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A New Deal in Development Banking

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[Development banking institutions should be geared to encouraging not only growth in production but a wider distribution of economic power and ownership. Present trends are toward increasing concentration of private ownership and/or expansion of the public sector; some proposals for fostering broad-based savings and investment are outlined.]

A fundamental dilemma faced by leaders of developing countries is: how can these countries achieve economic and social adequacy—let alone fulfillment—without recourse to totalitarian methods? Most leaders schooled in liberal traditions generally prefer a democratic form of society as one of their objectives. Are they fighting a losing battle? Can economic progress be achieved, and the disparity between the "haves" and the "have nots" be reduced, only by centralizing all power in a monolithic state or by repressive legislation and violence? The proposal to be described here is intended as a method of addressing this basic dilemma. In terms of conventional ideologies it contains elements that may appear novel, or unfamiliar, but wise leadership should at least have an open mind, and be prepared to appraise critically new ideas, adopting or rejecting them in the national interest.

Some of the important deficiencies in the economies of most developing countries, particularly small ones, which are adverse to development and particularly industrial development, may be described as follows:

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a. Markets are narrow, and are based on a pattern of income and wealth distribution marked by conspicuous inequalities in both rural and urban areas, which reduces the potential for mass markets. A substantial proportion of the population remains outside the market economy practicing subsistence agriculture; transport bottlenecks further accentuate narrowness of the markets for industrial goods.

b. Fragmented and uncoordinated entrepreneurial activity has resulted in high real cost of production in the absence of economies of scale; and large-scale industries are not feasible, except in a few cases, because of the constraint imposed by the technically determined minimum size of machinery in the context of the small size of the market. Small-scale entrepreneurs lack technical, purchasing, marketing, organization and accounting skills; they are undercapitalized and, lacking access to bank credit, have to rely on expensive unorganized money markets.

c. There is a lack of adequate measures and institutional devices to promote and mobilize savings and channel them for investment. Monetary and fiscal policies, particularly interest rate and tax policies, consciously or unconsciously, encourage the concentration of economic power—either in the hands of a relatively few individuals, or in the hands of the state; and there is a lack of broad-based money and security markets.

d. The resulting conflicts between the "haves" and "have nots" create many political problems and have an adverse impact on growth. The trend towards state ownership is a symptom of this conflict; and nationalization of large-scale enterprises is largely due to the fact that they are usually identified with closely held companies.

Efforts to bring about a reduction of inequalities, however, should not reduce the investment capacity of the community. Every endeavor must be made to increase the savings and investment capacity of the community and to direct it into the most desirable investments, taking into account the needs of the masses. Capitalists are traditional savers and investors. The masses generally are traditional consumers. The leveling down of the relatively few rich and the leveling up of the masses should be achieved progressively, and must be accompanied simultaneously with an increase in the investment capacity of those who constitute the masses, so that the savings and investment capacity of the community as a whole, which is so essential for economic growth, will not be jeopardized.

Methods For Mobilizing Savings

The United Nations and its agencies have from time to time issued reports on the subject of savings in great detail. They cover household savings; savings through commercial banks, purely savings institutions, life insurance organizations and provident funds; corporate savings; public savings through tax measures as well as from profits of government undertakings, and through restraint of government expenditure. They also cover fiscal and monetary incentives and such institutional devices as unit trusts. Education of the people on the importance of savings has been tried out both extensively and intensively by governmental and private organizations. All these incentives and devices have had varying degrees of success depending on the country concerned. Generally speaking, however, the efforts that have been made from time to time to encourage savings and investments have not been adequate for the needs of economic growth in newly developing countries. One common feature of most of the devices has been their dependence on purely voluntary savings, and on the wrongly assumed desire of the people, particularly at lower income levels, to save and to invest. Another common feature is that the savings are largely utilized by the state for its own requirements, or by a small and restricted capitalist class.

Among the various methods examined, provident funds providing savings for employees by deductions from their wages have been popular where they have been implemented, and also quite successful in the quantum of savings mobilized. Such schemes have never been objected to by the employees, and there is evidence that employees are often prepared to increase their contributions if employers would increase theirs. Provident fund schemes are generally popular even though the contributions are rigidly compulsory and the returns very small, and although the funds cannot be withdrawn until retirement or death of the member. The members ultimately receive their savings in the form of cash which has usually depreciated in real value, even over short periods of time. Nevertheless such schemes are popular because the political and economic environment does not provide adequate safeguards to other forms of investment, such as equities, also because the funds are usually invested in government securities and there is a false notion that these securities are "safe." It is not appreciated that they do not provide any hedge against inflation. Further, the savings mobilized in this way could often be better employed for development if they were invested elsewhere than in simply adding to total government resources.

Unit trusts, or mutual funds (in U. S. terminology), have the advantage that they can create investments in the private sector and are a convenient means of providing investment opportunities for the small man. But they are defective in that they do not provide adequate and direct incentives for savings, nor increase the willingness of the small income earners to save on their own initiative. The proposal to be described combines demonstrated advantages of the provident funds and the unit trusts; the safety and security of smallholder savings will be considered below.

Every developing country requires measures to achieve a greater monetization and mobilization of savings for investment, but these will necessarily vary from one country to another. For example, the measures needed to mobilize savings in countries which have opted for state ownership of the means of production will be different from those needed in countries which wish to give an important role to the private sector. The measures needed to broaden the ownership in the private sector cannot be identical with those which focus on savings of the wealthy few. Measures that would make small savers merely lenders to government, via government savings certificates or securities, or depositors in government financial institutions, would tend to concentrate economic power in the state. Measures that would make small savers largely lenders to financial intermediaries that serve only a privileged elite would result in the concentration of economic power in the privileged elite.

The savings institutions, the financial intermediaries, and the capital and money markets of the types which are functioning today are largely geared to mobilize financial resources in ways that enable the privileged few to increase further their wealth and incomes—except where the state has replaced the privileged elite. Emphasis has been given to bond and security markets to the neglect of equity markets. Financial intermediaries have neglected potential small investors. There is therefore a need for the establishment of new types of savings institutions and financial intermediaries that would be more appropriate to the achievement not only of a greater monetization and mobilization of savings but also of an equitable distribution of wealth and incomes, and a greater channeling of funds from small savers into equity investments in their own names.

Political Pressures

In most developing countries, politics frown on large-scale private enterprise, as it is usually associated with private monopolists. The political solution to this problem often appears to be the setting up of state enterprises, with the private sector being grudgingly permitted to operate in a minor role only. In the case of certain countries, this is done through such measures as heavy direct taxes, encouragement of trade union activities against private employers, and restriction of foreign exchange releases for import of raw materials for use by the private sector. There is also a simultaneous expansion of state activity, not only in new sectors but also in previously established sectors, in competition on unfair terms with the private sector. In certain other countries a complete state takeover is resorted to by governments on the excuse that private business and industry have become the preserves of private monopolists, or that they have not "delivered the goods"—whether the private sector is controlled by nationals or foreigners. If large scale private enterprise, in the existing environments, is to mean only a limited number of partnerships and closely held public companies, it may not be able to survive in the long term for political reasons.

A certain number of large enterprises will be needed, however, for a developing country to achieve meaningful economies of scale. In the modern world, where even large international corporations are merging with one another to gain economies of scale, it would be unwise for developing countries to attempt to achieve adequate growth—especially in the industrial field—through large numbers of non-integrated, uncoordinated small units of production. However, for social and political reasons, large-scale organizations should not be the preserves of a privileged few. State ownership, as an alternative, will lead to inefficiency, and will not produce the desired results except in societies which are thoroughly (and efficiently) regimented. People from developing countries, like anyone else, would not choose such regimentation voluntarily.

The institutional device that will shortly be described is primarily meant for the consideration of governments and political parties of developing countries which are seeking to achieve what I call "democratic socialism." Democratic socialism as used here does not mean doctrinaire or undemocratic socialism, synonymous with the state ownership of virtually all the means of production, which implies the concentration of both political and economic power in the hands of the state and the party in power. Democratic socialism has the socialist objective of providing social justice and greater equality while increasing national output, but within the framework of democracy. One prerequisite of democracy in this view is the wide diffusion of economic power, as opposed to the concentration of economic power in the hands of the state or of a small capitalist class. This would mean that one ingredient of a democratic political structure is a broad-based private sector, representative of the masses of the people, which could be styled the "peoples' sector," as distinguished from both a narrowly controlled private capitalist sector and from the state-owned public sector.

The development of the "peoples' sector" is not a problem capable of easy solution. Economic resources are limited in relation to population and cannot be divided and distributed physically among the population in portions that will be substantial or sufficiently integrated to be efficient economic units for development. However, the modern and highly developed joint-stock device, with proper safeguards to protect the interests of small shareholders, will enable a more even distribution of wealth, though not physically and in equal proportions, and will at the same time provide for the grouping of the resources into efficient economic units. If the joint-stock device, with the necessary safeguards for the small shareholders, is used to create a series of corporations for different economic activities, without giving scope for monopolistic controls, and if the shareholders constitute cross-sections of the masses of the people and enjoy adequate voting power within their corporations, then it can be said that a diffusion of economic power has been achieved to some extent, although there is not equality of ownership. The institutional device to be formulated below will have the joint-stock device as one of its ingredients.

A diffusion of economic power can also be achieved through the cooperative system. I have no opposition to any genuine expansion of cooperative societies based on voluntary joint action of persons with common interests. Unfortunately, however, the tendency in developing countries is for the governments to convert the cooperative movement into a convenient appendage of the bureaucracy and a quasi-government organization to serve as an instrument of the state. The environment in developing countries is such that it will be difficult in practice for the cooperative system to avoid such control and to conform to the needs of democracy while at the same time serving as an effective organ of economic growth in a wide—rather than localized—context. The shareholding system in the cooperative movement, with restrictions placed on the transfer of shares and the distribution of profits, does not provide the same incentive for greater productivity as is provided by joint-stock corporations. In socialist countries, agriculture under cooperatives or collectives has been a failure so far as productivity is concerned; the successes achieved have been in the building up of agricultural surpluses to support industrial development. The joint-stock device is more appropriate for both production and distribution in most fields of economic activity, particularly in fields where economies of scale are possible and desirable.

The institutional formulation described here should be considered a type, not a model or blueprint, for the reason that many variations in it will be necessary to suit different countries and situations. It must also be emphasized that this scheme does not deal with each and every problem of development; it is meant to focus attention on certain basic problems.

Development Savings Bank

The key institutional device which lies at the heart of this proposal is a "Development Savings Bank." It will obtain its funds as far as practicable from compulsory and/or voluntary contributions from every individual who is on the pay sheet of every employer within the government and private sectors for the credit of the respective employees. Suitable incentives and inducements will be provided to make such contributions attractive to the employees concerned. These contributors will become "members" of the Bank. Where provident funds already exist, these could be merged into the Development Savings Bank with the consent of the members. The Bank will also receive from employers compulsory and/or voluntary contributions for the credit of their employees.

In addition to this basic source of funds, which sets the course of the Bank in the direction of creating a "people's sector" but which will remain limited in amount for some years, other sources of funds must be mobilized to strengthen the institution. Some of the ways in which this could be done are the following: The Bank will receive tax rebates from government for the credit of taxpayers, in blocked accounts for investment in their names in approved projects. It will receive voluntary contributions from income-taxpayers for the credit of their accounts, which will be deductible within limits as an expense in their income tax returns. It will receive from non-income-taxpayers and other categories of persons voluntary contributions for credit of their accounts, under certain inducements. It will receive from government such part of the aid granted by foreign governments or institutions in the form of gifts, as may be determined by the government and aid donors, for the benefit of certain classes of the members of the Development Savings Bank. Aside from such contributions, the Bank may contract for domestic and/or foreign loans on behalf of its members.

Just as the Development Savings Bank employs a wide-ranging flexible policy in seeking resources, so it can deploy a flexible array of methods for making investments on behalf of its members. The funds of the lower income groups would generally be invested in the private sector. Since such an individual's savings will be small and most of these members will have scant knowledge of business, a useful device will be to consolidate these savings in unit trusts (mutual funds) which make equity investments in several enterprises; the owner of a unit in the trust has a fractional share in the trust's overall equity holdings, the value of which depends on this overall value. The small contributors to the Development Savings Bank will be given shares in the different enterprises in the private sector via these unit trusts. Resources mobilized by the Bank from the higher income groups, on the other hand, will generally be channeled into direct investments in projects or enterprises in keeping with any development policy of the government concerned, provided such investments are beneficial to the members themselves. Thus, the Development Savings Bank will generally be a savings institution and an investing agency rather than an investment holding institution or a lending agency. Only the investments of its common funds could be held in its own name, and that only within limits in any one company.

A country can choose to have as many Development Savings Banks as desirable and feasible, on a regional or other basis. They may be large or small, and specialized or non-specialized in their investment activities. The constitution of the Banks will provide certain safeguards to the members against undue interference by government.

Value of Equity Investments

A feature of this scheme which may appear most unfamiliar, and in need of explanation is the emphasis on moving funds from small savers into equity investments in their own names. It is not easy to get poor people to save when they own a bank account or a bond, and the value of what they have is defined in a way they can understand—i.e., an assured sum of money. When it is defined instead as a unit of ownership in a trust which holds units of ownership in other companies, and when the small man's unit is shifting in value depending on the activities of people he does not know, then a lack of confidence can be anticipated; voluntary savings in this form may be hard to elicit, and compulsory savings may well be resented. Yet a reasonably well managed equity investment fund should increase somewhat in money value where there is at least some inflationary trend, as there is in most developing countries and very substantially in some. A demonstration of this fact is needed to build small savers' confidence, which implies that the equity units be salable and that some actually be sold for a rewarding price. However, such sales must be hedged with limitations to prevent erosion of capital and to restrain the tendency of low income savers to sell assets for consumption purposes. A minimum holding period, say for a year, a requirement for delay between any decision to sell and the actual sale, or an individual savings minimum which cannot be sold, are devices that—together or singly—could serve this purpose.

In addition, it would be desirable to supply a guarantee of the value of small savers' assets by ensuring that the income from these investments would not fall below a determined level. Such a scheme could be supported by a National Capital and Dividend Equalization Fund, specially created from grants and low interest loans from the government revenue, and perhaps also from aid agencies of capital exporting countries and international organizations. Its main purpose would be to guarantee a minimum return on certain classes of investments in the hands of defined classes of investors at the low income level. This same Fund, if it could be sufficiently strengthened, could also stand ready to purchase such investments in the hands of the classes of investors referred to at prices that would not be less than those at which they were originally purchased by the investors concerned. If the value of the Fund builds up, provision may also be made for this Fund to grant loans to certain classes of Bank members subscribing to the scheme to enable them to purchase approved investments, if their existing savings are inadequate, on the basis of repayment from future savings. Given honest, competent management of the investment trusts, equities should normally appreciate in terms of money in view of both the government and people's commitment to the promotion of the private sector. General inroads into the National Capital and Dividend Equalization Fund to maintain equity values would normally be absent. The Fund should grow from strength to strength, as is true of well managed insurance companies, so that it could absorb even abnormal shocks.

Assuming that small equity investments for savings can be made familiar and relatively safe, they have several advantages. The flexibility that equity capital gives to firms as compared with borrowed money is well recognized in the more highly developed capital markets where such a choice is available. For the small equity owner, such ownership should impart a sense of participation in his country's development which is now generally lacking. This sense may be sharpened by the experience of actually receiving some return on his money, however small, and by its variability—hopefully in the direction of growth. It should give him a stake in the development effort, and in the future. It might be desirable to keep the size of the unit trusts rather small, to enable the owners of their units to develop some knowledge of the identity of these trusts and their activities, and eventually to have some notion of choice in investment decisions. Large unit trusts, however, may be better managed and give their small owners more sense of prestige from the association. There is much to be learned from experience in this untried field of incentive creation.

A question may be raised as to how people with no initial financial resources, especially in the poorest countries, could be enabled to participate in the ownership of companies on the basis of future savings. The answer is that a government which is prepared to implement the Development Savings Bank scheme and its supporting schemes should also be prepared to sell shares in existing or new state corporations to such persons on credit. Appropriate loan schemes under installment payment plans could enable state corporations to sell shares to those who are already in permanent employment, or self-employment, and are potential members of the Development Savings Bank. Government could borrow, if necessary, to lend to workers and to small savers at appropriate interest rates to enable them to buy shares in the state corporations. In this way the government would eventually realize some of its assets for cash, and may then need fewer additional resources to finance any expansion programs of its corporations.

Need for Broad-Based Companies

At least some economic activities, as noted earlier, must be undertaken by organizations large enough to mobilize sufficient resources for substantial economic growth with modern technology. What is required, in addition to the numerous small enterprises on which developing countries must depend for many economic activities, are large corporations, with provision for immediate or gradual broad-based ownership wherever feasible, along with foreign investment participation where appropriate, in order to achieve meaningful economies of scale and international competitiveness. The Development Savings Bank scheme, with the necessary ancillary measures to support it, could be used to broaden the base of ownership of these corporations through the joint-stock device. Mutual funds and unit trusts could bring ownership shares within the reach of small savers through the Development Savings Bank. External grants and loans extended to the Bank could give support to schemes aimed at broad-basing the ownership of industrial enterprises by financing installment purchases of shares. Other enterprises such as large transport, trading, agriculture and tourist companies, could similarly be broad-based. Government and foreign capital could also play their roles in conjunction with the small investors.

In the case of agriculture, and of business activities which are more appropriate for small private companies owned by proprietorships or partnerships, the funds lying to the credit of individual savers in the Development Savings Bank could be released for investment in forms other than shares under appropriate regulations to preserve the objectives of the Development Savings Bank scheme. It may be that new forms of organization of enterprises can be devised which would be appropriate in these fields. In agriculture, in particular, there is need for new thinking on organizations which could—more effectively than traditional cooperatives—supply coordinated facilities for procurement of inputs and tools, for marketing, and for supervision of credit uses, and which could also mobilize rural savings in ways not available to commercial banks. This might perhaps be accomplished by a new kind of joint-stock company which could organize medium or large farm operations and supervise credit uses more effectively than government bodies. Appropriate regulations might be devised which would make it possible to tie such companies into fruitful financial relationships with the Development Savings Banks.

If the economy of a developing country were organized around companies with broad-based private ownership, along with the small private enterprises, and with one or more Development Savings Banks generating small savings to flow into these companies, then the political connotations of private enterprise would be significantly improved. The economic advantages of the market mechanism could operate in an atmosphere of popular acceptability, and state ownership with its implied inefficiencies and regimentation would lose its appeal.

Appropriate Tax Policies

It will be necessary for governments to provide tax incentives for the formation of broad-based joint-stock companies, particularly in countries where the stock or share markets are narrow. Governments could also consider the conversion of some of their existing public sector corporations, in gradual stages, into broad-based public companies. Extra tax incentives should be provided to employers to increase their contributions, through profit bonuses or otherwise, to the accounts of their employees for investment purposes through the Development Savings Bank. The following tax proposals are based on a suggested law that I have drafted for my country, Ceylon; they should be considered as illustrative of measures which may be adapted for conditions in other countries.

One incentive could be, say, the exemption from tax of the first Rs. 500 [Ceylonese currency] of any dividend declared by broad-based joint-stock companies approved for the purpose, or the first Rs. 1,000 of any dividend declared by an approved unit trust or investment trust, provided however the dividends are not declared more frequently than twice a year. Another incentive could be the continuance of the non-refundable company or corporation tax in the case of private joint-stock companies or public companies whose shares are closely held or are not listed for transactions in the share market, while making the tax refundable in the case of broad-based and listed public companies, investment and unit trusts approved for the purpose. This measure would be beneficial to the low income investors, such as workers.

Any capital gains tax imposed on the sale of approved essential investments should be very low, and should be refunded into a special account in the name of the taxpayer concerned and maintained in an institution such as the Development Savings Bank. Such refunds should be released only for reinvestment in approved projects within a specified period. The purpose of this proposal is to encourage in the first instance essential investments and, once they have achieved stability, to induce their sale to low income groups such as workers who should look for safety and stable returns. The tax structure must also encourage a greater element of "risk bearing" among the richer classes of the country to meet the needs of the economy. Thereafter they must be induced to sell their more secure investments to the low income groups who should be encouraged to prefer security and reasonable returns to insecurity and high returns.

There should be a ceiling on the rate of income tax at 50 percent with appropriate adjustments on the different income levels. An extra charge over and above the adjusted rates of taxation should then be levied. A part of this levy should be refunded to the credit of the taxpayer's account in the Development Savings Bank for investment only in approved projects within a specified period. The remaining part should be paid into the National Capital and Dividend Equalization Fund described earlier, or a similar fund for the benefit of low income investors. In order to inaugurate or expand the capital market, a company could be established to function as stock or sharebrokers, in which the Development Savings Bank or the National Capital and Dividend Equalization Fund would have a controlling interest.

No tax concessions should be allowed on investments in government securities, or on savings or term deposits with banks or other institutions, as such concessions tend to discourage investments by the rich in risky enterprises in the private sector. These concessions are also not equitable for the reason that such concessions do not benefit in practice the low income savers because generally, their aggregate incomes are too low to be taxable. Higher interest rates on the savings of small savers would be preferable to tax concessions.

The various tax concessions suggested may in the short term reduce substantially tax revenue and, consequently, the resources needed for government expenditure. The various proposals, however, if successfully implemented, would tend to increase the national product, and at the same time reduce, everything else being equal, the requirements of government for finance. A restricted but efficient government sector functioning alongside an expanded and broad-based private sector, with the worker and the common man having a stake in it and being sensitive to their responsibilities, and supported by increased foreign private investment, would certainly contribute to increased output and larger revenue even at lower levels of taxation. If the economy operates on the basis of the proposals formulated, there will be no harm in the government borrowing within limits even to meet part of its current expenditure. Deficit financing against a background of increased personal savings and investment and productivity would have a less harmful impact on the economy than in the present environment which encourages a higher rate of personal consumption.

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