

## DEVELOPMENT FUND AS AN INSTITUTION FOR CONDUCTING FISCAL POLICY\*)

Branko HORVAT\*\*)

### Evolution of Ideas and Institutions

The development of market economy was accompanied by the ideology of *laissez-faire*, by the theory of the invisible hand and by the so-called Say's law. Violent cyclical oscillations during the entire XIX-th century did not prevent the appearance after the 1870s of neoclassical economics, preaching automatic stabilization by marginal adjustments and culminating in an aesthetically pleasing general equilibrium theory by Walras. On a more practical level people had already become aware of the problems and in the second half of the century governments began to regulate monetary affairs by establishing central or national banks. Usually one of the existing private banks was selected and transformed into a semipublic or public institution. By the time of the First World War it had already become pretty clear that monetary policy was indispensable for stability and that inherent market forces, whatever they were, would not do. But monetary theory was never really integrated with the dominant neoclassical theory. Besides, it was believed that monetary policy was not only necessary, but also sufficient.

This illusion was thoroughly dispelled by the Great Depression of the 1930s. Soon Keynes discovered that Say's law was fallacious<sup>1)</sup>, and that equilibrium often occurs at an underemployment level. Keynes explained why monetary policy alone under the usual circumstances would not be able to transform an underemployment equilibrium into a full employment one. To solve the problem he introduced fiscal policy into the game.

The explanation of *actual* saving by the time preferences of the population has been one of the cherished tenets of neoclassical eco-

---

\*) Revised version of the paper presented at the III Inter-American Conference on Taxation, Mexico City, September 1970.

\*\*\*) Senior Research Adviser, Institute of Economic Studies, Belograd.

1) Marx made the same discovery three quarters of a century before, but Keynes did not know that. And even if he knew, it would make no difference because Marx was a socialist and therefore disreputable. It is amusing to note that for a couple of years after the appearance of the *General Theory* Keynes was dismissed in a number of countries — the United States included — together with Marx as a dangerous socialist.

nomics until our time. Economic theorists in this century — like their colleagues in the last century, have not been worried by the extreme fluctuations of »time preferences« as reflected in the negative saving rate during the American depression and a 35 percent saving rate during the Japanese boom. Keynes explained the mystery by showing that in industrialized countries the cause of the low investment rate was not high time preference, but the reverse; in other words that too much saving was responsible for too little investment. It looked like Hegelian dialectics, but in fact it was hard positive economics. Yet in their »pure theory« sections, textbooks still determine the *national* saving rate by *individual* time preferences .

Potentially, Keynesian full employment economics was also growth economics because, given the rate of technological progress, the increase in the labour force uniquely determines the maximum possible growth of output — as was later elaborated in Harrod-Domar model building. Actually, however, Keynes never went beyond short term equilibrium analysis. In his time economies grew at rates of between two and four per cent per annum. Rates between five and ten per cent — common in our time — looked to Keynes (and his contemporaries: recall the appeal of the stagnation theory) unreal, fantastic, impossible, not worth bothering about.

Post-Keynesian economics did little to fill the gap. The Soviet-type administrative planning was neither appealing nor efficient in a highly developed country. The problem — usually known as market-cum-planning arrangement — still awaits its theorist.

In the meantime one could ask two obvious questions: Why should fiscal policy not be used as an instrument of growth? Why shouldn't the government establish a separate fiscal authority, resembling the monetary authority embodied in the Central Bank?

#### Four Basic Institutions

Once it has been realized that the market ought to be guided, regulated, controlled, one has to solve the problem of the institutionalization of control. I suggest that in this respect, apart from the government and parliament, the following four institutions are basic.<sup>3)</sup>

1. *The Planning Bureau (PB)* is an information producing factory. But unlike the Statistical Office, it generates information about the future, called forecasts, and development plans. PB has no administrative power whatsoever. Its sole function is to do *ex ante* what the market does *ex post* and to do it better. In other words, the task of the Planning Bureau is to accomplish *ex ante* coordination of economic activities on the basis of the relevant set of preferences. If PB's forecasts are good, the mere existence of a plan will act as a powerful coordinating device. What is still left can be accomplished by the remaining three institutions.

<sup>3)</sup> For a fuller discussion see my »Institucionalni model samoupravne socijalističke privrede«, (*Ekonomist*, 1971, 501—13). Available also in English in a slightly abridged version as »An Institutional Model of a Self-Managed Socialist Economy«. (*Eastern European Economics*, 1972, 369—92).

2. *The Central Bank (CB)* has to supply the economy with adequate amounts of domestic and foreign money. In controlling the money supply, CB also exerts important influence on general economic stability. Controlling prices is perhaps the most important task in this respect. The simple quantity theory of money explained inflation by an oversupply of money. Keynes' inflationary gap was not far from this explanation. Thus monetary restriction appeared to be an obvious remedy. Yet when applied it usually produces contraction of economic activities and unemployment. It was then found that inflation can be generated by structural disproportions. Structural inflation was especially analysed by Prebisch in Latin America. Monetary policy is powerless in dealing with it. Yet this is not the end of the story. The third type of inflation is caused by disproportions in income distribution.<sup>3)</sup> This is usually discussed under the heading of cost push inflation, together with some other less important forms (increase in the marginal cost of inputs). It is clear that monetary policy cannot handle this case either. Let me add that the Central Bank also tried to control investment by manipulating discount interest rates. However, empirical studies showed that investment demand is highly inelastic to interest rate changes. What matters is not the rate of interest but a profitable investment opportunity (in an industrialized country) or the availability of investment money with reasonable risks for lenders (in developing countries).

3. *The Central Development Fund (CDF)* supplements the monetary operations of CB by stabilizing investment, aggregate demand and prices whose changes were due to structural disproportions. Apart from that, CDF is responsible for achieving the desired rate of growth.

4. *National Committee for Income Distribution and Prices (NCIDP)* is an institution which I would recommend for socialist countries. In capitalist countries it is likely to remain ineffective because of the opposing class interests. NCIDP ought to be an independent institution, composed of qualified representatives of relevant interests (government, unions, business, academia), entrusted to handle complaints against discriminatory measures of government agencies and requests for equal opportunity conditions for conducting business. The Committee can order the government to change a particular policy or measure and/or to compensate the party that suffered losses.

### Central Development Fund: Objectives and Instruments

Fiscal policy has normally been conducted by the Ministry of Finance. It is usually so closely tied up with budget policy that theoretical analysis fails to separate the two. Yet the distinction is quite clear. A budget is a device by which the planned activities of government administration and various public services are financed from planned

---

<sup>3)</sup> In capitalist countries this type of inflation is the result of a struggle between unions and employers. While unions were weak at the time of Marx and Keynes it was not known. In a socialist self-government economy it results from attempts of underprivileged sectors of the economy to catch up. Cf. my paper "Analysis of the Economic Situation and Proposal for a Program of Action", *Praxis* 1971, 533—62.

sources. Stabilization, development<sup>4)</sup> and income redistribution activities are extra-budgetary activities and belong to the fiscal policy sphere. Of the three, the first two can be handled by CDF, and the last one by the Parliament exclusively.

One may think that a clear separation of budgetary and fiscal policy suffices, and that the two may continue to be conducted by the Ministry of Finance. The Ministry would then prepare two budgets: an Administrative Budget and a Development Budget. One such solution that I am acquainted with turned out to be inefficient. The Development Budget was constantly leaking money to the Administrative Budget, the government was manipulating information, the parliament was discussing the issues endlessly, and an enormous amount of energy was spent on accusations, explanations and negotiations. As a result the implementation of policy was worse than poor.

If CDF is established as a separate fiscal authority, certain conditions have to be fulfilled. CDF cannot invent new taxes or change tax progression and in general cannot affect income distribution among social groups or segments of the economy. If a particular tax or group of taxes is changed, all its elements must be changed in the same proportion so as to leave the structure invariant. CDF is entitled to change only taxes with short run effects. It cannot, e. g. change inheritance tax — either in isolation, or with the group of income taxes — because that would inflict windfall gains and losses on some individuals just before and just after a change. Whether that is socially acceptable or not is not up to CDF to judge. The social welfare function is to be determined by the parliament, and CDF can operate only within its confines. CDF is responsible for stability and growth under conditions of Pareto-type efficiency. Increasing efficiency, without disturbing distribution — that is the goal. Theoretically, the goal is not completely unambiguous and in practice deviations cannot be avoided. But the situation is not substantially different from the one in the monetary field where the Central Bank has come to be universally accepted as an independent monetary authority.

A. There are four sets of *objectives* which CDF is supposed to fulfil: implementing investment programs, short-term investment in working capital for special purposes, operating subsidy schemes and compensations.

1. *Investment in fixed capital* is a precondition of growth and has to be planned in a threefold way: (a) by volume, (b) structure, and (c) regional allocation. CDF is responsible for implementation of plan targets. Experience shows that in order to be able to accomplish this task, CDF will have to control directly more than ten and less than

---

<sup>4)</sup> Some economists, like Musgrave, would use the term *allocation*. This term usually refers to static allocation of resources, which is not particularly relevant for a real world economy. The term may, of course, be reinterpreted to cover the intertemporal allocation of resources. But in that case it is certainly more appropriate to state the policy objective directly: we are interested in development, and in allocation only to the extent that it contributes to development.

forty per cent of national saving.<sup>5</sup>) The more developed a country becomes, the smaller percentage of direct investment control appears necessary.

2. *Short-term investment in working capital is required for at least two distinct purposes:*

(a) Export promotion of capital goods industries. Capital goods can be exported only on credit terms. Firms in developing countries do not have sufficiently large working capital to meet the terms of competition of foreign giant corporations. The same is true of banks. It is hardly desirable to stimulate the growth of firms and banks until they reach the size of monopolies simply in order to make them financially strong enough. The alternative is to create a public fund for export promotion.

(b) Commodity stocks of agricultural and other products. In order to stabilize agricultural output, the parliament establishes price support programs and a specialized agency buys and sells agricultural products domestically and internationally. Other agencies deal in some other raw materials vitally important for a particular economy. CDF finances these activities.

3. *Subsidies and premiums* are used for general export promotion, for lowering prices of certain inputs (e. g. fertilizers) and of certain consumer goods (e. g. milk). They are established by special laws or introduced by annual plans (or by programs accompanying annual budgets). CDF is responsible only for routine financial operations.

4. *Compensations* — regionally and by industry for adverse effects or inequities due to specific acts (or lack of acts) of policy making bodies. CDF implements decisions passed by NCIDP.

B. *Instruments* that CIF can use to achieve prescribed objectives can be classified into two groups: instruments of collecting money (mostly taxes) and instruments of distributing money (mostly loans).

#### 1. *Instruments of collection*

(a) Positive or negative surtax levied proportionally to basic direct or indirect tax and tariff. As already mentioned, CDF cannot change the progression of income tax, the exemption rules, the relative rate of a luxury goods purchase tax or the structure of customs duties. It can, of course, ask that appropriate changes be made, but it is up to the Parliament to decide. CDF can only increase or lower the entire tax structure by introducing proportional surtaxes. It is of some importance to realize that the operations of CDF are fully compatible with a highly decentralized taxation system.

(b) Selling long-term bonds.

(c) Surplus absorption (replacing the traditional budget surplus, in this system the Administrative Budget is always balanced and every

<sup>5</sup> This is substantially less than in many capitalist economies today, of which France, Turkey and Mexico are perhaps the leading examples.

change must be authorized by Parliament). Decision has to be made jointly with the Central Bank.

(d) Positive or negative investment tax or temporary immobilizing of retained profits in a special bank account if investment is made in inappropriate industries or locations or at an inappropriate time (Swedish practice).

(e) Borrowing from abroad (together with CB).

## *2. Instruments of distribution*

(a) Long-term and short-term loans to particular sectors of the economy under particular conditions (regarding grace period, interest rate and repayment period) in accordance with the targets of the development plan (close to the former Yugoslav practice of using the Central Investment Fund for similar purposes).

(b) Regional distribution of investment resources by following the plan target that specified proportions of all investment resources be invested in specified regions (close to the current Yugoslav practice reflected in the operations of the Fund for Undeveloped regions).

(c) Discounting of commercial banks' investment loans given for projects included in the development plan (French practice).

(d) Buying long-term bonds (reducing public debt or contributing to special funds, e. g. to Export Promotion Fund).

(e) Deficit financing (together with CB).

(f) Lending abroad (together with CB).

## **Concluding Remarks**

In the second half of the last century one commercial bank in the country was selected and made public and central. Monetary control was introduced in order to overcome the vicissitudes of the market. In the second half of our century one government department may be separated from the administration in order to avoid the vicissitudes of politics. Governments and parties come and go, but central banks stay. It would be desirable if fiscal policy could be professionalized to the same degree so as to survive political changes.

In organizational terms CDF is a financial, not an administrative institution. Tax administration is left to the Ministry. However, experience shows that administration is poor if the administrators do not depend on the results of their work. Thus an efficient organizational arrangement seems to be as follows. In the budget law, voted annually or biannually, all revenues and expenditures are specified (together with the customary budgetary reserve) with the positive difference being allotted to CDF. In order to be able to finance government expenditures, the Ministry of the Budget has to collect all taxes on time. In fact, regarding the budget everything is orthodox and the four tra-

ditional rules apply fully. These are: (1) Unity — all revenues and expenses of all government departments are integrated in a single document; (2) universality — no government department should have any resources apart from budgetary appropriations; (3) yearly occurrence and (4) specific character of the appropriations — each appropriation is made for a specific purpose. The budget may also be divided into current and capital budget, the latter being concerned with the actual physical capital formation of government departments and public services in general.

While the Ministry is preparing the budget, CDF prepares its annual intervention program and CB prepares financial flows forecasts. The Administrative budget, investment (cum subsidies) intervention program and financial flows forecasts represent three components of an annual development plan. Annual plans represent operational breakdowns of a medium term development plan prepared by the Planning Bureau

By now most countries in the world have introduced planning. Also, by now, most of them have experienced a crisis in planning<sup>6</sup>). One of the reasons for this crisis is to be found in the fact that planning is often divorced from the means of implementing plans. A market-cum-planning arrangement needs special institutions in order to work properly. The Central Development Fund may prove to be one of the missing institutions.

(Rad primljen avgusta 1972.)

## RAZVOJNI FOND KAO INSTITUCIJA KOJA SPROVODI FISKALNU POLITIKU

Branko HORVAT

### Re z i m e

*U drugoj polovini prošlog stoljeća po jedna komercijalna banka u svakoj zemlji bila je izdvojena i pretvorena u centralnu ili narodnu banku. Zadatak centralne banke je da kontrolira novčane tokove u svrhu uravnoteženja tržišta. U drugoj polovini ovog stoljeća trebalo bi izdvojiti jedno vladino odjeljenje u samostalnu instituciju nadležnu za vođenje fiskalne politike. Na taj način bi se formirao Centralni razvojni fond (CRF).*

*Često se brka budžetska i fiskalna politika, što dovodi do ozbiljnih propusta u ekonomskoj politici. Budžet je instrument kojim se predviđene aktivnosti vladinih organa i javnih službi financiraju iz predviđenih izvora. Budžet uvijek mora biti uravnotežen, a promjene se mogu vršiti jedino na osnovu izričitog odobrenja Skupštine. Zadatak fiskalne*

<sup>6</sup>) Cf. M. Faber, D. Seers, ed., *The Crisis in Planning*, Vols. 1 & 2, Sussex Un. Press, London, 1972.

politike je, međutim, postizanje stabilnosti privrede, određenog tempa razvoja i određene društveno poželjne raspodjele dohotka. Prva dva zadatka mogu se povjeriti CRF, dok treći ostaje u isključivoj nadležnosti Skupštine.

CRF vrši slijedeće četiri funkcije: realizira investicioni program zacrtan društvenim planom, financira kratkoročne investicije u obrtna sredstva za posebne svrhe, te izvršava odluke vlade, Skupštine i posebnih tijela u pogledu subvencija i kompenzacija. Za obavljanje tih funkcija CRF ima na raspolaganju instrumente prikupljanja sredstava (prvenstveno otplate zajmova i proporcionalne dodatke na poreze) i instrumente raspodjele sredstava (prvenstveno investicioni zajmovi).

Sekretarijat za financije priprema budžet, CRF priprema godišnji interventni program, a Narodna banka planira novčane tokove. To su ujedno tri osnovne komponente godišnjeg plana razvoja, koji predstavlja operativnu razradu srednjeročnog društvenog plana koji je pripremio Zavod za planiranje, a usvojila Skupština. Poznato je da se planiranje nalazi u krizi u mnogim zemljama, uključiv i u našoj. Jedan od osnovnih razloga te krize je nepostojanje ili neefikasnost instrumenata za realizaciju planova. Sistem u kom se želi postići efikasna kombinacija planiranja i tržišta zahtijeva posebnu instituciju da bi mogao dobro funkcionirati. Autor smatra da je Centralni razvojni fond ta institucija koja je nedostajala.