REGIONAL MONETARY STUDIES
CONFERENCE, 1977

SUBSIDIES, TAX RELIEFS AND PUBLIC POLICY: THE DEVELOPMENT ASPECTS

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INTRODUCTION

Our concern in this paper is with subsidies, tax reliefs and public policy in dependent underdeveloped economies. The concept of dependent underdevelopment has been discussed extensively in the economic literature.[1] Consequently, we confine ourselves to outlining the central characteristics of dependent underdevelopment. A state of underdevelopment is indicated by chronic high levels of unemployment and by low levels of living, particularly with respect to nutrition, housing, clothing and other consumption items. An equally important feature of underdevelopment is the acute mal-distribution of incomes.[2] Income inequality is both a symptom of and a contributory factor to economic and social underdevelopment.

Dependent underdevelopment economies are also highly open in the sense that they are dependent on the rest of the world—a euphemistic term for the capitalist world—as suppliers of their imports of even basic foodstuffs and intermediate goods, as markets for exports which constitute a large part of domestic production, and as providers of finance for private and governmental consumption and investment expenditures. Summary measures are the ratio of imports, exports and total trade to GNP, and the ratio of foreign capital inflow to domestic expenditures. In accordance with Dos Santos [8] dependence is "a situation in which the economy of certain countries is conditioned by the development and expansion of another economy to which the former is subjected". Since these economies are also capitalist, albeit, at early and rudimentary stages of capitalist development, we also term them peripheral capitalist or dependent capitalist economies.

This paper outlines two broad approaches to development and examines the role of subsidies, tax reliefs and public policy within each framework. The first approach focuses on capital formation, while the second emphazes the human factor and hence the socio-economic objectives of development.

1. See for instance the essays in Girvan [12]; also Frank [10], Furtado [11] and Dos Santos [8].
2. Chapter 1 in Chenery *et al.* [6] illustrates some of the features.

The limitations of fiscal policy and broader public policy, within the framework of each approach, are discussed. Advantages of the socialist organization of an economy are outlined. The paper concludes with an examination of possible constraints to the transition to socialism.

THE TRADITIONAL PERSPECTIVE

Orthodox development theory identifies capital formation as the critical factor in development. The sequence of events is one by which increases in the capital stock lead to increases in incomes and employment. Different theorists, of course, identify different requirements for rapid investment. For instance, the Big Push theory of Rosenstein-Rodan [24], Nurkse [17] stresses the need for investment on a broad front to overcome the limitations of market size and the indivisibilities of capital, thought to be inherent in underdeveloped economies. On the other hand, Hirschman advocates a sequencing of investment such that the market opportunities created by or the constraints relaxed by projects already completed induce future rounds of investment [13]. A third, highly influential major theory, is that of W. Arthur Lewis [15] who argues that growth in the modern seetor and as a result growth of the entire economy will proceed as long as profits and the profits rate in the modern sector are rising. The particular twist of the Lewis model that attracted much attention is the rate of change in wage rates relative to that of productivity, though it is logical that other measures which affect the profits rate are just as important within the confines of the model.

These capital-led models of development, as we have termed them, have certain implications for public policy in general and for tax/subsidy policy in specific. On the general level the State is seen as engaging in measures essentially supportive of capital. Among these measures are infrastructural investment, wage policies that attempt to restrain the growth of labour incomes, liberal tariff regulations and other measures (such as the provision of factory sites and buildings) especially accommodating to foreign capital. The fiscal policies are directed towards the objective of keeping profits bouyant. The instruments most utilized are income tax reliefs (for extended periods of time) to foreign investors and domestic capitalists, subsidies to capital, and a variety of tax offsets such as initial investment allowance and capital consumption allowances.

These kinds of public policies are generally interpreted as signifying basically passive non-interventionists roles for government. Fundamentally, however, they have an inherent class bias. The benefits of State expenditures including infrastructural investment expenditures, accrue mainly to the business sector. A rough indicator is the proportions of budgetary expenditure allocated to capital infrastructure vis-à-vis health. More importantly, the burden of fiscal and wages policies falls mainly on workers, thereby amounting to a redistribution of income from labour to capital. The class nature of the State is of course most visible when the capitalists themselves form the political directorate and local elite.

Tax reliefs and subsidies to capital can, theoretically, satisfy the income growth objective of development while not fulfilling the employment and the termination of economic dependent objectives. Tax reliefs/subsidies to a given sector or economy-wide exert scale effects on the profits rate and hence on output and employment, but not on the choice of production technique in the sectors which benefit from the relief/subsidy. In cases where the system of tax reliefs/subsidies discriminates in favour of capital-intensive sectors, there will be a tendency towards an increase in economy-wide capital-intensity of production. Producers in the fiscally less-privileged labour-intensive industries shift resources to the capital-intensive sectors. In such cases, therefore, the system of tax reliefs and subsidies has an adverse effect on employment.[3] This tendency is even stronger when other aspects of public policy, for example, expenditure support policies, discriminate in favour of the capital-intensive sector.

Furthermore, it is usually the case that the labour intensive sector is critical to the problem of economic dependence and mass consumption, agriculture being a striking example. A shift of resources from this sector can result in reduced domestic production of food, an increased dependence on metropolitan economies for the satisfaction of basic consumption needs and, correspondingly, a greater burden on usually scarce foreign exchange.

There exists a substantial body of literature which shows that tax reliefs and subsidies have not significantly alleviated the development problem.[4] Though contributing to output-increases, fiscal measures have not achieved the desired reduction in the level of unemployment. There has been growth without employment. A major reason has been the producers' preferences for capital-intensive techniques of production. In addition, policies which bolster the profit rate as a basis for expanded reproduction have not been justified by experience since the rate of reinvestment is low and since, in the case of multinational corporations, *the rate of profit repatriation is high.*

Some later work on fiscal policy in the development context has sought to remedy the deficiency with respect to employment.[5] Two ways are instructive. One way is the allocation of subsidies/tax reliefs to labour as an input on an economy-wide basis and to labour-intensive sectors. In both cases, the labour-intensity of production should increase. The second direction in which recent work has developed is the allocation of subsidies/reliefs to commodities that are labour-intensively produced. It is argued here that expansions in demand for those commodities (and relative contractions in demand for the non-subsidized commodities) will lead to a decrease in capital-intensity and therefore to a more than proportionate increase in employment.

Though those developments are welcome, public policy within the confines of the capital-led model is too narrowly conceived and consequently, conceptually inadequate. Income inequality, by the logic of the capital-led model, retains a central strategic significance, though some efforts can be made to relieve the degree of the income differentials by taxation linked to subsidies and by public provision of some goods and services. In practice,

3. M. S. Ahluwalia [1] contains a very useful theoretical elaboration of these points.
4. See, for instance, Andic and Andic [2], Oldman and Taylor [19], Chen-Young [5], Lent [14] and Taylor [26].
5. Ready examples are Ahluwalia [1], Peacock and Shaw [20] and Prest [22].

the tax system designed to be progressive, turns out to be at best middly progressive and is sometimes regressive. Economic dependence is outside the confines of the model, as is the concern for adequate levels of living as an immediate policy objective. Moreover, government is accorded a subordinate role in production and the provision of the material and social requirements of society.

THE ALTERNATIVE PERSPECTIVE

A primary focus on issues of equity, basic needs and general human development distinguishes the alternative approach from the capital-led models of development. Within the new approach man is viewed as the subject of development so that development is measured by the degree to which it provides for the material and creative advancement of members of the society. The implications of the alternative approach for fiscal and other public policy are profoundly different.

The new model holds that equity in income and opportunity are necessary for development. Income equality is seen as resulting in the expansion of demand for basic commodities and those light manufactured goods which are stressed in the early stages of import substituting industrialisation. Furthermore, by reducing the degree of inequality, bias towards imported commodities is reduced since the propensity to consume imported goods and services is greater among the well-to-do in dependent underdeveloped economies. Additionally, a growing body of evidence has cast doubt on the traditional assumption that savings propensities are higher among the rich. The converse seems to be true. Finally, a reduction in inequality is an important precondition for relieving social dissatisfaction which would manifest itself in industrial disputes, social disorders and lack of political support for the governments.

Correspondingly, public policy must take explicit account of these aspects of income distribution. Tax reliefs as a means of redistributing money incomes should be biased towards the lower-income stratum, and towards labour since incomes derived from capital are an important contributing factor to income inequality. Subsidies and public production and provision of goods and services which help to redistribute real income should be similarly biased.

Greater equality of real incomes as well as a reduction of the generally heavy weight of the fiscal system on lower income strata can be also instituted by adopting a mix of consumption taxes/reliefs which impinge more heavily on those goods which form relatively larger proportions of the expenditure budgets of the higher income strata.

Such a policy is standard practice in socialist countries.[6] Recently, it has also been given recognition in the Western literature.[7] The fundamental underpinning of this kind of consumption tax relief/subsidy policy has several facets. Firstly, the realization that income redistribution is essentially concerned with the (differential) commands of different social groups over goods and services. Secondly, the realization that consumption patterns,

6. See for example Csiko-Nagy [7].

especially the mix between basic material requirements and "luxuries", vary across the social classes.

Subsidies are also linked to the direct provision for basic needs. The important shift in conception is that we are thinking about the subsidization of the human factor in development rather than subsidizing employers of labour. Its significance lies along the following lines. Firstly, such policies would tend to improve the quality and the physical capabilities of labour power. Secondly, subsidies to the human factor can be regarded as an investment in social stability, as a means of moderating or entirely removing the material basis for serious social conflict. Thirdly, and most importantly, subsidies within this framework are a direct and immediate contribution, to an essential objective of development, namely to provide for the material well-being of man.

PROBLEMS OF OPERATIONALISING THE NEW APPROACH

Several broad operational considerations emanate from the shift in the nature of public policy outlined in the immediately preceding section. Foremost among them is the fiscal constraint on the State. The scope for tax reliefs and subsidies must be viewed in relation to the tax revenues-expenditure budgets. There are likely to be serious difficulties confronting attempts to increase the tax take and simultaneously to shift the burden of the revenue budget on to the higher income strata and on to capital. These difficulties stem from the narrowness of tax structures and of the fiscal base, tax evasion and avoidance among high income recipients, and from the business community's resistance to the shift in taxes towards capital. Let us deal with each of these problem areas.

The narrowness of the fiscal structure in developing economies has been extensively described and analyzed in the literature.[8] There is widespread reliance on a few types of taxes foremost among which are taxes on foreign trade and taxes on income. Consumption taxes do not feature importantly, nor do property and wealth taxes. With the decline in the rate of growth of foreign trade which is consequent upon the strategy of economic self-reliance as well as being a result of serious foreign exchange difficulties in the present decade, there results a deterioration in the basis for taxation along traditional lines. The tendencies towards free trade among blocks of developing economies aggravate the problem. One solution is to introduce new, more widely based or more dynamically based taxes.

The fiscal base in dependent underdeveloped economies covers five segments: the high, middle, and low income strata, from the consumer side; the foreign and local capitalist from the business community side.

From a superficial analysis it might appear as if these five bases should provide a tax spread commensurate with the tax bases in the center-metropolitan countries. However, this is not the case. In the first instance, the high income stratum, which normally constitutes about five percent of the population, invariably secures in excess of seventy-five percent of the

7. See Chapter 4 in CHENERY *et al.* [6].
8. For a convenient summary and guide to the literature, consult MUSGRAVE [16].

income in dependent underdeveloped countries. Such acute maldistribution of income should normally permit the fiscal authorities to mobilize the surplus from this stratum and transfer the resources to the low income stratum in society through the fiscal mechanisms.

Nonetheless, this simple fiscal process is not readily attainable primarily because high income recipients exercise myriad ways and means of mitigating the burden of their share of the taxes. By utilizing the several exemptions and allowances by knowing the areas of widening tax loopholes, and by having access to tax consultants whose main function is to reduce the tax liabilities of their clients, they successfully minimize their contribution.

The upshot of these practices is a situation where the high income stratum, which *should* bear a tax burden in accordance with its income and wealth position, bears a burden that is inordinately less than what fiscal parity and equity would dictate. Implicitly, this means that fiscal revenue deficiencies must be made up by higher rates of taxation all around and by imposition of new indirect taxes on goods and services which are consumed in greater proportion by middle and low income recipients. This causes the incidence to fall on the latter two economic strata.

The tax burden and the impact of the incidence have been traditionally shifted to the middle and low income strata.[9] The former bears the burden and feels the impact more than the latter. It may be argued, that it is the middle income stratum which bears the burden of the tax, contributes most to fiscal revenues, and experiences greater fiscal incidence than any other economic groups.

On an evidenciary level, this statement is valid for two reasons:

(*i*) the middle income stratum is composed of more employees than the self-employed;
(*ii*) the stratum has a large number of government employees in its ranks.

Arising out of these two reasons are a set of interrelated factors which make middle income recipients the largest contributors to revenues derived from taxation of personal incomes.

Intimately locked in to the first reason is the *nature* of the middle income stratum. Since the stratum is composed mainly of employees, tax authorities tend to have more detailed and accurate information on them than would normally be the case. Furthermore, their incomes tend to be more stable and more identifiable than those of the other strata. The former may work on a consultancy basis and may request kickbacks, payments in kind or other remuneration which are not generally picked up in the fiscal net. On the other hand, the latter's remuneration is insignificant vis-à-vis the administrative and compliance costs.

The second reason is integral to the first in that government employees are in a peculiar position. Their position in the public sector makes the case obvious that they have to pay taxes which some of them may have devised. In most instances however, they recognize that they are bearing

9. Pechman and Okner [21] offer an interesting discussion on this issue. Shoup's [25] point regarding the changes in the burden is well taken; it does not present any fundamental departure from our view. For a critical analysis of tax burdens, see Prest [23].

a burden out of proportion to their income, but which is easily levied given their high visibility in the politico-economic structure. This view does not deny that many government employees have ways and means of avoiding taxes. Nonetheless our arguments point to the global case which stipulates that the stratum as a whole pays more taxes because of its visibility and its interconnectedness with the politico-economic structure.

The lower income stratum presents a paradoxical situation. In terms of indirect taxes it bears a very large degree of the burden of taxation. Many of the goods and services which it consumes traditionally fall under the levies of sales taxes, excises, customs duties, turn-over taxes, among other indirect taxes.[10] However, in light of the income levels of this stratum, the fiscal take is normally low. Essentially therefore, the fiscal base is narrower that what would obtain if those with the wherewithal were willing to contribute equitably to the public fisc.

Examples of tax evasion and avoidance abound in developing economies. It is generally accepted that tax avoidance is legal, and that tax evasion is illegal. However, both tax avoidance and tax evasion violate the equity principle.

Tax evasion and tax avoidance may be related to the failure of those members of the community to sympathize with the goals of public policy. Even when there is an acceptance of the goals, there may be other kinds of dissatisfaction. Firstly, there may be general dissatisfaction with the efficiency of the public sector; secondly, the feeling that non-delivery of public services is likely thereby occasioning the tax payer in private purchases; thirdly, doubts that intended beneficiaries will actually benefit from the fiscal outlay. As a final point on the subject of tax avoidance and evasion, tax haven policies of several underdeveloped countries could very well indirectly undermine the willingness of the general citizenry to contribute to the fiscal operations of government. This is one explanation for the resistance to the introduction of income taxes currently being experienced in tax haven societies.

Turning now to the resistance of the business community, it can be argued that adverse shifts in the distribution of taxes/subsidies from the standpoint of capital (i.e. favourable shifts towards the human factor) are likely to lead to a "loss of confidence" and demands for price increases, especially by chronic "infant-industries". Any refusal by the State to reverse the distribution of the fiscal burdens and benefits or to concede price increases can itself lead to disinvestment, and capital flight in the case of foreign enterprises, the slowing down of production, and other forms of industrial dislocations which themselves frustrate the basic developmental objectives of the society. In the final analysis, this set of circumstances is likely to enforce a policy reversal by the government. In essence, the State within the framework of the capitalist model is the captive of the business community.

Governments in dependent underdeveloped countries sometimes seek seemingly easy solutions by recourse to local and external debt finance. The ultimate outcome is not development but recurring crises of inflation,

10. See DUE [9].

international payments crises and recession, as well as the exacerbation of the development retarding effects of dependence on the center-metropolitan economies.

The overriding weakness of the alternative perspective is the very narrow conception of the role of the State under dependent capitalism and in particular its confinement to regulatory functions. The State has no direct control over production, distribution, prices, nor accumulation. As a consequence, it is basically powerless to achieve the objectives of development.

THE SOCIALIST ALTERNATIVE AND SOME PROBLEMS OF THE TRANSITION

An essential characteristic of public policy in the socialist model of development is that the State is centrally responsible for production, distribution, investment and pricing. The direct command over resources facilitates the pursuit of developmental goals in several fundamental ways.

First of all, it allows for the replacement, of production for profit by production for use (Best [3]). Output policies can thus be closely related to basic needs and other needs. In other words, there can be a convergence of demand and resource absorption. Secondly, State control of production allows for distribution and pricing along socially optimal lines, since what matters then is social efficiency in the global sense and not, as is the case under dependent capitalism, efficiency measured by profits at the level of the firm or of the industry. Within the fiscal sphere, control over the means of production and distribution clearly enhances the fiscal capacity of the State. Furthermore, the State is in a more advantageous position to incorporate distributional considerations in fiscal policies.

Within the socialist framework, there is also a distinct shift in the organisation of man within the production process. There is a departure from the concept of man as an atomistic, self-seeking individual motivated primarily by material rewards. Instead, the emphasis is on cooperation, interdependence and moral incentives. This shift is of concrete salience for developing countries where so many are poor and are low in the occupational hierarchy. Motivational barriers and uncreativity are very pronounced in systems which stress individual capabilities, individual achievements and personal rewards. A recent work states: "The ideology of individualism... is for the underclass... an ideology of frustration and impotence which leads victims to blame themselves for social injustices and to perceive the prevailing order as immutable and the existing conditions as hopeless" (Best [3]).

Socialist countries do not all attach equal weight to issues of real income inequality. Much depends on the county's level of development at the time of the transition. "If a country takes to socialism at a stage when the forces of production relations are still at a relatively low level, the socialist production relations make it imperative to establish an incomes policy subject to principles of social policy" (Csikos-Nagy [7]). Otherwise, difficulties of social incohesion, insufficient improvement in the quality of the labour force and low motivation, may subvert policies of socialist development.

It would be naive of us to believe that the transition to socialism is a simple process. Many constraints clearly present themselves. We will deal with two points.

Firstly, some internal forces within the countries of reference will perceive the changes as directly antagonistic to their self interests. Concretely, local capitalist interests and other economic strata will tend to oppose the transition because they view such deep-seated structural changes as encroaching on their private domains.

This resistance to change is sometime fostered by the belief that the small size of many underdeveloped countries poses an insuperable obstacle to autonomous, self sustaining development. Doubts about the viability of small countries revolve around several aspects of the concept of size: physical area, resource endowments, geopolitical location and power base. For example, it is generally felt that small dependent underdeveloped countries cannot survive the transition to socialism because their resource base is too small, the market size is limited, among other neoclassical notions. The drawback to this view is the methodological inappropriateness of evaluating a socialist system using a neoclassical framework.

Secondly, resistance to change might emanate from external sources due to the nature and characteristics of dependent underdeveloped economies. Since a considerable amount of foreign investment exists in these countries, it is quite conceivable that there may be opposition from foreign investors and their governments to the socialist thrust.

None of the two sets of problems are insurmountable. Clearly, the level and sophistication of domestic and international political organization is critical. In this context special cognizance is taken of the increased advocacy of the strategy of individual and collective self-reliance among the dependent underdeveloped countries.

SUMMARY AND CONCLUSIONS

This paper reviewed tax reliefs, subsidies and public policy within the framework of capital-led models of development. The analysis pointed to the conclusion that fiscal policy as well as broader policy measures tend not to achieve the objectives of socio-economic development, especially those pertaining to employment, income equality and the satisfaction of basic needs.

We argued that public policy should address itself directly to those objectives rather than indirectly as in the capital-led models. The concrete requirements are for a different mix of tax relief/subsidies which attempt to shift the burden away from labour and on to capital and to redistribute the fiscal benefits in favour of the lower income strata.

However, serious operational problems confront such attempt. Among these problems are the narrowness of the tax structure and the fiscal base, tax avoidance and tax evasion, and the business community's resistance.

Our conclusion is that State control over the means of production, pricing and distribution under socialism is a necessary step for achieving the goals of development. It is necessary, but not sufficient since there will be inherent barriers to the transition both from internal and external bases of operation. Mechanisms will have to be devised to overcome the barriers to change.

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Résumé

Cette œuvre examine les subsides, le dégrèvement et l'intérêt public aux pays dépendants et sous-développés. On aborde le sujet de développement par deux voies très larges qui se font contraste l'une avec l'autre. La première est concentrée sur la formation du capital ; le seconde sur l'élément humain. Dans les deux cadres sont identifiés l'efficacité des subsides, le dégrèvement et l'intérêt public. Les profits d'organisation socialiste de l'économie de même que quelques contraintes qui existent dans la phase de transition sont exposés dans les lignes générales.