The State and Economic Development

Role of State in Economic Development

Economic development implies to the development of an economy. It refers to a process where the real per capita income in a country increases over a long period of time. Because of economic development, the welfare of the people also increases in the economy.

The state plays an important role in the development of an economy by generating employment for the poor and promoting their social welfare. The promotional role of the state in economic development is as follows:

- Providing rural infrastructure and extending credit to the poor at a low rate of interest as an effective instrument to eradicate poverty.
- Development of infrastructure such as transport, irrigation, power and electricity, and communication is required to promote agricultural and industrial development.
- The state has to intervene in macro-economic management. The government can intervene in some sections of the population which are not covered by market mechanism.
- Income inequality is not a healthy phenomenon. Revenue policy and public expenditure policy are two measures undertaken by the government to reduce income inequality in an economy. The progressive and proportional system of taxation helps to reduce the gap between the rich and the poor. All the public expenditure incurred in projects benefit the middle class and the poor sections of an economy.

Guidelines from the Constitution

The Constitution of India embodies the goals of an economy and provides guidelines to the government for working with respect to the economy. These are provided through the directive principles of state policy. It specifies the guidelines to the government in supervising, directing and controlling the Indian economy.

Goals in the Preamble of the Constitution of India:

- Social, political and economic justice
- Liberty of thought, expression, belief, faith and worship
- Equality of status and opportunity

Hence, the goals mentioned are about welfare state and the establishment of a socialistic pattern in society.

Instruments of State Intervention

Fiscal Policy

Fiscal policy refers to the revenue and expenditure policies of the government and helps to correct the situations of excess and deficient demands. It is also called budgetary policy of the government.

Components of Fiscal Policy

- Government expenditure is increased to adjust deficient demand and decreased to adjust excess demand.
- Tax burden is decreased to adjust deficient demand and increased to adjust excess demand.

- Public borrowing is increased to adjust excess demand and decreased to adjust deficient demand.
- Borrowing from RBI is increased to adjust deficient demand and decreased to adjust excess demand.

Instruments of Fiscal Policy

The main instruments of fiscal policy are taxation policy and expenditure policy.

Taxation Policy

Direct taxes are those taxes whose burden cannot be shifted to the others. Tax on individual income and profits of business enterprises are examples of direct tax. After the reforms, there were reductions in the tax rates of individual income.

Indirect taxes are those taxes whose burden can be shifted to the others, e.g. tax on commodities. Many reforms are initiated to encourage the taxpayers by lowering the tax rate.

Differences between direct taxes and indirect taxes:

Direct Taxes	**Indirect Taxes**
Direct taxes refer to taxes which are really paid by those on whom they are legally imposed.	Indirect taxes refer to taxes which are imposed on an individual but are paid by another person either partly or wholly.
The tax burden cannot be shifted to any other individual or firm by the taxpayer.	The tax burden can be shifted by the taxpayer.
It is progressive because the tax rate increases with an increase in income slabs.	It is regressive because the common people bear this tax burden.
The impact and incidence of tax fall on the same person.	The producer bears the impact and incidence of tax on the consumer.

Merits of Direct Tax

- Equity: Direct tax is imposed on the income of a person based on the principle of ability to pay. The income tax burden is equitably distributed on different people and institutions, thereby the tax burden falls more on the rich than on the poor.
- Certainty: An individual knows how much tax is due and when it is due. The government knows with certainty how much tax revenue is to be collected from direct tax. Accordingly, the government can adjust its income and expenditure.
- Elasticity: Direct tax is more elastic. During the period of crisis, the government can yield more revenue by increasing the tax rates.

Demerits of Direct Tax

- Tax evasion: There is a greater possibility of tax evasion of direct taxes as these taxes are collected based on honesty of the taxpayers. Business groups try to evade direct tax by misrepresenting their income statements to the income tax authorities.
- Narrow in scope: Direct taxes are imposed heavily on the rich. The government cannot approach the low income group through these taxes. So, they have limited scope in collecting tax.

Merits of Indirect Tax

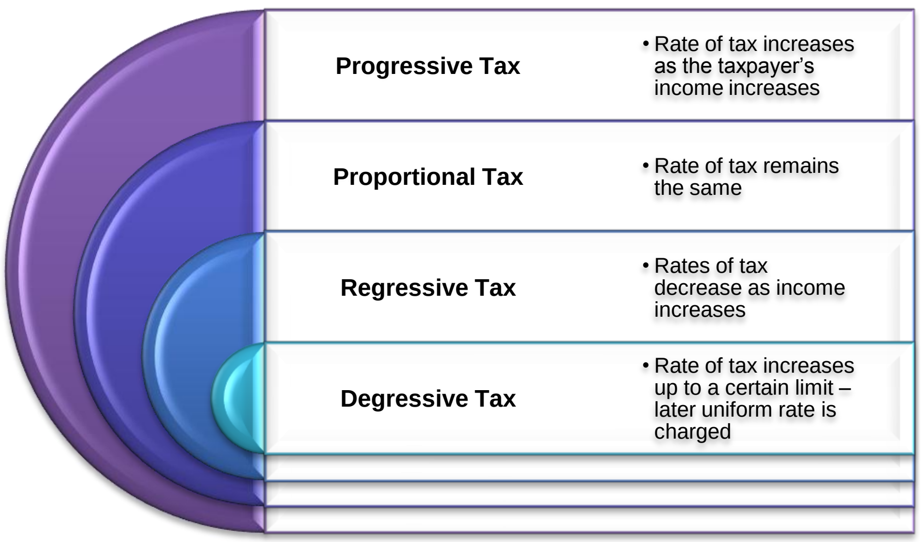
- Broad coverage: In the tax on commodity, all the buyers of the commodity have to pay the indirect tax irrespective of the income level—whether they belong to the high income group or low income group. By widening the tax net, the government can yield more revenue for public expenditure.

- Convenient: Indirect taxes are paid in small portion at regular intervals. It is not a burden to the taxpayer as it is included in the price of the commodity.

Demerits of Indirect Tax

- Uncertain: Taxes on goods with elastic demands are very uncertain. When the commodity is taxed, the price of the commodity increases, which reduces the demand for the commodity in the market. Hence, the revenue from indirect tax is uncertain.
- Discourage savings: Most of the income is spent on consumption of goods where the price of goods includes indirect tax, thus making savings impossible.

Other Kinds of Taxes



- Progressive tax: When the percentage of income collected as tax increases with an increase in the income, it is called progressive income tax.

Income per month	Rs 2000	Rs 4000
Tax rate	10%	5%
Tax collection	Rs 200	Rs 200

- Proportional tax: In proportional tax, the tax rate is constant irrespective of an increase in the income. All taxpayers pay an equal proportion of their income in the form of taxes.

Income per month	Rs 2000	Rs 4000
Tax rate	10%	10%
Tax collection	Rs 200	Rs 400

- Regressive tax: In regressive tax, the average tax rate decreases with an increase in the income of an individual. The absolute amount of tax collection increases with an increase in the income.

Income per month	Rs 2000	Rs 4000
Tax rate	10%	7.5%
Tax collection	Rs 200	Rs 300

- Degressive tax: Degressive tax is the rate of tax which increases up to a certain limit after which a uniform rate is charged. This system is a mixture of proportional tax and progressive tax. The absolute amount of tax collection falls with an increase in the income.

Income per month	Rs 2000	Rs 4000
Tax rate	10%	2.5%
Tax collection	Rs 200	Rs 100

Expenditure Policy

Public expenditure is incurred to maximise social and economic welfare of the economy. It is incurred to curb the inequalities of income and wealth in the economy.

Role of public expenditure in economic development:

- The public expenditure on infrastructural development improves the production efficiency of industries and increases employment opportunities.
- It encourages private enterprises by initialising state-owned financial and banking institutions to provide cheap credits.
- It helps in increasing the production of certain essential commodities to end private monopolies and by helping the state start public enterprises.
- It reduces income inequalities through welfare measures such as education and medical facilities.
- The aggregate demand increases with an increase in the public expenditure, thereby the producer receives an incentive to increase the production level. Because of excess demand for these products in the market, the stocks of their goods exhaust completely. Hence, the producers increase the production capacity to maintain the stock. This creates more demand for capital and labour, causing an increase in the level of production. Thus, it leads to an increase in the level of employment within an economy.
- It helps in removing regional disparities.
- It provides financial assistance to producers who establish industries in backward regions.

Monetary Policy

Monetary policy is the policy of the Central Bank which it introduced with the objective to control the country’s money supply including currency, demand deposits and foreign exchange rates. Monetary management is very essential for smooth functioning of an economy. This policy seeks to influence total demand by influencing the amount and cost of credit available to the borrowers.

Public Sector Enterprises

Today, the government has emerged as an active regulator, promoter and participant in economic affairs of the country in the public interest. Modern governments are expected to play a regulatory, promotional and entrepreneurial role.
Public sector enterprises play a dominant role in India. Their contributions are strong industrial base, export promotion and import substitution, generation of employment, and reduction in income inequalities. They are owned and controlled by the government. The main aim of the public sector is to maximise social welfare. It stresses more on the production of capital goods. The rapid industrialisation during the first three decades after Independence was mainly because of this sector. It has generated lakhs of new jobs. Central public sector undertakings employed 15.33 lakh people in 2008–09.

During the last ten years, several public sector enterprises have been suffering huge losses because of certain problems and shortcomings. These are

- Lack of incentive: There is a difference between the performance of a government servant and a person working in a private enterprise. Promotion is awarded by seniority and not by merit for government servants. They are not concerned with the profit of the enterprises.
- Delay in completion: It has been observed that many of the projects could not be completed within the stipulated period. Delay in completion of the project is an unnecessary burden on the economy.
- Capital intensive industries: To establish basic and key industries in the country, public sector enterprises were directed to adopt large-scale techniques of production which have shown to be capital intensive. As a result, priorities to generate employment and to encourage small-scale industries lagged.
- Price policy: Private sector enterprises are operated solely on the aim of profit maximisation, and prices are determined at a level which would cover total cost and provide sufficient net returns. However, for public sector enterprises, they are not guided by the principle of profit maximisation.

Privatisation

Privatisation refers to any process which discourages the participation of the state public sector in the economic activities of an economy. Its main objective is to make the best possible use of privately owned resources for collective welfare of the people.

Privatisation of public sector undertakings by selling off a part of their equity to the public is known as disinvestment. In privatisation, there is a vital role for private capital and enterprise in the function of an economy. It may take place because of the following reasons:

- Denationalisation
- Disinvestment
- Opening more industrial areas to the private sector
- Restrictions on further expansion of the public sector

Privatisation may occur in the event of decentralisation, but it does not lead to denationalisation. Denationalisation is the transfer of ownership from public enterprise to private enterprise. It leads to privatisation.

Privatisation in India

The new industrial policy announced by the government in July 1991 emphasised the following major measures to reform public sector enterprises:

- Reduction in the number of industries reserved for the public sector from 17 to 8 and introduction of selective competition in the reserved area.
- The disinvestment of shares of a select set of public sector enterprises.
- The policy towards sick public sector enterprises will be the same as the private sector.
- An improvement of performance through Memorandum of Understanding systems.