centre:			
(*i*) Net receipts from Cash Balance Investment Account ..	24	7	—
(*ii*) Decline or Increase (—) in cash balances	—12	4	76
(B) Part 'A' States			
(*i*) Net receipts from or payments (—) to Cash Balance Investment Accounts ..	—5	9	31
(*ii*) Net withdrawals from or additions (—) to Reserve Funds ..	14	17	18
(*iii*) Decline or increase (—) in cash balances	—4	16	5
(C) Part 'B' States			
(*i*) Net receipts from or payments (—) to Cash Balance Investment Accounts ..	7	5	3
(*ii*) Decline or increase (—) in cash balances	—7	14	7

* Includes revenue and capital outlays on defence.

† Covers security and administrative expenditure, 'ordinary' expenditure under developmental heads on revenue account; net outlay on schemes of State trading, commutation of pensions, refund of Excess Profits Tax and Income-tax deposits by the Centre, repayment of permanent debt by the Centre and States, etc.

(Source: *Report on Currency and Finance for the year* 1951-52)

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