Trends in and Structure of Public Debt

Introduction

It is now widely recognised that for rapid and coordinated development of emergent economies the State has to assume much broader obligations and to undertake responsibility for providing an extensive 'infra structure' through the development of transport and communications, major and medium irrigation, power, etc., and also to build up basic industries. In under-developed countries, therefore, the State's responsibilities in economic and social spheres are naturally far greater than those in advanced countries. Here the State has to undertake all kinds of developmental programmes which, for various reasons, are either unsuitable for private enterprise or beyond the latter's capacity or are to be undertaken by the State to serve some socio-economic objectives. It has also to develop social services to keep in step with the growth of economic activity and the growing expectations of the people, particularly in a parliamentary democracy.

Financing of all these schemes\(^1\) requires large resources which it is

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\(^1\)Since the initiation of planned economic development in India, the Plan outlays in the public sector have progressively increased with every successive Five Year Plan. It aggregated to Rs. 1960 crores in the First Plan, Rs. 4672 crores in the Second Plan, and Rs. 8630 crores in the Third Plan periods. The total for the three Plan periods was thus of the order of Rs. 15262 crores. The development expenditure in 1966-67, 1967-68 and 1968-69 was of the order of Rs. 2141 crores, Rs. 2230 crores and Rs. 2337 crores respectively.
impossible to secure from taxation alone. The government must borrow, therefore, on a vast scale in order to supplement its resources with a view to discharge its extended obligations effectively. Increase in public debt need not cause concern so long as it is accompanied by the growth of productive assets and increase in the productivity of the economy, and so long as borrowings came from the genuine savings of the community. It is, therefore, not so much the size of the debt as the manner and method of borrowing and the utilisation of borrowed money that are of crucial importance.

2

Rationale of Public Borrowing in a Developing Economy

Taxation constitutes a method of forced savings. Public borrowing is a device which can be used to mobilise a substantial part of the voluntary savings of the community in order to finance the development Plan of the public sector. Public borrowing as a means towards resource mobilization for economic development has, therefore, an advantage over taxation. Taxation, when carried too far, may have adverse effects on economic incentives. Public borrowing, on the other hand, involves the mobilization of resources which may not have that adverse effect on incentives, firstly, because of its voluntary nature, and, secondly, because of the expectations of repayment.

Commenting upon the relative share of taxation and public borrowing in the fiscal structure of an underdeveloped economy, a U.N. report observes that "taxation should cover at least current expenditure on normal government services. Borrowing is particularly appropriate to finance government expenditure which results in the creation of capital assets or which is otherwise directly productive." If the public authorities in the developing economies follow this policy on financing economic development from public borrowing, or rather finance a part of the development expenditure from revenue surpluses and the other part from borrowing, a growing public debt would not necessarily be a burden on the economy, provided that the capital assets thus created and additional productive

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2Probably, in a developing economy, there may not be much choice between taxation and public borrowing as means of resource mobilization to finance development Plans. In view of the magnitude of the problem of resource mobilization all possible resources are required to be tapped to the maximum extent possible in order to meet the demands arising out of developmental effort.
capacity are productively and efficiently used contributing thereby to the growth of national income. In an underdeveloped economy, therefore, the public borrowing and the resultant public debt, if skillfully and prudently managed, becomes an important instrument of economic development.

Apart from being used as an instrument of resource mobilization for financing economic development, a growing public debt has certain other distinct advantages. To the extent it mobilizes savings which would otherwise have been utilised as hoards, for investment in non-productive real estate, purchase of bullion, ostentatious residential construction, or for speculative purposes, the funds thus raised become a positive factor contributing towards an accelerated rate of economic development. A systematic and carefully planned policy of public borrowing may not only reduce the interest burden of public debt but may act as the most desirable instrument in channeling the flow of resources in the right directions.

The formulation of a monetary policy aimed at the achievement of economic objectives socially determined is intricately related to the growth, volume and structure of public debt. Money and capital markets in underdeveloped economies are ordinarily unorganised and underdeveloped. A growing public debt in these circumstances, therefore, provide the monetary authorities with assets which they can base upon for formulating a developmental monetary policy suited to serve the needs of economic development in these countries.

The public authorities in underdeveloped countries may make use of two important methods of public borrowing: (1) by floating negotiable government securities and bills/bonds which are traded in the capital and money markets and for which market quotations are given; and (2) public borrowing of a non-negotiable character.

Problems of Public Borrowing in Underdeveloped Countries

Public borrowing as a device for mobilization of the savings of the community in an underdeveloped economy is faced with some special problems.

Firstly, in many underdeveloped economies there are no organised capital and money markets. In the countries where such markets exist, they are narrow and thin in relation to the resource needs of a developing economy in as much as they are inadequate even to serve the needs of a small organized private industrial sector. In this context, if the public authorities enter the market with a substantial borrowing programme it may well have unsettling effects on the smooth functioning of such markets.

Secondly, one of the characteristics of an underdeveloped economy is that a major portion of national income originates from agriculture and
allied activities, i.e., rural sector. The savings originating in this sector are incapable of being mobilized through taxation because of the relatively inadequate monetization of this sector. Mobilization of such savings on a substantial scale through public borrowing would, therefore, be dependent primarily, on the development and extension of organised financial institutions in the rural sector, a factor which is generally absent in the underdeveloped economies.

*Thirdly,* the problem of public borrowing as a means of resource mobilization in an underdeveloped economy has two aspects: (a) the problem of finding out the propensities to save of the different strata of population classified by income groups and further into convenient sub-sectors such as rural and urban; and (b) the detailed examination of the constituents (and their relative propensities) of the money and capital markets which comprise together the financial system of the country. Such institutional studies would normally be faced with a number of difficulties in an underdeveloped economy.

*Fourthly,* in the rural sector, mostly the savers are the substantial farmers or the money lenders. They do lend their surpluses but at exorbitant rates of interest and for consumption purposes mostly. The volume of their lending activity and the rates of interest charged by them have an important bearing on the efforts at mobilization of domestic resources. A structure of very high rates of interest militates against the investment of savings owned by the people in the rural sector in the projects of long-term productive potentialities where the rate of return is invariably low. Thus, "so long as the competition of such high returns exists, there can be little hope of attracting increased funds into agricultural improvement, savings accounts, government bonds, small scale industry or other channels of investment." 4

*Fifthly,* in the predominantly agrarian economies, investment in land is the major factor. Another major element is the investment in precious metals. A pattern of investment in land, subsistence commodities and precious metals not only yields a relatively high return to the landowner lender, but also satisfies the liquidity preference and safety preference in such a society. 5

*Sixthly,* the prevalence of high rates of interest in the underdeveloped economies exercises a depressing effect on the private investment. In the investment programmes where the gestation periods are relatively longer, i.e., the interval between the point of investment and the point of earning


normal profits is considerable, a high rate of interest involves a substantial burden on the enterprises and that acts as a powerful factor for discouraging investment.

**Techniques of Public Borrowing**

The techniques to be applied for public borrowing depend primarily on the stage of the development of money and capital markets in the economy in question and the structure of its economic and financial organization. In order to mobilize a substantial amount of resources through public borrowing, the denominations of various kinds of securities floated, the rates of interest paid on them, and their relative maturities must suit the preferences of the different categories of investors. Securities meant for institutional investors are generally of large denominations whereas the securities meant for the public is of low denominations. A relatively high rate of interest is generally offered to the public on special securities meant for them whereas a lower rate of interest is offered on market borrowings.

**Public Borrowing and Financial Institutions**

The financial machinery in the underdeveloped countries is capable of improvement in a number of directions, and the striving for such improvement should be a part of all policies directed towards development. The financial institutions of underdeveloped countries share in the state of general economic development; added to the general weakness and insufficiency there is a specific weakness in financial provision for the productive investments and improvements which form the essence of economic development. The development and growth of financial structure of an economy, therefore, is one of the most important pre-requisites of effective mobilization of resources in underdeveloped economies.

3

**Loan Finance in the Five Year Plans**

In the financing of Plan outlays in the public sector since 1951-52, the borrowings have played an important role. The government have depended primarily on four principal forms of borrowing: (a) market borrowing through the issuance of dated rupee loans; (b) small savings through the sale of various debt certificates of different maturities and the post office saving accounts; (c) unfunded debt of various kinds which

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are contractual in nature; and (d) borrowings from the Reserve Bank of India through the issuance of ad-hoc treasury bills. The issue of ad-hoc treasury bills are in addition to the regular auctions of treasury bills to the public. The financing pattern of Plan outlays since 1951-52 is given in the Table I below:

**Table I**: Financing Pattern of Plan Outlays in the Public Sector since 1951-52  
(Rs. crores)

<table>
<thead>
<tr>
<th>First Five</th>
<th>Second Five</th>
<th>Third Five</th>
<th>Annual Plans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year Plan</td>
<td>Year Plan</td>
<td>Year Plan</td>
<td>1962-63</td>
</tr>
<tr>
<td>1951-52</td>
<td>1956-57</td>
<td>1961-62</td>
<td></td>
</tr>
</tbody>
</table>

| A. Budgetary and other own resources | 752 | 1230 | 2885 | 510 | 364 | 745 |
|                                        | (38.4) | (26.3) | (33.4) | (29.8) | (16.5) | (31.9) |
| B. Domestic borrowings | 1019 | 2393 | 3290 | 839 | 850 | 716 |
|                           | (52.0) | (51.2) | (58.1) | (39.3) | (38.6) | (30.6) |
| 1. Market Borrowings¹ | 204 | 756 | 915 | 204 | 200 | 158 |
| 2. Small Savings | 243 | 422 | 585 | 120 | 109 | 115 |
| 3. Unfunded debt and other capital receipts | 233 | 261 | 640 | 326 | 182 | 136 |
| 4. Deficit financing² | 333 | 954 | 1150 | 189 | 359 | 307 |
| C. Total domestic resources (A+B) | 1771 | 3623 | 6175 | 1349 | 1214 | 1461 |
|                           | (90.4) | (77.5) | (71.5) | (53.1) | (55.1) | (62.5) |
| D. External assistance³ | 189 | 1049 | 2455 | 788 | 991 | 876 |
|                           | (9.6) | (22.5) | (28.5) | (46.9) | (44.9) | (37.5) |
| E. Total Resources (C+D) | 1960 | 4672 | 8630 | 2137 | 2205 | 2337 |
|                           | (100.0) | (100.0) | (100.0) | (100.0) | (100.0) | (100.0) |

¹Figures for the First and Second Plan periods represent market borrowings while for the subsequent Plan periods, represent net absorption of loans and treasury bills by the public, i.e., investors other than the Reserve Bank of India.

²Figures of deficit financing shown for the Third Plan period and the subsequent years refer to changes in government indebtedness (both long-term and short-term) to the Reserve Bank of India. These are, therefore, not comparable with those for the first two Plans which relate to budget deficits. On a comparable basis, deficit financing during First and Second Plan periods works out to be Rs. 260 crores and Rs. 1170 crores respectively.

³Figures in columns 4 to 6 are at the new rates of exchange and consequently, these are not comparable with the figures of the earlier Plan periods.

It will be observed that the budgetary and other own resources, representing balance from current revenues and surpluses of public enterprises contributed 38.4 per cent of the total resources during the First Plan period. The ratio declined to 26.3 per cent in the Second Plan period and then increased to 33.4 per cent during the Third Plan period. The percentages for the years 1966-67, 1967-68 and 1968-69 (i.e., the period corresponding to the three annual Plans) were 23.8, 16.5 and 31.9 respectively.

The share of domestic borrowings in the total resources during the First and Second Plan periods amounted to 52.0 per cent and 51.2 per cent respectively. The ratio declined to 38.1 per cent in the Third Plan period. The ratios for the years 1966-67, 1967-68 and 1968-69 were 39.3, 38.6 and 30.6 respectively. It means that whereas domestic borrowings, including deficit financing, contributed more than a half of the total Plan outlays during the First and the Second Five Year plans, the contribution would have been less than one third in 1968-69.

In the resources raised from domestic borrowings, deficit financing accounted for 32.7 per cent in the First Plan period. The ratio for the Second Plan period was 39.9 per cent while it was 35.0 per cent for the Third Plan period. Deficit financing contributed 22.5 per cent, 42.2 per cent and 42.9 per cent of the domestic borrowings during 1966-67, 1967-68 and 1968-69 respectively.

Total domestic resources, i.e., budgetary and other own resources plus domestic borrowings, contributed 90.4 per cent of the total Plan outlays during the First Plan period, the balance of 9.6 per cent having been accounted for by external assistance. The respective ratios were 77.5 and 22.5 during the Second Plan and 71.5 and 28.5 for the Third Plan period. The declining ratio attributable to total domestic resources and a correspondingly rising ratio of external assistance indicate our growing dependence on external assistance for financing development Plans. The contributions from external assistance became still more significant during the years 1966-67, 1967-68 and 1968-69 touching a record percentage of 44.9 in 1967-68.

The structure of Plan outlays in the public sector since 1951-52 is given in the Table 2 on page 229.
Table 2: Outlay in the Public Sector (by Heads of Development) since 1951-52

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td></td>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
</tr>
<tr>
<td>1. Agriculture and Community Development</td>
<td>290 (14.8)</td>
<td>549 (11.8)</td>
<td>1103 (12.8)</td>
<td>331 (15.5)</td>
</tr>
<tr>
<td>2. Irrigation and Power</td>
<td>583 (29.8)</td>
<td>882 (18.9)</td>
<td>1919 (22.2)</td>
<td>546 (25.5)</td>
</tr>
<tr>
<td>3. Industry and Mining</td>
<td>97 (4.9)</td>
<td>1125 (24.1)</td>
<td>1955 (22.7)</td>
<td>558 (26.1)</td>
</tr>
<tr>
<td>4. Transport and Communications</td>
<td>518 (26.4)</td>
<td>1261 (27.0)</td>
<td>2116 (24.5)</td>
<td>423 (19.8)</td>
</tr>
<tr>
<td>5. Social Services and Miscellaneous</td>
<td>472 (24.1)</td>
<td>855 (18.2)</td>
<td>1537 (17.8)</td>
<td>283 (13.1)</td>
</tr>
<tr>
<td>Total (1 to 5)</td>
<td>1960 (100.0)</td>
<td>4672 (100.0)</td>
<td>8630 (100.0)</td>
<td>2141 (100.0)</td>
</tr>
</tbody>
</table>

1 Total actual expenditure works out to Rs. 2137 crores; comparable sector-wise data are not available.
2 Total expenditure expected to be Rs. 2205 crores; comparable sector-wise data are not available.


4 Constitutional Provisions Regarding Public Debt

In the Constitution, the borrowing provisions are contained in Articles 292 and 293. Article 292 empowers the Union government to borrow (and to give guarantees) upon the security of the Consolidated Fund of India within limits fixed by the Parliament. Article 293 empowers the State governments to borrow within India (and to give guarantees) upon the security of the Consolidated Fund of the State(s) within limits fixed by the State legislature(s). In terms of the provisions of Articles 293(3) and 293(4), "a State may not without the consent of the Government of India raise any loan, if there is still outstanding any part of a loan which has been made to the State by the Government of India or by its pre-
decessor government or in respect of which a guarantee has been given by the Government of India or by its predecessor government" and that "a consent under Article 293(3) may be granted subject to conditions, as the Government of India may think fit to impose."

The constitutional provisions clearly point to the fact that basically the State governments' ability and power to borrow is dependent on the discretion and consent of the Union government7 and in consequence, the latter may curb it if considered necessary in the given circumstances. Article 293 also provides that the Government of India may give loans to the States or give guarantees for State loans. The States are prohibited from raising loans in foreign countries as 'foreign loans' is a subject over which the Union government has exclusive jurisdiction (Item No. 37, List I of the Seventh Schedule). External loans, moreover, raise a transfer problem which exercises a pressure on foreign payments. Sometimes, they also raise international complications and it is, therefore, a desirable restriction on the power of the States to raise loans.

Competition between the Union and the State governments in borrowing has been avoided by the Reserve Bank of India which manages the public debt operations of the Union as well as the State governments. Besides, all the States have borrowed from the Union government, and, therefore, its consent is necessary before they can float loans in the open market. This helps in fixing an order of priority of State borrowings and the timing of the loans. It also avoids competition which would cause unhealthy movements in the money market to the disadvantage of all.

5

Debt and Other Liabilities of the Union Government

Ordinarily, the debt and liabilities of the Union government are classified into: (1) public debt, and (2) other liabilities. The public debt is further categorised into: (a) the debt raised in India, comprising of 'permanent debt' and 'floating debt', and (b) debt raised outside India. Other liabilities are also categorised further into 'unfunded debt' and 'reserve funds and deposits'. The terms 'permanent debt' or 'funded debt' cover all debts which at the time of issue have a currency of more

7The States are heavily indebted to the Union government (the outstanding loans as at March 31, 1968 amounting to Rs. 5149 crores) and cannot, therefore, float loans without the express consent of the latter. It follows that the Union government can direct and guide, through the Reserve Bank of India, the State governments about the form of their borrowings, the choice of their lenders, and the amounts so that the actions of the latter do not run counter to the objectives, policies and the overall strategy of the Union government especially in the context of planning.
than twelve months, i.e., repayable after twelve months of the date of issue of the loan.

The 'permanent' or 'funded' debt may be for a specified period of time or for an indefinite period to be paid at the will of the government. In the former case the debt would be known as 'terminable funded debt' and in the latter case the debt will be known as 'interminable funded debt'.

A 'floating' or 'temporary' debt is purely temporary in nature and is repayable within twelve months of the date of issue. It includes treasury bills, ways and means advances from the Reserve Bank of India, etc.

In most of the countries, unfunded debt is included in the floating debt, there being no distinction between the two. But in India the term unfunded debt is used in a special sense. The term has been reserved for certain interest bearing obligations of the Government of India as Post Office Savings Bank Deposits, 15-year Annuity Certificates, Cumulative Time Deposits, 12-year National Defence Certificates, 4 1/2% 10-year National Savings Certificates, etc., and other unfunded debt.

The trends in and the structure of the debt and other liabilities of the Union government since 1950-51, categorized as aforesaid, are reflected in the Table 3 below:

**Table 3: Debt and Other Liabilities of the Government of India since 1950-51**

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
<td>(4)</td>
<td>(5)</td>
<td>(6)</td>
<td></td>
</tr>
<tr>
<td>A. Public Debt</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Debt Raised in India</td>
<td>2022</td>
<td>2329</td>
<td>3975</td>
<td>5415</td>
<td>6214</td>
<td>6556</td>
</tr>
<tr>
<td>(1) Permanent Debt</td>
<td>1445</td>
<td>1521</td>
<td>2594</td>
<td>3462</td>
<td>3606</td>
<td>3776</td>
</tr>
<tr>
<td>(2) Floating Debt</td>
<td>577</td>
<td>808</td>
<td>1381</td>
<td>1953</td>
<td>2608</td>
<td>2780</td>
</tr>
<tr>
<td>2. Debt Raised Outside India</td>
<td>32</td>
<td>114</td>
<td>761</td>
<td>2591</td>
<td>4624</td>
<td>5401</td>
</tr>
<tr>
<td>Total Public Debt (x+a)</td>
<td>2054</td>
<td>2443</td>
<td>4736</td>
<td>8006</td>
<td>10838</td>
<td>11957</td>
</tr>
<tr>
<td>B. Other Liabilities</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Unfunded Debt</td>
<td>447</td>
<td>753</td>
<td>1519</td>
<td>2751</td>
<td>2911</td>
<td>3171</td>
</tr>
<tr>
<td>2. Reserve Funds, Deposits, etc.</td>
<td>364</td>
<td>315</td>
<td>289</td>
<td>572</td>
<td>606</td>
<td>731</td>
</tr>
<tr>
<td>Total Other Liabilities (x+a)</td>
<td>811</td>
<td>1068</td>
<td>1808</td>
<td>3323</td>
<td>3517</td>
<td>3902</td>
</tr>
<tr>
<td>C. Total Debt and Liabilities</td>
<td>2665</td>
<td>3511</td>
<td>6544</td>
<td>11329</td>
<td>14355</td>
<td>15859</td>
</tr>
<tr>
<td>D. Percentage of A2 to C</td>
<td>1.1</td>
<td>3.2</td>
<td>11.6</td>
<td>22.9</td>
<td>32.2</td>
<td>34.1</td>
</tr>
</tbody>
</table>

The outstanding debt and other liabilities of the Government of India, it may be observed, increased from Rs. 2865 crores as on March 31, 1951 to Rs. 3511 crores as on March 31, 1956, a growth of 22.5 per cent over the First Plan period. The corresponding growth over the Second Plan period was of the order of 86.4 per cent, i.e., the total obligations increased from Rs. 3511 crores as on March 31, 1956 to Rs. 6544 crores as on March 31, 1961. There was a further step-up to Rs. 11329 crores as on March 31, 1966 showing a growth of 73.1 per cent over the Third Plan period. The total debt and liabilities outstanding as at March 31, 1968 were Rs. 15859 crores exhibiting a more than five-fold increase as compared to the outstandings at the start of the First Five Year Plan.

Another significant development in the trends in the debt and other liabilities of the Government of India has been the growth of external obligations. The outstandings relating to the debt raised outside India, which constituted 1.1 per cent of the total outstandings as on March 31, 1951 increased to 3.2 per cent as on March 31, 1956, to 11.6 per cent as on March 31, 1961 and further to 22.9 per cent as on March 31, 1966. The ratio which stood at 34.1 per cent as on March 31, 1968 clearly emphasises the growing relative importance of external obligations in total obligations.

The public debt of the Government of India can also be classified in another way. Such a classification may be: (a) dated and non-terminable rupee loans; (b) treasury bills; (c) small savings; (d) other obligations; and (e) external debt. Items (a), (b), (c) and (d) represent the rupee indebtedness of the Union government and may be assumed to be held within the country. This excludes, however, a portion of foreign debt held in the form of rupee counterpart funds. The trends and structure of the public debt of the Union government, classified as such, is given in the Table 4 on page 233.

Ways and Means Advances from the Reserve Bank of India

It generally happens that public revenues do not come in regularly and uniformly throughout all the months of the year, whereas expenditure is more or less distributed uniformly throughout the year. For instance, in India, current revenue generally falls short of current expenditure in the period from April to December; the last quarter from January to March registers a good surplus of revenue over expenditure. Also, sometimes, exceptionally heavy payments have to be made at a certain period of the year by the government when the revenue has not sufficiently accumulated to meet them. To enable them to tide over such temporary difficulties, Government of India take advances from the

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8Perhaps an insignificant amount of the rupee debt of the Union government might be held by the non-residents.
### Table 4

Debt and Other Obligations of the Government of India since 1950-51

<table>
<thead>
<tr>
<th>Year</th>
<th>Rupee loans</th>
<th>Percentage (1) to (9)</th>
<th>Treasury bills</th>
<th>Percentage (3) to (9)</th>
<th>Small savings</th>
<th>Percentage (5) to (9)</th>
<th>Other obligations</th>
<th>Percentage (7) to (9)</th>
<th>Total internal debt</th>
<th>Percentage increase (+) or decrease (—) over the previous year(s)</th>
<th>External debt</th>
<th>Percentage increase (+) or decrease (—)</th>
<th>Total debt and other obligations (Rs. crores)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1950-51</td>
<td>1438</td>
<td>58.2</td>
<td>364</td>
<td>14.8</td>
<td>337</td>
<td>13.6</td>
<td>330</td>
<td>13.4</td>
<td>2469</td>
<td>32</td>
<td>2501</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1955-56</td>
<td>1509</td>
<td>48.9</td>
<td>595</td>
<td>19.3</td>
<td>580</td>
<td>18.8</td>
<td>399</td>
<td>12.9</td>
<td>3082</td>
<td>24.9</td>
<td>114</td>
<td>256.3</td>
<td>3196</td>
</tr>
<tr>
<td>1960-61</td>
<td>2571</td>
<td>46.8</td>
<td>1107</td>
<td>20.1</td>
<td>982</td>
<td>17.9</td>
<td>834</td>
<td>15.2</td>
<td>5494</td>
<td>78.2</td>
<td>761</td>
<td>567.5</td>
<td>6255</td>
</tr>
<tr>
<td>1965-66</td>
<td>3425</td>
<td>41.9</td>
<td>1612</td>
<td>19.7</td>
<td>1549</td>
<td>19.0</td>
<td>1580</td>
<td>19.4</td>
<td>8166</td>
<td>48.6</td>
<td>2591</td>
<td>240.5</td>
<td>10757</td>
</tr>
<tr>
<td>1966-67</td>
<td>3557</td>
<td>39.0</td>
<td>1920</td>
<td>21.0</td>
<td>1667</td>
<td>18.3</td>
<td>1981</td>
<td>21.7</td>
<td>9125</td>
<td>11.7</td>
<td>4624</td>
<td>78.5</td>
<td>13749</td>
</tr>
<tr>
<td>1967-68</td>
<td>3732</td>
<td>38.4</td>
<td>2014</td>
<td>20.7</td>
<td>1762</td>
<td>18.1</td>
<td>2219</td>
<td>22.8</td>
<td>9727</td>
<td>6.6</td>
<td>5401</td>
<td>16.8</td>
<td>15128</td>
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Reserve Bank of India with which they do their financial business.

In terms of Section 17(5) of the Reserve Bank of India Act, 1934, the Bank is authorised to make, to the Central and State governments, ways and means advances which are repayable not later than three months from the date of making the advance. There are no statutory provisions as regards either the rate of interest to be charged or the maximum amount of the advance. These matters are, however, regulated by the respective agreements or arrangements which the Reserve Bank has made with the Central and State governments. According to these, the Reserve Bank is prepared to grant advances to the government(s) concerned at a rate of interest not exceeding the bank rate. The actual rate charged has been one per cent below the bank rate. Interest is charged for a minimum period of seven days on each advance. In the case of the Central government the total of such advances outstanding at any time should not exceed the minimum balance which it has agreed to maintain with the Bank and in the case of the State governments twice the level of their agreed minimum balance. Outstanding advances are repayable in full not later than three months from the date of the initial advance. These advances are granted without any collateral.

The Treasury Bills

The purpose for the issue of treasury bills is the same as in the case of ways and means advances, namely, to finance a government's temporary excess of expenditure pending the collection of revenue.

There are several considerations which enter into the decision whether to take a ways and means advance or to sell treasury bills on a particular occasion. Firstly, the size of the requirement has to be considered. If the amount required is small it is not worthwhile to have recourse to treasury bills. A ways and means advance is more suitable in such a case. Secondly, the period of the requirement has to be considered. If the deficiency is to last for less than three months, the ways and means advance is the better course. Where deficiency exceeds three months, treasury bills are generally more suitable, but the state of the money market at the time of their repayment must also be taken into consideration. Lastly, the comparative cost of the two alternative courses must be the chief consideration. The rate of interest payable is the main factor; also the fact that while a ways and means advance can be repaid at any time and, therefore, interest is payable only for the period it is outstanding, in the case of treasury bills, repayment cannot be made earlier than the term of the issue in question and interest is paid for the full period.

The Reserve Bank also sell treasury bills to the public, whenever considered necessary, on behalf of the Central government, by tender at the weekly auctions. Treasury bills are issued for a currency of 91 days. The sale of treasury bills provides short-term finance to government and
also helps to absorb any excess liquidity in the money market.

Capital Outlay and Loans Advanced by the Union Government

Creation of public debt by the governments of today becomes necessary to meet certain important situations. Firstly, loans may be floated for meeting the normal budget deficits due to some unforeseen contingency. Secondly, borrowing may become necessary for meeting large abnormal expenditure in emergencies. The most extreme example of such situations is war. Thirdly, loans may be used for financing commercial enterprises run by the government. They are generally productive enterprises which bring in every year a net revenue from which may be paid the annual interest on debt together with the annual depreciation charges of the assets. Fourthly, debts may be incurred for those public activities, such as the creation or expansion of education or health services, which improve and enhance the general social well-being and productive capacity of the nation, but which yield no direct financial return or revenue for the payment of interest and the redemption of the principal. Finally, the government may borrow not for a specific productive enterprise or social service, but for planned economic development in general. The funds so obtained may not be earmarked for a particular project, but may be used, as is currently being done in India, for financing the development Plan in general.

The capital outlay of the Union government as classified into: (a) outlay on departmental undertakings; (b) investments in autonomous corporations, government companies, etc.; and (c) other capital outlay, since 1950-51 is given in the Table 5 below:

**Table 5**: Capital Outlay and Loans and Advances by the Government of India

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<td>(Rs. crores)</td>
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<td>(3)</td>
<td>(4)</td>
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A. Capital Outlay

1. Outlay on Departmental Undertakings
   - 895
2. Investments in Autonomous Corporations, Companies, etc.
   - 260
3. Other Capital Outlay
   - 333

B. Loans Advanced
   - 221

C. Total Capital Outlay and Loans Advanced (A+B)
   - 1709

Debt Position of the States

The public debt of the State governments may be classified as follows: (a) permanent debt; (b) floating debt; (c) unfunded debt; (d) loans from the Union government; and (e) other debt.

The permanent debt represents rupee loans issued to the public. It includes cash and conversion loans as well as bonds issued in compensation for the abolition of intermediary rights in land. The outstanding permanent debt which stood at Rs. 58 crores on March 31, 1951, increased more than four-fold during the First Plan period to Rs. 265 crores on March 31, 1956. During the Second Plan period, it increased from Rs. 265 crores on March 31, 1956 to Rs. 493 crores on March 31, 1961, i.e., an increase of 86 per cent. The corresponding percentage increase during the Third Plan period works out at 67.1 per cent. The outstanding on account of permanent debt amounted to Rs. 970 crores on March 31, 1968.

The floating debt consists of ways and means advances from the Reserve Bank of India and short-term loans secured from the State Bank of India.

The unfunded debt consists of State provident funds, savings bank deposits, employees’ insurance contributions, etc., and against the total debt position of the States, its significance has progressively been declining since 1950-51.

Loans from the Union government are given mainly for the Centrally-assisted schemes and Centrally-sponsored schemes, although some loans are also granted for non-Plan purposes. That means a bulk of these loans are given for specific projects. The outstandings which were put at Rs. 155 crores on March 31, 1951 rose to Rs. 876 crores on March 31, 1956. The outstandings increased further to Rs. 2016 crores and Rs. 4101 crores by the end of Second Plan and Third Plan periods respectively, i.e., as on March 31, 1961 and March 31, 1966. The figure stood at Rs. 5149 crores as on March 31, 1968.

Table 6 on page 237, brings out the trends in the debt position of the States since 1950-51.

The public debt of the States may be defined to include permanent debt, floating debt and unfunded debt only. A portion of ‘other debt’ may also be included in such a definition but for the difficulty of dividing it into components readily. Permanent debt is comparable to the rupee loans of the Union government; floating debt could be put at par with
the treasury bills and the ways and means advances taken by the Union government from the Reserve Bank of India; and the unfunded debt with its counterpart in the debt position of the Union government.

Table 6: Debt Position of the State Governments since 1950-51

(Rs. crores)

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<tr>
<td>A. Public Debt</td>
<td></td>
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<td></td>
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<tr>
<td>1. Permanent Debt</td>
<td>58</td>
<td>265</td>
<td>493</td>
<td>824</td>
<td>905</td>
<td>970</td>
</tr>
<tr>
<td>2. Floating Debt</td>
<td>2</td>
<td>8</td>
<td>42</td>
<td>170</td>
<td>32</td>
<td>34</td>
</tr>
<tr>
<td>3. Loans from Union Government</td>
<td>155</td>
<td>876</td>
<td>2016</td>
<td>4101</td>
<td>4680</td>
<td>5149</td>
</tr>
<tr>
<td>4. Other Debt</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>B. Unfunded Debt</td>
<td>30</td>
<td>83</td>
<td>135</td>
<td>195</td>
<td>220</td>
<td>261</td>
</tr>
<tr>
<td>C. Gross Total Debt</td>
<td>245</td>
<td>1232</td>
<td>2737</td>
<td>5445</td>
<td>6000</td>
<td>6629</td>
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Loans from the Union government do not necessarily form part of the public debt of the States. The item indicates, however, the magnitude of the transfer of resources from the Union to the States in the form of loans since 1950-51. In view of the ever-increasing dependence of the States on the Union for financing various schemes assisted or initiated by the Union government, this category of States' indebtedness is bound to grow in relative importance for the years to come.

7

States' Borrowing from the Reserve Bank of India and the Problem of Unauthorised Overdrafts

All the State governments, except Jammu and Kashmir government, have entered into arrangements with the Reserve Bank of India, under Section 21A of the Reserve Bank of India Act, 1934, to enable the latter to handle their monetary transactions. Section 17(5) of the Act provides that the Reserve Bank of India may make advances to the State governments repayable in each case not later than three months from the date of the advance. As regards procedures governing State governments' borrowings from the Reserve Bank of India, the loan transactions take mainly
three forms: (1) ways and means advances; (2) special ways and means accommodation; and (3) extraordinary form of borrowings by the State governments, known as 'unauthorized overdrafts'.

Regarding ways and means advances, the basis for devising limits for such borrowings have been related to the minimum balances which each State is required to hold with the Reserve Bank of India. Presently, the States can draw up to twice the amount of these minimum balances. "This lending is almost automatic once a request comes from the State government concerned and does not involve any complicated procedures. For the purpose of availability of this facility, the State governments are required to execute a promissory note for the entire limit of advances and a letter of continuity (renewal) if necessary is obtained on 1st July every year. Under a revised procedure introduced from September 19, 1965, the promissory notes are to be renewed once in two years." 8 No cover is necessary for such advances.

As regards special ways and means accommodation, "the theoretical limit of this type of advance is Rs. 2 crores and is granted against hypothecation of Central government securities. In practice, this theoretical maximum is not always adhered to, the outer limit being allowed to vary with the size of Central government securities the States are in a position to pledge..... The loans are normally repayable within three months but can be renewed after expiry of the usual period..... The debtor governments clear the amounts borrowed either through authorizing the Reserve Bank for sale of the securities pledged or making good the amount out of normal budgetary receipts." 9

The extraordinary form of borrowing, commonly known as 'unauthorized overdrafts' are considered unauthorized in the sense that no prior arrangements are entered into between the borrowing State governments and the Reserve Bank of India. Such borrowings arise either because the limits agreed to between the States and the Reserve Bank of India, for ways and means advances and special ways and means commitments are exceeded or because these advances are not repaid within a period of three months. "In view of the delicate relationships with the State governments, the Reserve Bank cannot dishonour these cheques. All that it does under the circumstances, is to draw the attention of the State governments to the debit balances and to request them to clear them as quickly as possible..... The Central government is also kept informed of the position. Sometimes these overdrafts are cleared through

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9 Ibid.
adjustment against Central assistance to the concerned State for Plan schemes sanctioned by the Government of India. However, it is a rare occasion that these overdrafts are cleared in this manner. All sorts of political considerations supervene and eventually it is the Central government which is left to hold this unwanted baby.....Thus the State governments’ debt undergoes a metamorphosis and results in being a liability of the Central government, which treats them as a special loan to the concerned State. The repayment schedule of such loans is then fixed in consultation with the defaulting State governments though there is no standard procedure for the purpose.”  

"The persistence and large size of unauthorized overdrafts are a matter of very serious concern. Apart from the contravention of Article 293(3) of the Constitution and the agreements entered into under Section 21A of the Reserve Bank of India Act, the occurrence of such overdrafts and their practically automatic clearance by the Centre through ad hoc loans have grave effects on the national economy. In all federations, it is the sole responsibility of the Central government to take decisions regarding the need for and the extent of deficit financing in the context of overall economic considerations. No country with a unified currency system can afford to have more than one independent authority taking measures which result in increase of money supply. Unauthorised overdrafts violate this fundamental principle of sound monetary management. The benefits of this violation go to a few States which draw on the national resources at their own will without any scrutiny of their needs at the national level, while the burdens are borne by all including the States which are less prosperous. There is a serious danger that the example of having recourse to such unauthorized overdrafts by certain States, followed by their almost routine clearance by the Centre, may prove infectious.”

It may be observed that as the procedures and practices stand, the regulation of ‘normal ways and means advances’ and ‘special ways and means accommodation’ by the Reserve Bank of India does not pose any significant problem. Moreover, the existing procedures and practices can always be reviewed and refined further in the light of emerging situations out of expanding State budgets. Viewed from an overall context, the idea behind State governments taking ways and means advances from the Reserve Bank of India is to cover the temporary shortfalls in their revenues so that their commitments to budget expenditures should not be adversely affected. On the basis of the trends of the State governments’ revenues and expenditures, and their size, a realistic

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11Ibid.
measure for fixing borrowing limits can easily be located.

A major difficulty arises, however, about the manner in which the Reserve Bank of India may be in a position to prevent the State governments from overrawing their accounts. But before a solution to the problem is thought of, it would be worthwhile to search for the causes which lead the State governments to overdraw their accounts. Some of the more important causes may be divided into two groups according to their nature: (a) temporary difficulties arising from the uneven flow of receipts or expenditure and the inadequacy of the limits of normal 'ways and means advances' and 'special ways and means accommodation' with which they could be met; and (b) relatively more chronic imbalances between the resources of the States and their commitments, inadequate devolution, and the absence of suitable mechanism to deal with unforeseen difficulties.

The factors leading to the first category of difficulties, i.e., temporary difficulties, may be: (1) delays in the receipt of devolutions, statutory grants and Plan assistance from the Union government; (2) payments by any State government on account of other State governments and the Central government—which are initially met from the State balances; (3) inadequacy of the limits of 'ways and means advances' and 'special ways and means accommodation'; (4) certain unanticipated developments facing the State, e.g., famines, floods, etc.; and (5) advances continuing beyond three months.

The aforesaid difficulties are further accentuated by another factor. In view of the sprawling machinery of the State governments, it is possible that the disbursing officers, widely spread spacially, may draw amounts from the Consolidated Fund of the State concerned in excess of the balance at any given point of time. The monetary transactions of the State governments go on simultaneously at over 2000 Treasuries, Sub-Treasuries and banks. Owing to large number of places, it is not possible for the Reserve Bank of India to ensure beforehand that payments on behalf of a State government do not exceed the balance held by it by more than the limit specifically agreed to. These factors explain only the temporary unauthorized overdrafts which should get cleared as soon as progressive receipts reach up to progressive expenditure.

The second group of difficulties which can lead to persistent unauthorized overdrafts may be attributed to: (1) imbalance between resources and commitments of the States; (2) problems arising out of emerging situations; and (3) repayment of Central loans.

**Imbalance Between Resources and Commitments**

The State governments represented to the *fifth* Finance Commission that there was a great amount of disparity between their resources and
commitments under the Constitution. Recent technical and economic developments leading to integration of the national economy have resulted in an effective centralization of a number of highly productive taxes leading to a growing imbalance between States' own resources and commitments and the increasing dependence of the States on the Union government in the form of share in Centrally raised taxes, statutory non-Plan grants, in-aid and the discretionary Plan grants.

Problems Arising out of Changed Circumstances

Many States represented to the fifth Finance Commission that while the size of State Plans and Central Plan assistance were reviewed and revised from year to year, the recommendations of the Finance Commission remained in force for longer periods without any such review. If due to changed circumstances, such as increases in the cost of living requiring payment of additional dearness allowance to the employees, the States have to incur substantially larger non-Plan expenditure, there is no machinery as at present for providing increased devolution of resources to the States to meet the increasing deficits.

Repayment of Central Loans

Besides the requirements of unforeseen circumstances which have led to the difficulties in the States' revenue budgets, the volume of repayment of Union government's loans has in recent years resulted in a considerable strain on the capital budgets of the States. This has resulted in substantial amounts of non-Plan capital deficits which have largely been responsible for unauthorized overdrafts by several States. According to the existing arrangements large repayments of Central loans have to be made by the States in the month of October and this creates ways and means difficulties for some States during that month and the succeeding few months.

The fifth Finance Commission have been requested, according to their terms of reference, to probe into the problem of unauthorised overdrafts on the part of certain States with the Reserve Bank of India and to recommend the procedure to be observed for avoiding such overdrafts.

As regards ways and means advances which remain outstanding for more than three months, a period specified in Section 17(5) of the Reserve Bank of India Act, 1934, the fifth Finance Commission observe that "the prolonged continuance of substantial ways and means advances is likely to result in their exceeding the permissible limits when there is a small time-lag in the inflow of receipts or unanticipated increase in expenditure. The Reserve Bank has been allowing such advances to continue beyond
three months without renewal and without calling for their repayment, on the view that the continuance of advances in this manner does not contravene Section 17(5) of the Reserve Bank of India Act. We think that it is necessary to review such advances instead of allowing them to continue automatically. We suggest that the Reserve Bank should keep a continuous watch over the ways and means position of each State, and whenever any advance is found to continue beyond the period of three months, the Bank should examine whether it is due to a long-term imbalance in the State’s budgetary position or any temporary reasons. Where the continuance of the advance is not due to a long-term imbalance, it should be formally renewed by the Bank and treated as a fresh advance. In other cases the Bank should call upon the State government to repay the advance, and in the case of default, it should be dealt with as an unauthorised overdraft.”

Regarding ‘unauthorised overdrafts’, the fifth Finance Commission observe that “in the context of overall shortage of financial resources available to the Central and State governments and rising demands for expenditure in a welfare State, it is inevitable that the State governments, even after receiving all possible devolution of tax shares and grants as well as Plan assistance from the Centre, will not find themselves in a position to meet their needs in full. If the evil consequences of unauthorised overdrafts are to be avoided, it is a matter of vital importance that, inspite of the relative inadequacy of their resources, the State governments must have balanced budgets and they should not embark upon any expenditure in excess of their available resources. Where, after the adoption of a balanced budget, there are fresh developments likely to result in lower receipts or higher expenditure, the responsibility for restoring the budgetary balance must necessarily lie on the State government and it should take timely steps to mobilize sufficient additional resources or curtail its expenditure to the necessary extent......Even when there is a balanced budget, it is necessary that a careful watch is maintained on the flow of receipts and expenditure throughout the year...... With the adoption of balanced budgets and an effective system of control over expenditure, the States should be able to avoid any of the difficulties in their ways and means position.”

A summary of recommendations of the fifth Finance Commission regarding adoption of measures for avoiding unauthorized overdrafts is given below:

(1) The State governments must accept the basic position that the

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13 Ibid., p. 21.
14 Ibid., p. 22.
15 Ibid., pp. 24-27.
facility of ways and means advances is meant only for meeting temporary requirements and not for financing general budgetary needs.

(2) The States should, as a matter of necessary fiscal discipline, balance their budgets and manage their affairs within the resources available to them. They should adopt the policy of having overall balanced budgets both at the beginning of the year and at the time of revised estimates.

(3) There should be no deficit financing at the State level and the size of the State Plans should be regulated strictly within the States' own resources and available Central assistance. Ways and means advances should not be considered as a resource.

(4) While the present position regarding limits of ways and means advances does not call for any immediate change, periodical reviews of the limits should be made by the Reserve Bank.

(5) The State governments which do not have sufficient Central government securities may, in special difficulties, avail themselves of such further clean advances as the Reserve Bank can allow subject to being satisfied about repayment in time.

(6) The Central government may consider more frequent releases of the States' share of income tax during the last two quarters.

(7) To avoid ways and means difficulty due to delay in the final adjustment of Plan assistance, the State governments should arrange for speedy reconciliation of departmental actuals with the accounts maintained by the Accountants General during the course of the year. Efforts should also be made to expedite completion of audit.

(8) The Central government may consider suitably modifying the procedure for consolidation of loans to States so that their repayment in instalments may correspond with release of Central funds to States and the usual time of floatation of their market loans.

(9) Where a State government experiences difficulties due to unforeseen developments, it should make efforts to raise further resources or to reduce expenditure, instead of incurring unauthorised overdrafts. If inspite of all possible measures it cannot meet the additional expenditure which is immediately necessary, it may apply to the Central government for a short-term loan to tide over the difficulty. The Central government should in such cases provide the necessary assistance to the States.

(10) The Planning Commission should, in their annual Plan review, take into account the adverse effect of the new developments and if necessary modify the size of the annual Plan of the State concerned.

(11) Whenever a deficit on non-Plan capital account is anticipated, the State government should consider reducing its non-Plan capital
expenditure and make efforts to increase its capital receipts including better recovery of loans. If the capital budget cannot be balanced in spite of such efforts, the Central government may consider deferring the repayment of Central loans falling due during the year to the necessary extent.

(12) Every State should have an effective ways and means section in its Finance Department. Forecasts of the ways and means position should be prepared, on the basis of which necessary corrective measures should be taken.

(13) The States may consider the introduction of a system in the nature of 'letters of credit' in the case of major spending departments and a monetary limit of expenditure may be fixed for each disbursing officer.

(14) The Reserve Bank should keep a continuous watch over the ways and means position of each State and the ways and means advances should not be allowed to continue beyond three months automatically. The Bank should formally renew an advance only where it is satisfied that its continuance is not due to a long-term imbalance in the State's budgetary position. In other cases the State should be called upon to repay the advance and in case of default it should be dealt with as an unauthorised overdraft.

(15) Where an unauthorised overdraft takes place, the Reserve Bank should issue a notice to the State government as at present, and at the same time inform the Government of India. It should be the duty of the State government to take immediate steps for clearing the overdraft within the notice period, failing which the Reserve Bank must proceed to stop payments.

(16) In view of the serious consequences which would ensue from stoppage of payments, the Government of India should help the State to regain a position of budgetary balance and to achieve fiscal discipline. To do so it should assist the State to clear the overdraft. It must be clearly recognised that this would be possible only where the State does not persistently follow policies resulting in financial difficulties and that the Central government cannot clear unauthorised overdrafts repeatedly.

(17) For this purpose the Government of India should, as soon as it is informed by the Reserve Bank about issue of notice to the State, ascertain from the State what steps it proposes to take to clear the overdraft. If the State government is not in a position to clear the overdraft it should urgently approach the Central government for special assistance. The Central government should, where it decides to assist the State, release in advance the State's share of devolution or Plan assistance payable during the year. When the amount due to the State during the year is not sufficient for the purpose, further assistance should be given as
an ad hoc loan to be adjusted against the devolution or Plan assistance falling due during the next year.

(18) The Central government should also have consultations with the State government to ascertain the causes of its difficulties and to ensure that the situation does not recur. It should depute a team of its officers, including a nominee of the Planning Commission, to visit the State for assessing the situation and recommending remedial action, and also considering whether any further temporary loan assistance is necessary for tiding over the immediate difficulties of the State.

(19) The Central government should call upon the State to adopt such measures as it may deem necessary. For the purpose of securing effective control over expenditure so as to keep it within actual receipts, it should be open to the Central government to nominate an officer to be associated with the Finance Department of the State. The State government should comply with these requirements.

(20) If a State government persists in incurring an unauthorised overdraft it would not be proper that the Central government should clear it and the consequences of failure to clear it will have to be faced. In such a case, or where an overdraft cannot be cleared in accordance with the procedure we have suggested, the Central government would have to take a view whether the crisis resulting from stoppage of payment of the State's cheques should be allowed to develop or it would be expedient to forestall it by invoking its Constitutional powers.

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Price Policy of Public Enterprises

Organisation and Structure

Prior to 1951-52, the year planning for economic development commenced in this country, activity in the public sector was confined to railways, ports, communications, broadcasting, irrigation and power, and a few departmental industrial undertakings such as the ordinance factories, railway workshops, post and telegraph workshops, etc. Since then the growth and expansion of the public sector, both in dimension and direction, has been phenomenal. Today, public undertakings cover a vast and varied range of activities, e.g., mining and metallurgy; heavy electricals; heavy engineering; machine tools; petroleum; heavy chemicals and fertilizers; drugs and pesticides; building of ships, aircraft and locomotives; transport, aviation and shipping; building and construction; banking, insurance and trade; and industrial financing.¹ This large scale expansion of public sector during the last eighteen years gives an idea about the growing entrepreneurial effort on the part of the State in this country.

¹Except for the nationalisation of life insurance, air transport, Imperial Bank of India, and the acquisition of controlling interests in a few units like the Praga Tools, the Hindustan Shipyard, the Hindustan Zinc, etc., the growth of the public sector represents the entrepreneurial effort of the State. The investment in the public sector has thus been strategically placed so as to put the public enterprises in an important position of influence in the economy.
Judged from the magnitude of investment outlays, the investment in the Union government’s commercial and industrial undertakings alone would have been more than Rs. 3500 crores by March 31, 1969.

The setting up of public enterprises has proceeded in accordance with the industrial policy of the Government of India as embodied in the two Industrial Policy Resolutions of April 1948 and April 1956. The 1948 Resolution called for a dynamic national policy directed towards a continuous increase in production by all possible means together with measures to secure its equitable distribution. The Resolution stressed the need for the State to play a progressively active role in the development of industries. The Resolution stated that “for some time to come, the State could contribute more quickly by expanding its present activities where it is already operating and by concentrating on new units of production in other fields rather than acquiring and running existing units.” The public and private sectors were thus assigned complementary roles in the promotion of industrial development. The manufacture of arms and ammunition; development, production and control of atomic energy; and the development, ownership and management of railways were declared to be the exclusive monopoly of the State. The responsibility of setting up new undertakings in six basic industries (i.e., coal; iron and steel; aircraft manufacture; ship building; mineral oils; and manufacture of telephone, telegraph and wireless apparatus, excluding radio receiving sets) was reserved to the State.

The initiative and direct participation in the industrial sphere by the State were thus restricted to a comparatively narrow field. In view of subsequent developments in socio-economic thinking, the need arose for further amplification of the policy and for extending the scope of public sector in the industrial set-up. The Directive Principles of State Policy enshrined in the Constitution adopted on January 26, 1950 indicated the socio-economic goals towards which the efforts of the State were to be oriented. In the light of these principles, it was considered that planning as a means for economic development assumed a vital role, and accordingly, Planning Commission was set up in March 1950.

While the First Five Year Plan, covering the period 1951-52 to 1955-56, was under implementation, the Parliament adopted a ‘socialist pattern of society’ as the principle objective of the socio-economic policy of the State. In the light of these developments, the Government of India reformulated their industrial policy and adopted the Industrial Policy Resolution of 1956. According to 1956 Resolution: “The adoption of the socialist pattern of society as the national objective, as well as the need for planned and rapid development, require that all industries of basic and strategic importance, or in the nature of public utility services,
should be in the public sector. Other industries which are essential and require investment on a scale which only the State, in present circumstances, could provide, have also to be in the public sector. The State has, therefore, to assume direct responsibility for the future development of industries over a wider area."

The 1956 Resolution classified industries into three categories. In the first category were placed the industries the future development of which was to be the exclusive responsibility of the State. The second category consisted of industries which would be progressively State-owned and in which the State would, therefore, generally take the initiative in establishing new undertakings, but in which private enterprise would also be expected to supplement the effort of the State. The third category included all the remaining industries where future development would generally be left to the initiative and enterprise of the private sector. It is in pursuance of this policy that the government have set up an increasing number of industrial and commercial undertakings and thus the public sector has come to occupy a commanding position in the economy and to play a strategic role towards a 'self-reliant and self-generating economy'.

Categorised according to the form of organisation, public sector undertakings can be classified under three groups: (1) undertakings run directly by the Departments/Ministries or executive agencies of the government, commonly known as 'departmental undertakings'; (2) 'statutory corporations', established by special Acts of Parliament; and (3) joint stock companies incorporated under the Companies Act, 1956, popularly known as 'government companies'.

**Departmental Undertakings**

The principal characters of a departmental undertaking are: (a) it is financed by annual appropriations from the Consolidated Fund and all, or a major share of, its profits/surpluses are paid into the Consolidated Fund; (b) it is subject to the budget, accounting and audit controls applicable to government activities; (c) its permanent staff consists of civil servants, and their conditions of recruitment and service are the same as for other civil servants; and (d) it can be sued only by following the procedure prescribed for filing suits against the government. The more important departmental undertakings in the Central sector are: Railways; Posts and Telegraphs; India Security Press; Currency Note Press; Neemuch and Mandasur Opium Factories; Government Opium and Alkaloid Works Gazipur; Overseas Communication Service; Light Houses and Light Ships; Delhi Milk Scheme; Forest Department, Anadamani; and Kolar Gold Mines.
Statutory Corporations

Efficient, economical and effective conduct of the public enterprises demands that their form of organization should be such as to afford the management an adequate sphere of independence of functioning within a broad framework prescribed by the Statute. Independence of day-to-day administration on the one hand and faithful carrying out of the obligations set in the Statute so as to be answerable to the legislature must go hand in hand. The public corporation or statutory corporation is designed to satisfy these twin requirements. "Admittedly, Western opinion has run fairly strongly in favour of the public corporation, on the grounds that it provides just the right combination of commercial freedom and Government control."2

A public corporation may be defined as a legal entity created by a special Act of Parliament, but exterior to the government organisation, financially independent, for carrying on specific functions prescribed in the Statute. The main characteristics of a statutory corporation are:
(a) it is created by a special law defining its objects, powers and privileges, and prescribing the form of management and its relationship with government departments; (b) it is a body corporate and can sue and be sued, enter into contracts and acquire property in its own name; (c) except for appropriations to provide capital or to cover losses, it is usually independently financed; it obtains funds by borrowing either from the government or, in some cases, from the financial institutions or the public and through revenues derived from the sale of goods and services, and has the authority to use and re-use its revenues; (d) it is ordinarily not subject to the budget, accounting and audit laws and procedures applicable to government departments; and (e) excluding the officers taken from government departments on deputation, the employees of statutory corporations are not civil servants, and are not governed by government regulations in respect of conditions of service. "Deriving its existence and authority directly from a Statute, such a corporation is usually characterised by a body of management, a management board, invested with such greater autonomy and much larger financial and other powers than is usual for officials heading an undertaking managed directly by a ministry or a government department. At the same time, the statutory nature of the corporation and its management, while reserving to the minister concerned or the executive government a large measure of initiative, appointment to top management and general supervision relieves them, at the same time, of the primary responsibility for the detailed

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2Hanson, A.H., Public Enterprise and Economic Development. London : Routledge and Kegan Paul, 1959, p. 357,
working of the corporation and its business."

A list of statutory corporations engaged in the commercial and industrial activities in the Central sector, as they exist presently is given below:

A. Banking, Insurance and Investment
   Agricultural Refinance Corporation
   Deposit Insurance Corporation
   Employees' State Insurance Corporation
   Industrial Development Bank of India
   Industrial Finance Corporation of India
   Life Insurance Corporation of India
   Reserve Bank of India
   State Bank of India
   Unit Trust of India

B. Air Transport
   Air India
   Indian Airlines Corporation

C. Commercial and Trading
   Food Corporation of India

D. Promotional and Developmental
   Central Warehousing Corporation
   Oil and Natural Gas Commission

E. Industrial
   Damodar Vally Corporation

Government Companies

Another form of organization which has quite extensively been adopted in India is to incorporate a public enterprise as a joint stock company under the Companies Act, 1956. The main characteristics of a government company are: (a) it has most of the features of a private limited company; (b) fifty one per cent or more, even the whole, of its capital must be owned by the State; (c) all the directors, or a majority of them, are appointed by the government depending upon the extent to which private capital is participating in the enterprise; (d) it is a body corporate, created under a general law, viz., the Companies

Act, 1956; (e) it can sue and be sued, enter into contract, and acquire property in its own name; (f) unlike a statutory corporation, it is created by an executive decision of the government without Parliament's specific approval having been obtained, and its Memorandum and Articles of Association, though conforming to the requirements of the Companies Act, are drawn up and are revisable by the executive government; (g) its funds are obtained from the government and, in some cases, from private shareholders, and through revenues derived from the sale of its goods and services; (h) it is generally exempt from the personnel, budget, accounting and audit laws and procedures applicable to government departments; and (i) its employees, excluding the deputationists, are not civil servants.

"There are several advantages to this form of organization for public undertakings. It provides considerable flexibility and freedom of action on the part of management, more so especially than direct management of an undertaking by a ministry or a government department. Experience has also shown that a corporation functioning under a special Statute governing it often lacks the managerial flexibility and degree of freedom which is necessary to a commercial enterprise. Where a general law, such as the Companies Act, makes provision for an almost endless variety of different kinds of trading and industrial enterprises, there appears to be built-in flexibility and freedom of movement which are often wanting when the management has a single specific Statute as its point of legal reference. It is also a good thing for a public undertaking conducting business to be a distinctly separate commercial entity from the rest of the governmental administrative apparatus."  

As at March 31, 1968, the total number of government companies at work was 241 with a paid-up capital of Rs. 1532 crores. Of these 85 companies were in the Central sector and the remaining 156 in the State sector. The following are the first ten of the government companies in the Central sector:

- Bharat Heavy Electricals Limited
- Bokaro Steel Limited
- Fertilizer Corporation of India Limited
- Heavy Electricals (India) Limited
- Heavy Engineering Corporation Limited
- Hindustan Aeronautics Limited
- Hindustan Steel Limited
- Indian Oil Corporation Limited
- National Coal Development Corporation Limited
- Neyveli Lignite Corporation Limited

Principles of Pricing in Public Enterprises

In a mixed economy, where a significant proportion of production activity is controlled by the undertakings in the public sector, the price policy of public enterprises attains a considerable degree of importance. As a matter of fact, the State, exercising control of such enterprises, can influence directly the functioning of a substantial sector of the economy and this affords the public authorities an additional means to pursue their socio-economic objectives. In the underdeveloped economies particularly, where the emergence and growth of public sector forms an important element in the entire process of economic growth, the price policy of public enterprises acquires an added significance.

Generally, the public enterprises are designed to serve certain well defined socio-economic objectives. The objectives they are expected to serve are usually defined and detailed in their relevant Statutes and accordingly, their price policy has to be determined in the light of such aims and objects. In their actual operations, public enterprises are guided by a combination of commercial and non-commercial elements in varying degrees, and this involves certain important implications. Firstly, the public enterprises are designed to serve certain well defined public purposes and as a consequence, a pricing policy pursued by the private enterprise and the principles involved thereunder may not be entirely suitable for the public enterprises. Secondly, the nature and extent of socio-economic objectives in relation to public enterprises may not be capable of being defined precisely and may differ in amount and character from one undertaking to another (may be from one country to another). As such no uniform principles can be laid down for price policy in public enterprises. Thirdly, the price policy of public enterprises shall also be guided by the degree of monopoly enjoyed by them and the extent of protection they enjoy vis-a-vis foreign competition. Fourthly, such a policy shall have to take into consideration the character of the consumers of their end-products and the undertakings which are using their outputs as inputs.

Of the principles of pricing which have generally been advanced in relation to price policy of public enterprises, the most important are: (1) the principle of break-even or the principle of 'no-profit no-loss'; (2) the principle of marginal cost of production; (3) the principle of average cost of production; and (4) the principle of making profits. The basic outlines of these approaches are examined in the succeeding paragraphs.
The Principle of Break-even

The traditional argument in respect of the conduct of public enterprises is that such undertakings are meant primarily to serve certain well-defined socio-economic objectives and as such they should be run on 'no-profit no-loss' basis. "The sort of price policy that a public corporation ought to follow can be stated simply in two rules; (1) it should make neither a loss nor a profit after meeting all capital charges; and (2) the prices it charges for different services should correspond to relative costs." Professor Lewis adds that "if the corporation makes a profit or loss it should be required so to adjust its prices as to eliminate the profit or loss." He maintains that the principle, if followed energetically, would avoid under-capitalization or over-capitalization of the undertakings in question and would check inflationary and deflationary tendencies. If, under compulsions of certain socio-economic considerations, it becomes socially desirable to supply a commodity or service at a price below or above the average cost of production, the most desirable method would be to use the mechanism of subsidies or commodity/service taxation and reflect the difference in the budgetary expenditure or receipts.

The principle of break-even suggests therefore that the public enterprise should operate in such a manner that it is able to recover its costs from its revenues and is able to provide for the normal depreciation on equipment and the due replacements of such equipment. A.D. Gorwala suggested the same principle to be adopted by the public enterprises in India. According to him "the general pricing policy should be to fix such a price for the product so as to enable the enterprise to 'break-even' over period of years or taking one year with another" as is sometimes stated. In other words, "taking several years together the enterprise should make neither loss nor profit." "As a general rule public undertakings — while complying with the rule of economic viability, which applies to them also — should refrain from seeking maximum profit and operate directly with a view to promoting the general interest."

Professor Robson on the Principle of Break-even

While formulating the general financial aim of public enterprises on the basis of the principle of break-even, Professor Robson does not agree

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6Ibid., p. 189.
with the above interpretation of the break-even principle. Though he does not favour a public enterprise to be operated so as to be a source of revenue for the public sector to finance its activities elsewhere, he suggests that adequate surpluses must be earned in order to finance the expansion and development of the undertaking concerned. "While we may agree whole-heartedly with the proposition that publically owned industries should not be run in order to provide a source of revenue for either the national government or for local authorities, this by no means concludes the question. There are other purposes for which a surplus may be required. If a public corporation makes a surplus in the course of its business, it must by law be applied for the purposes of the corporation as defined by Parliament in the relative statute. This means in practice that any excess revenue would ultimately be ploughed back into the undertaking, or be spent on improving the service or quality of goods, in pursuing research or development, reducing prices, increasing wages, or bettering conditions of employment. The normal method of disposing of a new surplus is to place it to reserve. Indeed, the main reason for making a net surplus is to build up the reserve fund."  

Ordinarily, retained profits (alongwith the excess of depreciation provision over replacement costs) constitutes an important source of financing the expansion and development of the undertakings in the private sector. Professor Robson had calculated that public companies quoted in the London Stock Exchange Market were able to finance 75 per cent of their investment requirements from retained profits and other internal resources during the quinquennium 1949-1953. The comparative account for the corporations in the U.S.A. for the same period was put at 64 per cent.  

Even in India, a bulk of the investment requirements of the non-financial corporate sector is met from to internal resources generated by the corporate sector. There is no reason, therefore, why a similar norm should not be adopted by the public enterprises so as to earn surpluses for the purpose of internal financing of expansion and development. According to Professor Robson, there is "no reason why nationalized industries should not be as free as profit making companies to find as much money for capital development from internal resources as they think fit." He is of the opinion, that "much larger allocations to reserve should be made, whenever possible, in the nationalised industries, in order to enable them to finance a much higher proportion of their capital investment from internal resources. These allocations should be charged against revenue, as required by the

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11Ibid., p. 311.
statutes, in order to preclude unfounded demands for higher wages or lower prices. The allocation of such reserves is in no way incompatible with the obligations of the public corporations about breaking-even, but in order to do so they would have to increase prices.”

Normally, according to 'accounting' principles, the depreciation provision is based on the book value of the productive assets, commonly known as 'depreciation provision on historical cost'. A sound policy would, however, be to relate depreciation provision to the replacement cost of the plant and equipment at current prices, and the consumers of the commodity/service produced should be charged for making good fully the real productive resources which are used-up in producing the commodity/service. Such a policy would not be incompatible with the principle of break-even. In the light of the aforesaid, thinking has crystallised in recent years that even based on the principle of break-even, the performance of the public enterprises should be such that not only they are able to meet their normal costs but should also be able to create sufficient, but just sufficient, surplus for adequate replacement of plant and build up reserves for development purposes. Elaborating on the financial and economic obligations of the nationalized industries, the British government remarked:

"The Government consider that the financial objectives of the nationalized undertakings under their Statutes should now in general be interpreted on the following lines:

(a) Surpluses on Revenue Account should be at least sufficient to cover deficits on Revenue Account over a 5-year period: in arriving at the surpluses and deficits for each year there should be charged against revenue the items normally so chargeable (including interest, and depreciation on the historical cost basis).

(b) Provision should also be made from revenue for: (i) such an amount as may be necessary to cover the excess of depreciation calculated on replacement cost basis over depreciation calculated on historic cost as in(a) above; (ii) adequate allocations to general reserves which will be available inter-alia as a contribution towards their capital development and as a safeguard against premature obsolescence and similar contingencies.""
cost of their capital development out of their own earnings, and so
reduce their claims upon the nation’s savings and the burden on the
Exchequer: this is particularly so for those undertakings which are
expanding fast and which have relatively large capital needs.”

The Principle of Marginal Cost of Production

The principle of marginal cost of production for pricing in the public
utilities in a mixed economy was propounded by Professor Hotelling. The
principle so as to be applicable to all enterprises (whether public
utilities or otherwise) in a socialist economy was advanced by Professor
A. P. Lerner. According to the principle, the prices of the commodity /
service should be fixed on the basis of the marginal cost of production in
order to ensure an optimum allocation and utilization of productive
resources resulting in an optimum output. In a perfectly competitive
market, where prices are autonomously determined and are beyond the
influence of the producers, the output is extended to a point where mar-
ginal cost is equal to price as well as the marginal revenue. The pro-
tagonists of the marginal-cost prices contend that although perfect
competition may be an unreasonable and untenable assumption in the
context of public enterprises, nevertheless the norm can ideally be applied
to other market structures also.

The principle of marginal cost of production, sometimes known as
the ‘Hotelling-Lerner’ Rule, suffers, however, from the following short-
comings:

Firstly, undertakings operating under the conditions of increasing
returns or decreasing costs would be confronted with a situation where
average cost of production would be higher than the marginal cost of
production. A price which is equal to the marginal cost of production
would result in a lesser amount of total revenue than the total cost. Such
losses are not regarded, however, as a reason for departing from optimum
output as defined by the marginal analysis. The loss arising in this way
may be made good either by subsidies financed out of general taxation or
taxing the commodity/service by an amount equal to the difference be-
 tween the average cost of production and the marginal cost of production.
If the loss is covered by subsidies financed out of general taxation, the

\[14\] Ibid., p. 8.
\[15\] Hotelling, H., “The General Welfare in Relation to Problems in Taxation and
of Railway and Utility Rates”, in the *Econometrica*, July 1938.
\[16\] Lerner, A. P., “Statistics and Dynamics in Socialist Economics” in the *Economic
Journal*, June 1937.
\[17\] Meade, J. E., “Price and Output Policy of State Enterprises”, in the *Economic
users of the commodity/service are likely to gain at the expense of general taxpayers. A subsidy to such enterprises, in addition to leading to a redistribution of income (which may not always be conducive to the general economic welfare) may lead to laxness and inefficient management resulting in a higher cost of production. Moreover, in a mixed economy, if guided by the principle of equity, subsidies are also to be given to enterprises in the private sector as may be enjoying the conditions of increasing returns or decreasing costs, the amount of total subsidy may come up to some fantastic figures. On the other hand if the commodity/service is taxed, it would make the price of the commodity/service equal to the average cost of production and as such would be counter to the very concept of marginal cost pricing.

Secondly, the argument that the principle of marginal cost pricing leads to optimum allocation of resources loses its validity once we drop the assumption of the existence of a perfectly competitive market. Moreover, in a mixed economy, if the principle of marginal pricing is applied for the pricing of the products of public enterprises, but, in the private sector, under conditions of imperfect competition, the criterion of profit-maximisation is applied, the discriminatory application of the rule is unlikely to lead to ideal output. Further, marginal cost pricing fails to provide any investment criterion.

Thirdly, in the case of monopolies operating under the conditions of increasing costs, situations which are quite possible in the case of public enterprises, marginal cost pricing would lead to huge profits—not always an objective with the public enterprises.

Fourthly, the marginal cost is not capable of being assessed accurately because of the lumpiness of production in the modern industrial set-up. The difficulties would still be more where multiple products/services are being produced.

Fifthly, if the principle of the marginal cost of production is faithfully followed, fluctuations in demand and supply would result in a significant amount of fluctuations in the marginal cost and hence prices. Introduction of time periods, of uncertainty, and changing characters of the market situations makes the problem still more complex. "Irregular and unforeseeable fluctuations are, however, a nuisance.... This is one of the reasons why uniform prices have been enforced by the law on railways and taxicabs, and by customs on department stores, hotels, professional men, and in many other fields."

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To sum up, the principle of marginal cost pricing does not provide a correct criterion for optimum allocation of productive resources, for emerging investment policies, for efficient conduct of public enterprises, and for guidance under imperfectly competitive conditions. "The general case against marginal cost pricing is overwhelming. All arguments, even the dubious purely theoretical ideal output arguments, are against it." 20

The Principle of Average Cost of Production

The prices of the commodity/service supplied by the public enterprise should be determined with reference to the principle of average cost of production, is commended for the following reasons:21

(a) the public sector undertakings are expected primarily to meet needs, that is, to provide an optimum volume of supplies cheaply without seeking any profit;

(b) every purchaser of the commodity/service pays the average cost of production of the commodity/service in question rather than paying the additional cost of producing the marginal units;

(c) average cost pricing means absence of exploitation;

(d) average cost pricing acts as a reliable criterion for determining the investment decisions; and

(e) the principle of average cost assures full recovery of the entire cost of production and secures thereby the viability and autonomy of the undertaking.

The theory suffers, however, from a number of limitations.

Firstly, the determination of average costs is not as practicable as it appears from the accounting point of view. "The task of correctly allocating cost elements is fraught with theoretical difficulties of principle, which cannot be overcome by any degree of improvement of the accounting systems of individual economic units and the economy as a whole." 22

Secondly, the problem of calculating the 'capital consumption allowance' or the 'depreciation allowance' and its appropriate distribution while determining the average cost of production has to be solved in a satisfactory manner. Whether depreciation should be calculated on the basis of book value of the capital assets, or, on the basis of replacement cost, or, a liberal financial prudence is to be followed in order to make suffi-

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22 INRICE Theory Committee, op. cit., p. 273.
cient allowances for technological advancements, is a matter which has attracted a considerable amount of controversy.

Thirdly, the problem of the measurement of social costs—tangible and intangible—involves the problem of the cost of production poses another difficulty for accurately determining the average cost of production. Similarly, if allowance is to be made for the social benefits, the problem becomes still more complex.

Fourthly, the average cost pricing may lead to excess capacity or undue restrictions on investments where potentialities exist, especially in industries/undertakings enjoying economies of large scale production or increasing returns. The criterion may hide the inefficiency of an enterprise and force the consumers to pay the full costs of an obsolete high cost plant, by removing any incentive for innovation.

**Price Policy Aimed at Earning Profits**

The growing dimension of the public sector in the underdeveloped economies is the manifestation of the growth and development of a significantly growing number of public enterprises. In such economies the propensity to save being lower, the effort at accelerating economic development is hindered by the inadequacy of investible resources. Without entering into the details of the alternative methods of resource mobilization in an underdeveloped economy, it may be pointed out that both taxation and borrowings have their limits. Taxation used as a mobiliser of investible resources cannot be pushed very far because of the thin tax-absorption capacity of these economies. Similarly, borrowings for financing the Plan programmes may not attract sufficient amounts of investible funds because of the very low propensity to save in the underdeveloped economies, underdeveloped capital and money markets, and other such inhibitors. Deficit financing, though often resorted to, can be potentially dangerous for growth with stability if pushed excessively.

The fact that in such economies the emphasis is on a predominant role the public investments and the public sector has to play in accelerating the pace of economic growth, for ideological reasons or as a practical expedient, or both, it becomes both desirable and necessary that the public enterprises should adopt pricing policy in order to earn sufficient profits to meet the financial requirements arising out of their expansions and development. Moreover, these profits should allow for reasonable returns on investments put up by the Exchequer so as to contribute to the general revenues of the State. "In certain cases where the State has made substantial investments, a policy of regulating prices so as to secure an adequate return on the capital invested is not only unobjectionable but may, indeed, be desirable. This is particularly so in the conditions
of economically underdeveloped countries where public enterprise itself, fostering at State expense, may in turn play a role in financing the country's development."

In this connection, Professor V.K.R.V. Rao observes that "the price policy should be such as to promote the growth of national income and the rate of this growth......Public enterprises must make profits and the larger the share of public enterprises in all enterprises, the greater is the need for their making profits. Profits constitute the surplus available for savings and investment on the one hand and contribution to national social welfare programme on the other; and if public enterprises do not make profits the national surplus available for stepping up the rate of investment and the increase of social welfare will suffer a corresponding reduction......Hence the need for giving up the irrational belief that public enterprises should, by definition, be run on a no profit basis." According to Professor J.K. Galbraith: "If I had to lay down a measure for performance of publicly-owned corporations in the developing country, it would be the earnings that it is able to put into its own expansion......The most successful firm would be the one which by its efficiency and drive finds the earnings that allow it the greatest growth."

The chief merit of such a price policy by the public enterprises is that it is an economical and convenient way of resource mobilization for economic development. "The case for resource mobilisation through the price policy of public enterprises also rests on the fact that it is an administratively very convenient and politically very feasible method of raising very substantial resources for the public sector. It does not involve any administrative expenditure as the mobilisation of resources through the instrument of taxation does. The earning of surpluses by public undertakings is also necessary in order to realize the capital expenditure incurred in the establishment of such undertakings when a substantial portion of such expenditure may have been financed by internal and external loans." In underdeveloped economies, notwithstanding the sizeable growth of the public sector with successive efforts towards economic growth initiated and sustained by the government, a change is likely to take place in the compositional character of the public sector. Instead of

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public sector being confined to the development of public utilities and social overheads like irrigation and power, transport, education, health, etc., large scale expansion of industrial and commercial enterprises may also take place in the developmental process of an economy. The public sector actually becomes a partner with the private sector for the fuller exploitation of industrial and commercial potentialities of the economy. The economic motive of the pricing in the private sector usually is profit maximization and there is no reason why should not the public sector industrial and commercial enterprises adopt the same consideration in their pricing policy in order to mobilize the investible surpluses.

Moreover, if the expanding socialist sector is to attain commanding heights in the industrialization of the economy and has, therefore, to generate ultimately, a substantial portion of the national income, such an important and dominating sector logically cannot be run on the principle of 'no-profit no-loss'. Public enterprises which constitute a significant sector of the national economy, if run on 'no-profit no-loss' criterion, would disturb the pattern of the revenues of the State. A good source of tax receipts which would normally come from the profits of public enterprises would have dried up and the undertakings who suffer losses would draw upon the Exchequer so as to eat into the resources mobilized otherwise. If such a drying up of the source of revenue to the government is to be avoided, it becomes necessary either to devise an appropriate system of taxation on public enterprises or to run them in order to earn profits. Thus the changing character of the public sector, quantitatively as well as qualitatively, would demand that a departure should be made from the traditional principle of 'no-profit no-loss'.

It has been observed "that private enterprise could be relied upon to operate in all fields in which profits could be made in more highly developed countries, but not to the same extent in underdeveloped countries. When private enterprise failed to operate in a profit-making field, it was appropriate for publically financed enterprise to fill the gap, profit could be made available for further development. Furthermore, a publically owned profit making enterprise might be carried on in underdeveloped countries in order to serve as a yardstick to measure the efficiency, tax-paying capacity and prices of private enterprise. Government enterprises in profit-making fields might also put the public authorities in closer touch with economic realities and thus better enable them to control the process of development, formulate development programmes and improve economic policies generally."

Over and above the above-mentioned justification for running the

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public enterprises on a profit criterion, the concept has an added importance in the context of an economy being transformed into a socialist set-up. "The theory of ‘no-profit no-loss’ in public enterprises is particularly inconsistent with a socialist economy, and if pursued in a mixed economy it will hamper the evolution of the mixed economy into a socialist society. The sooner, therefore, the theory of ‘no-profit no-loss’ in public enterprises is given up and the policy accepted of having a price and profit policy for public enterprises such as will make the State increasingly reliant on its own resources (as distinguished from taxing the personal incomes of its citizens), the quicker will be the evolution of a socialist society."28 Socialist industrialization depends primarily on the profitability of public enterprises which is a less cumbersome source of resource mobilization for the public sector programmes.

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Criterion for Profit-Making in Public Enterprises

In the context of underdeveloped economies, it is now generally agreed that the public enterprises should be run so as to aim at earning surpluses to make a substantial contribution for their own development, besides making a significant contribution to the national Exchequer for financing development elsewhere. But such a policy of profit-maximisation would, in practice, be subject to certain important qualifications. Firstly, in a mixed economy, where in several fields public and private undertakings are in competition, the prices of the commodities/services supplied by public undertakings would be competitively determined as under duopolistic or oligopolistic market structures. This would limit the powers of the public authorities to maximise profits or to achieve the desired targets of profits. Secondly, although the ability of the public undertakings to earn profits, where they operate as monopolies or quasi-monopolies, is enhanced considerably, a policy of profit-maximisation may run counter to certain other important social objectives. The commodity/service produced may be of basic or essential character, and it may be in the public interest or in the interest of growth that such commodities/services are sold deliberately at subsidised prices. Thirdly, in certain cases, the products of the public undertakings may be purchased and consumed by other public undertakings/departments, e.g., the products of Hindustan Aeronautics, Indian Telephone Industries, Heavy Electricals (India),

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Bharat Heavy Electricals, National Coal Development Corporation, etc. Profits earned by such undertakings would mean higher expenditures on the part of other public undertakings/departments with a built-in offsetting effect. In such cases the 'cost-plus’ principle is applied generally. *Fourthly*, the commodities/services produced by the public undertakings may be consumed by the vulnerable sections of the society and as such it may not be publicly desirable and politically feasible to earn profits on such commodities/services.

In the context of the aforesaid, for a realistic determination of a pricing policy, public sector undertakings in underdeveloped economies can conveniently be divided into the following categories:

1. public utility enterprises;
2. undertakings which have monopoly position in the market; and
3. undertakings which compete with the private sector enterprises in the market.

Price policy usually followed in the public utilities is based on the principle of break-even which takes into consideration the needs of the enterprise in respect of depreciation and replacement allowances in addition to the resource requirements arising out of expansion and development programmes. "In the case of underdeveloped countries, such enterprises may not be made a source of revenue to the public authorities in the initial stages of development in order to encourage demand and widen the market, but they should not be prevented from earning a surplus to be made available for capital formation over the long period."22

As regards public monopolies, other than public utilities, a number of criteria is generally suggested for their pricing policies: (1) the criterion of growth; (2) the criterion of optimum allocation of productive resources; (3) the criterion of maximum utilisation of the existing stock of capital; (4) the stimulation of certain products at the cost of others; (5) provision of the maximum possible incentives for promotion of efficiency. These criteria are often competing with each other, rather may sometimes be conflicting, and as a consequence the actual policy decisions may present a sort of compromise aiming at the achievement of the declared socio-economic goals.

Viewed from the criterion of growth a price policy should be designed in such a way that the public sector enterprises should produce sufficient amounts of investible surpluses for financing the development programmes in the public sector. "If the enterprise makes no profits, it cannot help finance its own expansion. Therefore, on the assumption that it is unable to raise money by issuing securities to the public, the whole of its capital

22Tripathy, R.N., *op.cit.*, p. 263.
supplies must come from the government. The latter, in its turn, will have to raise the necessary funds by increasing taxation, which may be difficult or by inducing inflation which is always dangerous. Moreover, even if capital can be raised from the public, it is not necessarily desirable to have recourse to this method, the effect of which may be to redistribute income in favour of the wealthier members of the community. Admittedly if the enterprise makes profits and uses them for self-financing, or if the State mops them up and invests them elsewhere, it is the consumer who pays, and there is undoubtedly some inequity. But it is also the consumer who, in the long run, pays for loan-financing and ultimately pays more. Apart from this, and much more importantly, it may be desirable, from the point of view of planned, coherent economic development, not to pass on the benefit, in the form of low prices, to the consumer, for the individual consumer is not inevitably induced thereby to save more, and the industrial consumer will not necessarily use the resultant higher profits of his enterprise to the best national advantage."

In case the criterion of optimum allocation of productive resources is to be followed, pricing related to the marginal cost of production seems to be most appropriate. "One may choose the rate of growth criterion, or one may choose the criterion of optimum allocation of resources. From the point of view of the latter criterion, the economist will not only rule out the element of monopoly profit, but would in certain cases recommend a price policy which involves loss to the enterprise. Where the overhead cost is high, as in major irrigation, and where the average cost is a decreasing function of output, the criterion of optimum allocation would dictate maintenance of a price which is below average cost. On the whole, since the majority of industries in an economy are supposed to conform to the principle of constant returns to scale, the near approximation to optimum allocation is provided by cost-price equation which is the competitive criterion. This is a perfectly legitimate criterion to adopt even under socialism."

In a developing economy which is set upon attainment of a rate of growth which is distinctly higher than that warranted by normal savings in such an economy, and in which the public sector has taken upon itself to give a push to the growth, it may become expedient to deviate from the criterion of optimum allocation of resources and to aim at growing surpluses from the public enterprises with a view to mobilize the maximum resources for development purposes. It may be pointed out, however,

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that, under certain circumstances, pricing based on maximisation of surplus may not be justifiable even from the criterion of economic growth. In cases where the end-products of the public enterprises are capital goods, metals or other intermediate commodities, prices of such goods based on the maxim of profit-maximisation may increase the cost of development in industries where such goods are used as inputs, which in turn may check the growth of the industry in general. The same argument can be advanced, with equal force, in respect of irrigation, power and transport undertakings operating as public monopolies. The situation assumes particular relevance in a developing economy operating within the framework of a mixed economy, and where the public sector occupies the basic or strategic points of several industrial complementaries.

Notwithstanding all this, viewed from the point of resource mobilization, and this is a point of utmost importance in an underdeveloped economy, a price policy aimed at realization of substantial surpluses, must take precedence over other criteria. Other considerations, in this context, may be relegated to subsidiary and unimportant position.

The question of an appropriate price policy to be adopted by public enterprises, operating under monopolistic and semi-monopolistic conditions, was examined by the Taxation Enquiry Commission. It was observed that “normally such undertakings should operate on the basis of meeting their full costs of production including adequate depreciation provision (taking account of higher replacement costs) and a reasonable return on capital and, as a rule, subsidisation of prices should be avoided. Where revenue requirements necessitate the levy of taxes on commodities or services which are as ‘basic’ or ‘essential’ as those which are the products of State enterprise......the State should not regard itself as being precluded from using its monopolistic and semi-monopolistic power to secure larger revenues by an appropriate price policy.”88 The Commission was of the opinion, however, that with a view to encourage demand and widen the market so as to make the enterprise profitable over a long period, it may be desirable, in the early phase of development, to keep prices low, even if this involved incurring losses. This would particularly be so in the case of public utilities like electricity undertakings where usually promotional pricing policies are adopted in the early phases in order to reap best long-run results. For other semi-monopolistic undertakings producing basic commodities like pesticides, fertilisers, ship-building, etc., subsidies may be recommended, for certain initial periods, as a matter of policy.

As an overall policy, however, even the Commission was of the view

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that in cases where the State has incurred large amounts of investment, a policy of regulating prices with a view to secure an adequate return on the capital invested is not only unobjectionable, but also desirable. This would particularly be so in underdeveloped economies, where the public enterprise, itself fostered at State expense, is expected to play a role in financing economic development. "There is need for greater recognition on the part of public opinion of the principle of obtaining for the State a share of the higher output made possible by State investment in order that it may assist further investment and thereby accelerate economic development." 83

Commenting upon the argument, generally advanced, that the public undertakings should primarily be guided by public interest rather than profit motive, the Commission observed: "In the public sector profit is not necessarily inconsistent with public purpose, on the other hand, it may itself constitute a public purpose, even if it remains secondary. In certain circumstances, as in the case of fiscal monopolies avowedly established for the purpose of maximizing revenue, it forms the primary objective, though it is sometimes combined with a social objective in the form of a regulatory or restrictive function. In other public enterprises, the first objective, of course, is maximum service combined with maximum efficiency with a view to the widest extension of social welfare and economic development. Consistent with these, a certain measure of profit, and in some circumstances, even a significant amount of profit, should not be precluded under the broad principles which regulate pricing policy." 84

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Certain Limitations

Price policy in public enterprise, when used as a means for mobilizing substantial surpluses for further financing of public sector investments may, however, be subject to certain disadvantages:

Firstly, this is a method of resource mobilization which is convenient administratively and practicable politically, and as such the State may have the temptation of exploiting its monopolistic or semi-monopolistic position by raising the prices arbitrarily. In a parliamentary democracy, however, where the State is to keep social considerations and the climate of public opinion in the forefront, such arbitrarily increased prices may not be translated into reality.

83Ibid., p. 201.
Secondly, an argument is advanced sometimes that "the element of profit contained in the prices of public enterprises is a concealed form of commodity taxation, and as such, this form of taxation is bound to be regressive. Thus it would tend to exaggerate the regressiveness of a tax structure in a developing economy. But in such an economy, the need for mobilization of maximum investible surplus necessitates that the principle of equity in public finance may have to be relegated to a subordinate position, and as a result, the tax structure inevitably becomes regressive in character." Moreover, whether the profit element is regressive in character or not, depends upon what sections of the society the final incidence of the public sector pricing falls.

Thirdly, in an underdeveloped economy, the most real and serious danger inherent in the price policy aiming at generation of substantial surpluses, especially when the public enterprise is in a monopolistic or semi-monopolistic position, is that the enterprise may be running inefficiently and such an inefficiency may be concealed in putting up prices of the products. There cannot be two opinions on the need that it must be ensured that the public enterprise is run on high standards of performance and efficiency. In order to ensure that there must be some independent organization to keep a watch on such undertakings.

Fourthly, generation of substantial surpluses as a test of efficiency of the public enterprise must take into consideration the social costs involved as such.

Fifthly, the norm should be greater production and lower margin of profit, rather than restricted production and a higher margin of profit as usually happens in case of monopolies. The prime measure of efficiency as breaking-even, or slightly more than even, is at the greatest possible aggregate of production.

Sixthly, granted that public enterprises in the underdeveloped economies must earn a substantial margin of investible surpluses for generating resources for further development, it must be borne in mind that the element of profit concealed in the prices of the products of public enterprises cannot be viewed on a uniform basis. It would, necessarily, differ from enterprise to enterprise depending upon the nature of the commodity produced and the importance of the industries, using these products as inputs, in the developmental programmes.

According to Professor W.A. Lewis, the price policy of every public corporation should be made subject to the scrutiny by an independent

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36Tripathy, R.N., *op.cit.*, pp. 267-68.
tribunal. \textsuperscript{37} Professor William A. Robson remarks that "there is much to be said in favour of a form where the arguments for and against proposals to alter the prices of goods and services produced by the nationalized industries can be ventilated in public before an objective and expert tribunal provided that the evidence and arguments are not confined to the formal or legal aspects but are directed to the basic questions concerning the management of the industry." \textsuperscript{38} Professor A. H. Hanson maintains, however, that in case of fixation of rates and prices by public enterprises, we are not primarily concerned with the dispensing of even-handed justice between producer and consumer for which a tribunal may be well suited, but with an aspect of economic planning. Policy, not justice, is the criterion, and policy cannot be decided by the process of weighing the arguments and counter-arguments presented by the variety of interested parties. \textsuperscript{39} Professor Hanson has conceded, however, that judicial types of specialized bodies having adequate expertise to inquire into price policies and to make recommendations may have some use, a price policy cannot be imposed on a public enterprise; it has to emerge from consideration of the facts and the most important of those facts are the costing data and market forecasts produced by the enterprise itself. \textsuperscript{40}

\textbf{SELECTED BIBLIOGRAPHY}


\textsuperscript{39}Hanson, A.H., \textit{op.cit.}, p. 439.

\textsuperscript{40}\textit{Ibid.}, pp. 439-440.


