Macro-Economics and Public Policy in economically underdeveloped areas[1])

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1. Introduction.

The subject of my address today is mainly related to the field of analysis and theory, although emphasis is being laid on their implications for public policy.

This does not imply a disregard for practical problems in specific fields of underdeveloped regions. On the contrary, we have witnessed, how member countries of ECAFE have recently been together to discuss and labour on particular issues of high importance to the economics of our part of the world. But if we want to prevent ourselves from engaging in rather unimaginative fact gathering or from bogging down under the burden of day-to-day administrative decisions, a retrenchment at certain times into the spheres of analysis seems to have its merits, if only for the purpose of cross-checking theory and practical experience. It should also help to clarify some important issues of public policy.

The economist's contribution in this context is threefold: (1) he can assist in the formulation and the clarification of social ends; (2) he can assist in determining what facts will be economically relevant to the consideration of a problem; it follows that he requires a theoretical framework to select such relevant facts; (3) he can aid in the selection of means to the attainment of given objectives.

2. As a starting point reference is made to a method of economic analysis which is commonly known as the macro-economic approach. Stress is laid on the operation of the economic system as a whole with the application of so-called aggregative concepts such as the national income, the level of employment, the volume of private investment and consumers' spending, government spending, — all of them as total (aggregate) quantities. [2])

I shall rely mainly on the analytical equipment as developed by Keynes and post Keynesians such as Hansen, Hicks, Harrod, Samuelson, Lerner and others.

Modern analysis of the determination of income and of income-fluctuation constitutes an intergrated theory based on three strategic concepts:

(a) autonomous investment as a determinant of income,
(b) the role of the investment multiplier (based on the consumption-function) in relation to income-formation,
(c) the fact that changes in income affect the inducement to invest (the role of the accelerator).

With regard to investment, Keynes has followed largely the investment-theory of Spiethoff and Wicksell, while the accelerator-principle was already stated by Aftalion (and at a later stage by J. M. Clark). Keynesian economics obviously, has its roots in a long development of economic thinking; as far as the macro-economic approach is concerned, one may even go back to Lauderdale, Malthus and Marx.

While taking full cognizance of the essential continuity in macro-economic thinking, it must be stressed, however, that it was only after Keynes introduced the concept of the consumption-function that modern economics is able to provide an intergrated analysis, as a theory for the explanation of business-cycles.

1) Public lecture on the Anniversary of the University of Indonesia, February 16, 1953.
2) This method is contrary to the predominant features of the analytical tools in classical and neo-classical economics, which were mainly concerned with the study of individual households and firms.
Their theory was focussed on the behaviour of individuals: as consumers, workers, landowners, investors. They took for granted that the picture of the economy as a whole (the macro-economy) would automatically be a summation of the behaviour of the individual household and firms, without direct examination of the aggregative relations.

Not until Keynes introduced the concept of the consumption function [1]) and subsequently the theory of the investment-multiplier, was it possible for modern economics to establish relations of fluctuations in investment to fluctuations in income, taking account simultaneously the role of investment, the role of consumption as well as the role of money. [2])

Above interrelationsships comprise the mechanics of the process of expansion and contraction, which opened new perspectives in regard to the principles of public policy.

The central objective of public policy of the leading industrial countries is as we know reflected in the term "full employment", a concept related to the size of the wage-earning labour force, e.g. the number of people willing and seeking work for wages and for the normal hours of work.

Before we go on with the aspects of public policy as based on modern economic analysis, it may be useful to digress a little to deal with often-heard charges directed at Keynesian thinking. It is sometimes suggested that Keynesian economics is primarily a product of the depression; as depression economics therefore it should be regarded as obsolete, not having validity for a post war situation with strong inflationary tendencies. But it is just as easy to explain one phase of the business-cycle as any other with Keynesian analysis, provided we take into account the correct structure of relationships involved during each phase. [3])

One can even go further by stating that it is only with the Keynesian tools that a thorough understanding can be obtained of situations of either deflation or inflation, with the use of the gap-analysis (deflationary or inflationary gaps).

Furthermore it is true that Keynes' own theory was mainly static and not truly dynamic. It was a theory of equilibrium of the economy as a whole and of movements from one equilibrium position to another. [4])

But it is equally true that the theories of trend developed by Harrod, Hicks and above all Hansen were made possible only on the basis of the Keynesian system and with the application of Keynesian tools. Witteveen [5]) amongst others maintained that a theory of underconsumption (as he regarded Keynes' views) would bear validity only in situations of structural overcapacity (with availability or excess of capital equipment) while in a period of structural capitalscarcity ("bottleneck" levels) the overinvestment-theory would come again to the fore. We see here that the influence of continental thinking as represented by the investment theory of Spiethoff still looms large in Witteveen's approach. It seems to me that Witteveen has not or inadequately realized that the modern theory of fluctuations provides in itself the selflimiting factors, caused by a falling marginal efficiency of capital, a flattening of the rate of increase in output (whereby induced investment declines) and by the slope of the consumption function (widening of the gap between consumption and investment) as full employment is being approached.

Autonomous investment becomes progressively exhausted the longer the boom lasts. [6]) Once the rate of increase in output begins to taper off and the accelerator begins to fade out, then both autonomous and induced investments will tend to die down. The system does not progressively feed on itself, it does not move on indefinitely in a cumulative fashion. [7])

3. Modern analysis, then, reveals that so long as the economy remains dynamic (so long as the requirements of growth and progress call for large investments outlays) volatile cyclical fluctuations are inhaerent in the nature of such economy. Modern theory of income and employment has greatly clarified outstanding issues

1) the ratio of consumption-expenditure to income at different income-levels.
2) Cf. Alvin H. Hansen: "Business cycles and National Income", 1951; p. 491, p. 493.
3) Cf. Lawrence R. Klein: "The Keynesian Revolution", London 1950; p. 153.
4) Cf. B. H. Higgins: "What do economists know", Melbourne 1951; p. 43.
5) Cf. H. J. Witteveen: "Conjunctuurtheorie en Conjunctuurpolitiek", Haarlem 1952.
6) Investments being determined by: (a) the expected returns on new capital goods. (b) the costs of the new capital goods, (c) the rate of interest.
7) Cf. Alvin H. Hansen, ibid. p. 496.

of public policy. Two principal methods have since been recommended to ensure stability at a level of full employment: stabilization of investment and/or stabilization of aggregate demand.

A policy for stabilizing investments results from the consideration that the volatile nature of investmentfluctuations represents the major primary cause of economic instability. The problem of instability could therefore be largely solved if adequate measures could be devised to stabilise the rate of investments. Apart from practical difficulties in regard to efforts to stabilize the rate of investments, there remains the question that even if the level of investment can effectively be stabilized, economies might still be faced with the problem of ensuring that the total demand for goods and services generated in the economic system should be adequate to guarantee full employment. It is for this reason that many industrialized countries have usually resorted to the alternative approach, viz. that of influencing the general level of consumers' demand rather than attempting to control investments directly. This second approach seems also less difficult to implement, as it appears that the multiplier process operates equally strongly whether income is raised in the first instance by an increase in investment or by an increase in consumption. A stabilization of total effective demand would in itself exert a stabilising influence on the level of investment and this in turn would further stabilize consumption so that fluctuations of both could be reduced to smaller magnitudes. [1])

It is obvious that both methods of public policy must be implemented through the budgetary policies of governments. Government in other words must play through its budget the role of a balancing agent resorting to a managed compensatory cycle policy. In this context government should supplement or stimulate total private spending on consumption or investment by exactly the amount that will maintain full employment. Private outlays plus public outlays must result in a total required to reach full employment. If conditions are such that the problem is of one filling a deflationary gap (in periods of depression), government must undertake a program of positive spending activities. On the other hand if under changed circumstances the task is to level off an inflationary gap, government activities must be directed at negative spending. Next to **spending policy,** government can also make use of **fiscal policy.** In the case of stimulating investment it may be done by reducing business taxes in order to increase the incentive to invest. If it wants to increase consumers' spending, the logical method would be a fiscal policy directed at a redistribution of income, whereby purchasing power is redistributed from the rich (with a relatively high marginal propensity to save) to the poor (with a relatively high propensity to consume). In this way governments try to affect the purchasing power of consumers by changing the level and structure of taxation. These then are the main themes of public policy as formulated in industrial countries under the impact of modern macro-economic analyses.

4. The fundamental question posed before us now is as follows: what bearing does analysis (as represented by Keynesian and neo-Keynesian thinking) have in regard to conditions and problems of underdeveloped areas? To what extent do we accept the scope and validity of analysis and public policies as developed in modern macro-economic thinking? Let me start with a few critical remarks which may lead us further to the subject of economic analysis and public policy in underdeveloped areas. First of all we must be aware that Keynes and the neo-Keynesians have developed and applied their analytical equipment under circumstances and to problems prevalent within a social framework whereby certain structural factors are taken as given data. Basic aspects of the social organization, such as the stage of technological progress, availability of capital, the existence of modern economic and financial institutions, the effect of customs and social behaviour, groupconflicts and the like are regarded as given. It is **within the context** of such existing data, that attention has been

1) "National and international Measures for Full Employment", U.N. publication 1949. II. A. 3, p. 37.

concentrated on economic analysis and economic policy. This observation in no way belittles the value of macro economics; its approach in this respect was only logical and understandable. Neither does it imply that economists of the west have not been aware of the effect of customs and institutions on economic behaviour. But regarding those sectors as data, they naturally were concerned only with their **effects** on economic behaviour while not considering it their duty to study how those phenomena arose or should develop in the future. Nor do I hold that therefore the theoretical framework and the tools of analysis of the Keynesian system have completely lost validity in a different set of social circumstances.

My purpose in this lecture is to show, **with the use of the same analytical tools,** that a different set of economic and social conditions will throw a different light and often new perspectives on the principles and policies as modern macro-economics have hitherto suggested. Keynesian and neo-Keynesian economics have given us a set of tools primarily directed to solve problems of employment and unemployment, expressed in terms of percentages of wage earners, out of work and seeking work. Under related conditions of the social setting it is logical that the role allocated to government should be confined to that of a balancing agent engaging in counter cyclical (compensatory) policies. However, from our viewpoint here it must be stressed that we will only come near to a solution of our outstanding problems (in underdeveloped countries) through efforts which will bring about **a change in structural conditions,** which by neo-Keynesians are usually regarded as given data of the social setting.

Thirdly the fundamentally different nature of the problems and the issues accordingly sets forth differently formulated economic objectives. It is not the issue of full employment in terms of wage-earners or the maintenance of effective demand that are dominant in our minds, but the problem of development, i.e. raising productivity, raising output and income per capita. Should government play not more than a balancing role (such as in highly developed areas), it would less than adequately solve even the minor problems of underdeveloped areas.

5. After these preliminary observations let us now endeavour an intergrated approach with regard to analysis and public policy in underdeveloped areas. It has become clear to the audience, that my argument is built around three strategic angles:

(a) factors related to the economic structure,
(b) aspects of economic power within the social framework,
(c) aspects of social institutions and social behaviour.

Structural aspects of the economy.

I shall only submit a brief enumeration of the characteristics in the economic structure of underdeveloped areas. Generally the level of production and income depends on a limited range of activities related to an undiversified agrarian economy; the direction of production is concentrated on food and raw materials essential to industrial countries (inclusive of extractive minerals such as in the case of Indonesia). The lack of industrial capacity, obsolete techniques of production in the agrarian field, increasing population pressures on arable land have resulted in low productivity both in aggregate and per capita, and an income that is often below the subsistence-level. Large-scale rural underemployment in many disguised forms is a characteristic phenomena of most Asian countries. The instability of export economies and their dependence on foreign trade have been aggravated by the continued deterioration in the terms of trade. Such has particularly been the case where exports consisted of a relatively few primary commodities. It is now a generally accepted contention that basic commodities — raw materials for industrial use — are subject to violent fluctuations in prices. The fall in prices are usually not compensated by an increase in the volume of exports. More often than not changes in quantities (decreases in volume) are added to the deterioration in prices. The total value of exports may vary within a short period and a total fall in value amounting to more than 50% within a period of some years is not uncommon, as we know by the experience of our own country. Sensitivity to economic fluctuations, generated originally in industrial countries, makes societies in underdeveloped countries therefore extremely vulnerable. We observe here the working of the accelerator in a very specific form, viz. as a result of the dependence on effective demand abroad. The farther the productive process is removed from the final consumer, the wider the magnitude of the fluctuations in output (and exports). Fluctuations in the consumers demand produce wider fluctuations in the output of semi-finished products and even wider fluctuations in the exports of raw materials producing countries. [1]) The secular movement of the terms of trade over a long period, have caused great anxiety among people in our areas. For the last 60 years basic agricultural commodities lost 40% of their value in terms of manufactured goods. The combination of factors and conditions, such as mentioned above, constitute in themselves grave impediments for a steady public policy, steady development and steady investment in underdeveloped areas.

Socio-economic aspects.

Within the social environment of economically underdeveloped regions, lack of technological, organizational and managerial skills deserves the greatest of attention. While this is more or less a consequence of the social framework, it has adverse consequences in the economic sectors. Nowadays the economic process is based on the availability of skill in all forms; the element of managerial skill can even be regarded as the fourth agent of production. In this context preservation of long standing social institutions and social habits can in themselves be substantial obstacles towards modernization, economic development and social progress. Above economic and social factors are also the underlying causes for an everincreasing state of indebtedness of the rural population. In areas where there is a concentration of landownership with a relatively small section of society (and consequently large scale land-tenure), the state of indebtedness of tenant to landlord tends to be perpetuating in a cumulative way. Where there is no landlordism in the sense of accumulation of property-titles, the plight of the rural population is in fact not very different. In such cases — where peasants are smallholders — they are usually indebted to commercial middlemen or to moneylenders living in urban centers. Either the crop or the land — often both — are mortgaged against money-advances.

As the creditors control the prices of the crop, the proceeds are usually inadequate to redeem the debt. Prolonged indebtedness results in landmortgage and the peasant becomes a tenant or sharecropper on his own land, to which he still holds nominal title. Accordingly actual absentee-ownership exists even where there is supposed to be no landlordism.

Concentration of economic power.

Economic control is usually vested in a relatively few private groups, whether foreign or indigenous, which in the first place control export channels and are concentrated in commercial centers. In economies where exports are an important determinant of aggregate income, it means that such interests control a substantial part of the nation's income. By combining their business with the imports of manufactured goods from industrial countries, they control or at least influence the supply and flow of finished goods to and within the country. It is not uncommon that through an intricate system of corporate structures they also have their hand in banking and other financial institutions, in land-transportation as well as

1) This is due to a tendency to stock up in an expanding market and to sell from stock in a falling market.

shipping. The powerful influence of such oligopolistic groups in the economic process is increased by the fact, that they sometimes finance the commercial middleman to whom the producers in rural areas live in a state of debt. In general the class of commercial middlemen form the distributing channels of the importhouses (combined with exportbusiness) and work to some extent with money-capital and credits, supplied by the big enterprises. It stands to reason that such concentration of powers is not to the advantage of an equitable distribution of wealth and income.

We come to the conclusion then, that the ultimate causes of poverty and unemployment in economically underdeveloped areas are directly related to the existing social framework and its inherent structure of the economy. Inefficient organization of the economic process, obsolete techniques of production, low productivity, instability of income, gross inequality of wealth and property and inequality in the distribution of gross and nett-incomes, are logical consequences. A near solution to the outstanding problems of the areas under discussion must therefore involve efforts directed at effectuating structural changes, based on an integral approach towards economic development and social progress.

6. Outline of basic considerations in public policy.

I shall make merely for the sake of clarity a division between the field of general economic policy and that of financial policy. With the lack of adequate industrial capacities and in view of the retarded development in the agricultural sector, it is obvious that no change in the economic constellation can be achieved without industrial development. Only through a balanced progress of agriculture and industry can stability of production and employment be safeguarded at an expanding level with rising per capita output and rising per capita income. I will not in this context deal with specific aspects of industrialization, but shall only make a reference to the macro-economic aspects of industrial development in its relation to the burden of rural disguised unemployment. As industrial development and technical progress proceed, possibilities are opened for the population to be fed from the labour of a smaller proportion of itself. [1]) The labour thus released, moves from agricultural into other occupations for which the possibilities have been opened. An expansion of employment opportunities will have a favourable influence on the standard of living as reflected in per capita income. Furthermore development such as referred to can also lay the foundation for social progress and for modernization of the societies involved.

The role of governments.

With a view to the fundamental difference in scope, magnitude and nature of the problems as well as of the formulated objectives, the role allocated to government in regard to public policy gets also a different meaning. Unlike the case in an industrially developed economy, government in underdeveloped countries cannot limit itself to be a mere balancing agent trying to stabilize investment or effective demand through budgetary programs, countered to business-swings.

Government therefore must actively determine and influence the direction of production and investment. A much more active role is thus given to government for laying the foundations of development and modernization, both of agricultural production and industrial activities.

Would it not be far easier and more feasible to leave everything to private initiative, so that the process of development and modernization in its entire scope can be implemented by the more active private elements, either domestic or foreign? Offhand, such reasoning seems to bear a great deal of logic. But if we look further into the matter, several aspects deserve attention, which may throw a different light

1) Cf. "Measures for the development of underdeveloped countries", U.N. publication No. 1951. II.B. 2, p. 59
Also K. Mandelbaum: "The industrialization of backward areas". Oxford 1947.

on the issue. First, should we leave everything connected with development of the economy entirely to private interests (most probably foreign) then in all probability investments will be directed to or concentrated on sectors already known, viz. agriculture produce (for export) and/or extractive minerals. Even if total production can be raised, it would not bring about any change in the structure of the economy and of the social setting; these may even be perpetuated. Total aggregate output may be increased, but it would not solve outstanding problems of underdeveloped areas, which as we have seen, can in the long run only be done by changing structural factors. It would continue to bear the same unfavourable aspects which would pose the very same issues which we now face: low per capita real income, concentration of economic power and accumulation of wealth, indebtedness of the rural population, sensitivity of the economy to world economic fluctuations, and further deterioration of the terms of trade. Past experience has also shown that foreign investment, if entirely left to private initiative tends to be extraordinarily unstable: it tends to dry up in periods of depression, at the very time when cessation is harmful to the maintenance of prosperity. While as we shall see foreign investment **should continue to play an important role,** the above **limiting factors** should be borne in mind. Finally there is an aspect to the problem which leads up immediately to the necessity of a more active role of government in the areas under discussion. Large scale private activities in the industrial sector (a direction of which I have advocated the desirability and the necessity) will only take place, if and when a certain minimum amount of social overhead capital is already available (power, transportation, highways, public utilities in general). In other words large scale private industrial activities presuppose the existence of such kind of capital investment. Otherwise while they may count on cheap labour cost, they will be at a great disadvantage in terms of external economies by the lack of social overhead capital. One may say therefore with a good deal of justification that **government activity must to a certain extent substitute** and make up for the lack of "autonomous" investments (which in the industrial countries in its early stages were implemented by private initiative). If this is recognized, then it becomes plain at once that the issue of public investment is decisive to the attainment of formulated objectives. Government's primary task in the economic process therefore is to create the conditions to enable public investment. Public policy in industrial countries can be confined to a policy of stabilization (of investments and/or effective demand) because of the existence and the availability of a minimal amount of capital accumulation (through autonomous and induced investments in the past and the required organizational and technical skills. But those agents of production are not or inadequately available in underdeveloped areas. Public investment activities of government comprise the sector of capital investment as well as of human investment. In terms of capital investment there is the responsibility for the formation of social overhead capital covering a.o. the following sectors: the establishment and expansion of electric power, transportation and highway-construction, communications, irrigation and soil conservation, assessment of natural resources and the like. Without adequate facilities in these fields, i.e. without sufficient public investment to be devoted for social overhead capital, no substantial progress can be made, either in the agricultural sector or as to industrial development. If next to the formation of this kind of social overhead capital it is also a necessary condition that efforts be made to organize or improve extension services, to aid co-operatives, to improve financial institutions, to mobilize savings and to channel these into desirable projects. In the near future human investment is at least as important as capital investment in the sense of social overhead capital. Specific reference is made to the organization of technological, managerial and administrative skill. It applies to the sector of public administration as well as to that of business organization. In many cases investment in people would lead to a greater increase of the flow of goods and services than would follow upon any comparable investment in capital. No matter how many capital goods are made available, progress in countries with an economic and social constellation such as ours will be greatly hampered or slowed down, unless primary attention is given to the [illegible] above all of qualified and honest public administrators. The importance of a good public administration is directly related with and a logical consequence of the active role that government must play in the economies of underdeveloped regions. This point gives me an opportunity to clarify possible misgivings in connection with what I have said about the direct organization of production and investment, in particular of public investments. My statement above does not exclude the services of private enterprise. On the contrary I do not think it wise, that the government apparatus itself should engage in the implementation of for instance electric power projects, or highway construction. It can be done more quickly and efficiently by contracting it to private organizations, specialized in this kind of work. But it must be done under a policy planned and determined by the government who retains control throughout. Outside public administration and extension services, encouragement should be given to the development of skills in terms of business-management, technical and manual work, craftsmen, etc. Skills of these kinds are also required to increase the bargaining position of rural producers and rural labour vis-a-vis other economic groups of the community. This brings us to the aspect of economic power in societies of underdeveloped countries. We have seen that the existing conditions regarding economic control do not have a favourable effect upon the distribution of wealth and income. In industrial countries redistributive taxation has often been advocated as a corrective means to obtain an ultimate equitable distribution of (net) income. It would not work in most underdeveloped countries, because fiscal policy in this respect does not go to the ultimate causes. The most logical cause of action would therefore seem to gradually, but steadily alter the conditions which determine the distribution of gross incomes (e.a. incomes before taxation). Fiscal policy can then serve as the "residual" element and the supporting implement of public policy. A way to alter in a democratic manner existing power relations amongst economic groups of the community, is to actively increase the bargaining strength of procedures in rural areas as well as of labour groups. Bargaining power of small producers either engaged in agricultural production or in cottage and small-scale industries can best be achieved by organizing and sponsoring cooperatives on a nationwide scale. Credit cooperatives and production cooperatives should be integrated and connected with marketing cooperatives, the latter serving as the former cooperatives' buying and selling agencies. Neglect and lack of commercial skills on the part of small producers have been primary causes for indebtedness and exploitation by the other groups of society. Organization and development of the cooperative-movement should therefore be based on an integral approach towards the credit, the production and the marketing aspects of the problem. Attention should also be paid towards increasing the bargaining power of labour by the organization of healthy labour unions based on sound principles. One of the major objectives in a policy purportedly to sponsor strong and healthy labour-unions is through the organization of training programs to increase skills and productivity. Labour policy in this respect should be directed at the prevention of workers-exploitation, raising productivity and skills, the acquisition of a sense of responsibility and the development of leadership.

In view of the powerful position of commercial interests in urban centers, and of the importance of foreign trade in the economies of underdeveloped areas, governments cannot fail to exert control on foreign trade as well as on foreign exchange. According to particular circumstances, such control can be exerted indirectly through a system of licenses or in some specific cases by directly organizing government agencies as single buyer and/or single seller. This may sometimes be necessary with regard to commodities, which are of economically strategic importance to production, employment and income of the countries concerned. Matters regarding foreign exchange must be absolutely controlled by the government to ensure their most economical disbursement in relation to development. In passing it may be mentioned that there is not infrequently a conspicuous tendency on the part of certain groups in the community to invest in bankdeposits abroad. I have indicated above the active function of government in the public sector, and stressed the need for increasing the bargaining strength of procedures and labour groups. This does not mean that there is only small room left for private initiative and individual enterprise. On the contrary, even in the implementing aspects of the formation of social overhead capital, it was advocated to incorporate private organizations' activities. Private activities, however, should not infringe on the general interest of the community. Where they do not run counter to the fundamental principles above, it is even the duty of government to give leadership, aid and guidance to private initiative. But the state should retain the powers to exert control if it wants to and to influence at all times the size and the direction of economic activity of private enterprise.

7. **Social institutions and social habits** prevailing in the agrarian economies of underdeveloped regions are often impediments to economic development and social progress. They constitute in a number of cases obstacles to the **mobility of capital,** the **mobility of labour** and **to the formation of modern skills,** — factors all of which are required to meet the issues posed by present day world-economy. Emphasis was laid earlier on an integrated approach towards economic and social development. In this context it follows that if **education** must perform its proper social function, then its foundations, nature and scope must be determined by the specific requirements as conditioned by the process of economic development and social progress. Educational aspects of society should be so organized as to contribute in easing the difficulties connected with social transitions. Economic and social development and education are here interrelated factors, which should be concentrated at creating conditions which will enable the dynamic process of social change to take place on the basis of active and voluntary cooperation of rural populations.

8. **Public finance, fiscal policy and monetary policy.**

The principles guiding financial policies are fundamentally a corollary of those infuencing general economic policy. In other words, the principles underlying general economic policy are here translated into money-terms and into practical financial principles. By the same token the application of policies in the field of public finance and in the monetary sector should also be directly related to the conditions which we face, i.e. conditions determined, as we have seen, by the social framework and economic structure. The structural and social data therefore greatly influence the choice of means in the application of budgetary, fiscal and monetary policies. There is a great variety of factors to be taken into account in the financial aspects of economic development; the combinations of the economic variables which are of strategic importance to the decision as to the best suited financial policy are sometimes greatly different in one country from the other. There are however some important aspects to which I would like to draw particular attention because they are of general value to underdeveloped regions.

Industrial countries have come to rely as we have seen on budgetary policies to maintain production and investment with a view to full employment. Government-spending policy (counter-cyclical budgets) has become an important, if not the most important, instrument of public policy in safeguarding income and employment. We have observed in this context how particularly the stabilization of aggregate effective demand has come to play an increasing role. This concept, however, — and this should thoroughly be kept in mind — relies heavily on the working of the principle of derived demand, which through effectuating a certain level of (money-)income (effective demand) may keep investment and production at a high level as the result of the spending effects of such income. Accordingly, the effect of (increased) effective demand should be that orders for new good are given, that factories will come to work and provide more additional employment. The maintenance (or increase) of a certain level of income should guarantee the required

level of investment. However, ...
"induced investment". Investment is here "induced" by the maintenance or increase of income. But as we know income itself is a function of investment but of another kind of investment that has taken place sometimes in a preceding stage of development whereby savings of the community have enabled the accumulation of capital ("autonomous" investment).

In short, the principle of derived demand **presupposes** that in a prior phase autonomous investment has taken place. Only where there are excess reserve industrial capacities or maybe even idle factories, increases in effective demand will result in additional investment, production and employment (induced investment responding to the working of the principle of derived demand). Secondary expansion of production in other words will take place only where there is capital (a minimum of capital accumulation formed sometime in the past) that still can be used to increase the production of manufactured goods. Such a situation does not yet or only to a minor extent exist in many Asian countries. Now that we have considered the accelerator (= principle of derived demand), what is there to say about the other strategic factor in Keynesian and neo-Keynesian analysis, viz. the multiplier? In as far as the multiplier-process is based on the consumption function, we face conditions where in substantial areas the community's marginal propensity to consume is high, probably not far below unity. This factor would suggest a high multiplier-coefficient. There are however, specific counter balancing factors which may result ultimately in a smaller net-multiplier-coefficient than would follow from an arithmetic conclusion based exclusively on the marginal propensity to consume. An inhaerant characteristic of underdeveloped regions is that substantial parts of the economy are not yet incorporated in a money-economy. Prevailing social habits and institutions may also slow down the multiplier. Finally the fiscal process in underdeveloped areas does usually not redistribute incomes from savers to spenders. The fiscal structure usually shows a great number of taxes encroaching upon consumption. It may therefore well be possible that the ultimate effect of the fiscal process in underdeveloped areas is a net-redistribution from spenders to savers and consequently a reducing influence on the velocity of money circulation.

Obviously, above realities with regard to the working of accelerator and multiplier bear consequences as to financial policies in underdeveloped areas. In regard to government-spending policies, undue increases in the flow of money and total outlays are more dangerous than in highly developed countries where industrial equipment and capacity are available. Increases in effective demand can there be met to a considerable extent by enlarged output based on existing capacity or capacity that can be increased within a not too long period. The output of underdeveloped areas is much less responsive to sudden or undue increases in purchasing power. Monetary effects may result in an increase in the propensity to import, especially on the part of wealthier classes with higher incomes, who under such circumstances usually tend to engage in conspicuous spending, causing an unjustifiable drain on the balance of payments. Surplus purchasing power may also result in speculative hot money, seeking its way by hoarding raw materials as well as manufactured goods which ultimately results a rise in the costs of living. The above considerations do not imply that we must go to the extreme and reject a priori a policy of deficit spending, or that we must now suddenly return again to the orthodox concepts of annually balanced budgets. It does mean, however, that a budget deficit should be judged upon its domestic monetary consequences, its effects on the balance of payments position (and vice-versa) and the possibility to raise output (potential production) for maintaining monetary equilibrium and economic stability. In the short run a deliberately created deficit on the balance of payments may help to relieve inflationary pressures particularly if it takes the form of an import surplus of commodities reducing money in circulation.

Whether or not and to what extent the effect of a budget deficit can be mitigated by a balance of payments deficit, depends of course on the availability, if at all, domestic production. It is equally important to prevent a depletion of exchange reserves to levels endangering essential imports or international solvency.

The **direction of spending** is important in that way that the flow of money should be so directed as to contribute in breaking economic bottle-necks which prevent the country's output from expanding. Therefore, the flow of money should primarily be devoted to the sectors where output can be raised within a relatively short period. Also from a "structural" development point of view it is of utmost importance that deficits be devoted to development projects of great economic value that will ultimately increase or **create** the **capacity to produce** consumers goods.

The decision as to how to direct the funds created by deficits must therefore be dictated by economic reasoning in the first place. In industrial countries it is sometimes argued that the direction of spending is of secondary importance, as it is not of essential revelance, whether the decision is influenced by considerations of social priorities or by economic reasoning. This argument as we have seen is valid only to the extent that one can rely on the working of the principle of derived demand. The above analysis leads us to the conclusion that public policy should strictly keep in mind a harmonious synchronization of budgetary policy, trends in the balance of payments, production and development planning.

Coordination and integration between budgetary policy and development policy is imperative because an attempt must be made to devote a larger share of total resources to the formation of capital (to compensate the lack of autonomous investment).

8. Consumption and investment.

This brings us to the issue of the **ratio** between total **consumption** and total **investment** in a country. The fundamental problem in underdeveloped areas is the need to divert resources from uses which do not contribute to development to uses which do. It is obvious that in these areas consumption can be reduced but very little in the process of development, because it is already so low on a per capita basis.

The general rule then would seem to suggest itself that in the course of a development programme, the per capita level of consumption should at no time fall below the initial level, while subsequently a rising proportion of additional output should be devoted to additional capital formation. This fundamental concept on the division of resources between consumption and investment, is based on the reality that even a temporary curtailment of consumption would involve too great a sacrifice to be compensated by the prospect of greater consumption in the future. On the other hand, a significant improvement of the economic situation in underdeveloped countries is in the long run attainable only through a substantial increase in the rate of capital formation. The best approach seems to be to restrain the growth of consumption by capturing **increases** of income and directing them into development (and not to cut consumption in absolute terms) [1]) It follows that an increase in consumption must sometimes be prevented for a certain period. Economic development is not a shortterm proposition but a continuous process extending over a long period.

It is here that fiscal policy and measures can play an active role for the purpose of siphoning off additional income (particularly of higher incomegroups), and channeling it into the hands of the government for further use in the investment sector. One of the primary tasks is then allocation of an increasing share of total available resources for the creation of social overhead capital as stressed before.

9. Public investment and private investment.

It is difficult to determine a fixed ratio between public investment and private

1) Cf. also Walter S. Salaut in: Les aspects financiers, fiscaux et budgetaires du développement des pays sous développés, page 67.

investment which would be valid under all circumstances. The proportion between public and private activity varies from country to country. It depends in the first place by what is considered as the minimum rate of formation of social overhead capital. Subsequently there are the functions which sometimes governments must perform because private enterprise fails to perform sufficiently. On the other hand public interest sometimes demand that governments must reserve functions to themselves which otherwise private enterprise would be anxious to perform. Even beyond the public sector of the economy as we have seen previously there remain functions for the government in the sector left to private initiative and private investment. In the latter case, then, the desirability of controlling or at least **influencing the size and direction of private investments comes to the fore.**

Again, there are social and institutional factors which bear an impact on the ratio between public and private investment. Viewed from an opposite angle, there is the reality that the size of public investments is directly related to the means that governments can claim for themselves from the total resources of a community (i.e. to what extent governments can claim through taxcollection). The limitations become obvious when we note that a recent ECAFE publication indicate that if a government wants to build capital on public account (i.e. altogether by means of taxation), it would require the proportion of national income taken in taxes to increase very steeply so that it eventually would include both 15% or so which modern welfare governments need for current purposes and **another** 20% or so for gross capital formation. [1]) Such would be the case if we want to effectuate capital formation of a country entirely through the funtions of government (no private capital formation). Up till now governments in Asia have in practice carried inadequate ratios of their budgets which have been devoted to public investment. [1]) It means that the burden of current administrative expenditures on the community have been too large in relation to the really productive activity of the State.

Referring to taxes, it seems to be a common feature in underdeveloped countries that by and large the major part of government revenues is derived from indirect taxes of which the greater part constitute taxes on consumption. They either take the form of import and/or export duties, excise taxes proper, or shifted business taxes. This too is related to the social structure, imperfect public administrations and inadequate expansion of economic organizations. Only recently have Asian countries introduced income taxes or business profit taxes with a certain degree of progressiveness in the taxstructure. Import- and export duties if rightly applied may also imply a certain progressiveness. Where the consumption pattern of urban centres differ greatly from that of the rural population, the imposition of import-duties (whether or not differentiated) result in a higher tax burden on the relatively well-to-do, compared with that on the rural people. By the same token export taxes may contain progressiveness to the taxstructure if the export sector of the economy is exclusively or largely in the hands of the upper income groups, such as usually is the case. At some stage in the postwar period, high prices of raw materials resulted in large, if temporary, windfall profits which accrued mainly to the exportsector and which were confined to a few business groups. The inflationary effects and the danger of conspicuous spending should therefore be siphoned off through the imposition of export taxes. The utilization of such tax-proceeds for the financing of development expenditures means at least a temporary increase in the rate of capital formation. If we accept a previously advanced contention that in the process of economic development the initially prevailing level of consumption should not become lower, then the burden of development expenditures (whether public of private) should fall primarily on the middle and upper income-groups. In other words the revenue needs should be derived from the taxation of such higher incomegroups. The argument that an increase in the taxation of the business classes will curtail investments loses much of its strength if we bear in mind that through appropriate

1) ECAFE: "Economic Bulletin for Asia and the Far East", Bangkok November 1952.

credit institutions additional investment funds can be provided for essential investments. Therefore the imposition of additional taxes on the upper income brackets in underdeveloped countries need not curtail productive private investment to any significant degree and may in the long run even likely increase. [1]) Summarizing at this stage, public finance and fiscal policy with a view to economic development should keep in mind the following criteria: (a) to transfer funds of proper magnitudes to the state for government use, entirely or mainly to finance public investments; (b) transfer savings from the private to the public sector and vice-versa to assure their most productive utilization, (c) influence or if necessary even control the size and the direction of private investment. The necessity of the latter consideration is based on the experience of many Asian countries that there is a tendency of owners of investible funds to engage in profitable investment opportunities which are however often neither those which appear the most economically nor socially the most desireable. Fiscal policy in this context must therefore be directed at the encouragement of investment of fixed capital producing goods and services for the market, the curtailment of profitable but less productive or even unproductive investment, and the tying-up of a relatively high proportion of total savings frequently intended for short run speculative purposes.

In view of the necessity for integration of **fiscal** and **monetary** policy, government cannot fail to exert control over the banking system. This certainly applies to the central bank. Government must completely control the central bank because of its importance in the monetary sector. On the basis of experience and analysis of the last 20 years the gravity center of monetary policies has shifted. Whereas before the prime objective of monetary policy was to maintain the value of the monetary unit in terms of gold, in present day economics, monetary policy is an active instrument for the attainment of monetary and economic equilibrium. Monetary policy therefore com price problems of interdependence and interrelations between monetary aspects and economic activity. Furthermore an active role must be given to the central bank in the process of economic development. Since monetary policy is but an aspect of public policy, it goes without saying that government must at all times be able o lay down policy directives to the Central Bank, as the most important instrument in the monetary sector.

With regard to private commercial or industrial banks there is need for general banking legislation by which government (either directly or through the central bank) can exert control over the banking system. Government is helpless in its efforts to tackle monetary problems (inflationary or deflationary trends) or unemployment if it is not in a position to extend its powers over the commercial and other private banks. Monetary policy is of importance in underdeveloped areas, where the marginal efficiency of capital is likely to be high.

10. Even if governments in such countries should set out to capture the proportion of resources in the national income required for total investment expenditures — formation of capital for economic development entirely on public account, i.e. 35% of the national income in taxes, of which 20% to be devoted gross capital formation — it is still very doubtful whether they would be able to raise the total absolute amounts required by the objectives of rapid economic development. Generally speaking the countries in Asia suffer from insufficiency of investment outlays. Under the circumstances people in Asia do not provide enough in current savings and/or in taxes to finance capital accumulation of the magnitude sufficient to keep pace with population growth and at the same time to provide the basis for raising the standard of living. [2])

1) Cf. J. H. Adler in: "Les aspects financiers, fiscaux et budgetaires du développement des pays sous développés", page 83.
2) For brevity's sake on this subject, I refer to: "Measures for the economic development of underdevoloped countries", U.N. series 1051, 11B2.
For Indonesia in particular, see my article: "The budget and its implications" in "Ekonomi dan Keuangan Indonesia", January, 1953.

The insufficiency of investment outlays constitutes the great dilemma for underdeveloped areas. It is in this context that foreign private investments and/or foreign aid come to play an important role. However, we want to pursue the objectives as set forth in this address, outside aid (government-loans or technical assistance) and private foreign investments should be entirely geared to the plans and programmes as formulated by the governments of the areas involved. Within such framework it stands to reason that adequately renumerative terms and conditions be provided for foreign capital.

I should like to stress that the question of inadequate savings of underdeveloped regions forms equally as great a dilemma to the highly developed areas. We have seen that public policy in industrial regions is focussed on full employment through countercyclical policies of stabilizing investment and/or aggregate demand.

But full employment in the industrial countries cannot be achieved, "except in the context of an expanding world economy of which the economic development of underdeveloped countries would form the most important single element". [1])

Thus **(counter)cyclical policies** of industrially developed countries and **development policies** of underdeveloped regions really are two aspects of **one world-wide problem,** which comprise the social challenge to mankind today.

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1) "National and International Measures for full Employment" U.N. Publication, No. 1949. II A. 3, page 12.