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Public Finance

Distance learning module

Module Two

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CHAPTER SIX

PUBLIC DEBT

In this chapter we will cover five sections: 1) Nature and kinds of public debt. 2) Effects of public debt. 3) Burden of public debt. 4) Redemption of public debt. 5) Public debt in a developing economy.

Learning objectives

After studying this chapter, you should be able to

- Explain the objectives of public debt
- Explain the nature of public debt and the burden of public debt
- Discuss the effects of public debt on consumption, distribution, production and on economic activities.
- Discuss the different methods of redemption of public debt and estimating debt burden of a country.
- Explain the differences of taxation and pubic debt
- Explain the role of public debt in economic development

1.1 NATURE AND KINDS OF PUBLIC DEBT

Public debt is of recent growth and was unheard of prior to the 18th century. In modern times, however, borrowing by the States has become a normal method of government finance along with other sources such as taxes, fees, etc. The government may borrow from banks, business houses, other organizations and individuals. Besides, it can borrow within the country or from outside. The government loan is generally in the form of bonds (or treasury bills if the loan is required for short periods) which are promises of the

government to pay to the holders of these bills the principal sum along with interest at the stated rate. Borrowing is resorted to in order to provide funds for financing a current deficit. This definition very clearly explains the three features of public debt.

1. Public debt arises in the form of borrowings by the treasury or by the state exchequer.
2. The government borrows a certain amount now but promises to pay in the future not only the principal amount but the interest also.
3. The government borrows when there is a budget deficit i.e. public expenditure is more than revenue.

Classification of Public Debt

Public debt can be classified in different ways according to various factors like sources of borrowing, purpose of loan, the term duration of loan provision for repayment, nature of contribution, marketability.

1. **Source of Borrowing** (**internal debt and external debt).**

There are two sources of public debt, internal and external. Internal debt refers to public loans floated within the country, while external debt refers to the obligations of a country to foreign governments, or foreign nationals or international institutions. Though external debt is becoming very common these days, there has been general prejudice against foreign debt, based on ignorance and faulty economics.

2. **Purpose of the loan (Productive and unproductive debt)**

Public debt is said to be productive if the investment yields an income which will not only meet the yearly interest payments of the debt but also help repay the principal over the long run. All public debt can be said to be productive in another sense too. The government may undertake certain projects through loans which may not be productive in

the sense given above but which may be really useful to the community – for example, a railway line connecting a backward region, an irrigation work to prevent famine conditions in an area, and so on. In this sense all public debt is productive. But in many cases, public debt may be contracted during war-time to finance war. Such debt is unproductive because it does not create an asset; it is a dead-weight debt or a useless burden on the community.

3. **Funded debt and unfunded or floating debt.**

Broadly speaking, funded debt is a long-term debt, undertaken for creating a permanent asset and the government normally makes arrangements about the mode and the time of repayment. Unfunded and floating debt is a relatively short-period debt meant to meet current needs. The government undertakes to pay off the unfunded debt in a very short period, say, within six months. Treasury bills are examples of unfunded debt. The rate of interest on unfunded debt is lower.

4. **Time Duration of loan (short, medium, and long term loan).**

According to time duration of the loan, public debt can be classified into short term, medium term, and long term loans. Short term loan is usually incurred for a period varying from three months to one year. Usually government gets such loans from the central (national) banks by using treasury bills. These loans are also called 'ways and means advances'. Such loans are obtained to overcome temporary deficits in payment to be made by the government in the course of one year to pay salaries etc.

Medium term loans are those which are obtained for more than one year but less than ten years. Usually the governments borrow only long term loans for more than ten years. The

maturity period is long so that the rate of interest tends to be higher on the long term loan than short term loan. Long term loans are incurred to finance development schemes.

Why Public Debt is incurred?

(Causes of public debt)

Public loans in modern times are necessary to meet difficult situations. In the first place, modern governments do not have any large accumulated balance or treasure to meet a budget deficit. Normally, the annual expenditure of the government should be and is met by annual income. But because of many circumstances the yield from taxation and other sources may not be equal to the actual expenditure. Similarly, there may be unplanned and unexpected emergency situations like major fires, floods and famines. It may not be possible to secure funds through taxation. Short-term borrowing in anticipation of tax collections in subsequent years is ordinarily used in the above two circumstances.

Secondly, a factor which necessitates public loans is war. Modern warfare is so costly that the normal income through taxation falls short of the actual war expenditure. A public loan is a better and easier method of collecting revenue than taxation. Governments, therefore, have to borrow extensively from individuals and institutions towards war financing. In fact, the enormous increase in public debt in most countries is due mainly to the First and Second World Wars.

Thirdly, public borrowing is considered very useful to remedy a depression. Business depression and unemployment are generally due to deficiency of demand for goods and services. Keynes advocated increased public expenditure financed through borrowing and not through taxation. For, while taxation will reduce the incomes of the public and their demand still further, borrowing will have no such effect. Besides, loans enable the

government to make use of idle and unutilized funds of the public.

Finally, public loans are resorted to for development purposes. Underdeveloped countries interested in the development of their natural resources to the optimum *level* find public borrowing a very useful device to finance the various development projects. In countries like Ethiopia, public debt has been increasing in recent years because of this factor.

Sources of Public Borrowing

Every government has two major sources of borrowing-internal and external. Internally, the government can borrow from individuals, financial institutions, commercial banks and the central bank. Externally, the government generally borrows from individuals and banks, international institutions and other governments.

When individuals purchase government bonds, they are diverting fund from private use to government use. More important than individual subscribers to government bonds are the financial institutions such as insurance companies, investment trusts, mutual savings banks, etc. These non-banking financial institutions prefer government bonds because of the security provided by the latter and also due to their high negotiability and liquidity. While individuals and non-banking financial institutions take up government bonds out of their own funds, the commercial banks can do so by creating additional purchasing power-known as credit creation. The central bank of the country can subscribe to government loans. By purchasing government bonds, the central bank irradiates the account of the government. Borrowing from the central bank is the most expansionary of all the sources, for not only the government secures funds for its expenditure but the commercial banking system gets additional cash which can be used as the basis for further credit expansion.

Government may borrow from other countries too to finance war expenditure or to pay for development projects or to payoff adverse balance of payments. Two important sources have become prominent. They are: *(a)* international financial institutions, *viz.,* the IMF and World Bank, which give loans for short term to payoff temporary balance of payments difficulties and for long term for development purposes; and *(b)* government assistance generally to assist in development projects. For developing countries like Ethiopia, external sources of borrowing are becoming considerably important in recent years.

1.2 EFFECTS OF PUBLIC DEBT

We should clearly distinguish economic effects of public borrowing from economic effects of public debt. Borrowing refers to the method of securing funds, and it is one of the four alternatives available to the government-the other sources being taxation, profits from State enterprises and money creation. The effects of borrowing, therefore, relate to government expenditure financed through borrowing as different from the effects of a similar programmed financed by taxation. On the other hand, the effects of public debt refer to the effects on the economy which are caused by the existence of public debt, after it had been incurred.

Public borrowing from individuals and firms has effects on all aspects of economic life.

They may be considered as follows:

1. **Effects on consumption**. The effect of public debt on consumption depends upon how it is financed by individuals. If they lend to the government out of their idle savings, consumption is not affected. If they buy out of past savings it has only a limited impact on present expenditure. But if they lend by cutting present savings, it may make them feel less secure and so they may reduce consumption. But if the

people feel that they have invested in government securities which are considered safe investment, they may actually increase their consumption.

2. **Effects on Production and Investment**. The effect of public debt on production depends upon whether it affects private investment or not. If people buy government bonds by selling their shares or debentures in private individual firms, there is an adverse effect on private investment. But if the money borrowed by the government is for productive purpose, over all production is not affected. But if it is used for wasteful or non-productive purpose, total investment is affected negatively.

   If people buy government bonds by taking away their bank deposits, bank's lending capacity is reduced and this again affects private investment. Private investment is not affected only when it is financed by people out of their idle funds.

   If the government uses the funds for productive purpose, it can repay it out of income generated by these projects. But if pubic debt is used for unproductive purposes, it can be repaid only by through additional taxation in future which affects future consumption as well as production by reducing future disposable incomes. However, if public debt is used for welfare schemes, it may increase people's efficiency to work and thus improve productive capacity.

3. **Effects on Distribution.** Public debt is bound to have effects on distribution of income because it involves transfer of purchasing power from one sector to anther. Usually government bonds are purchased by the richer section. But the burden of tax to repay the debt falls on all sections including the poor. To that extent the inequality of income will increase. If the bondholder and taxpayers is the same people, theoretically there will be no effect on redistribution of income. Hence

redistribution of income effects of public debt depends upon whether the taxpayers and the bond holders are the same people or not.

However if the public debt is used for public welfare programmes especially the poor, inequalities of income deceases. But if public borrowing creates inflation, the beneficial effects of redistribution will be neutralized as prices rise.

4. **Effects on National Income**. Public debt has an adverse effect on national income only if private investment is adversely affected. However if government expenditure is incurred on capital goods, it gives incentive to greater production and this again increases the income. Government investment financed by public debt will have a multiple effect on national income. If public debt is financed by commercial banks and national banks, the credit creation and the public expenditure from that will have a very large expansionary effect on national income.

5. **Effects on Resource Allocation.** Unlike tax finance, public debt has little effect on resource allocation. Public borrowing curtails business investment activities but the decline of business investment varies from one industry to another. Allocation of resources is not affected much.

6. **Effects on Liquidity.** Effect of public debt on liquidity is favorable because the governments bonds are liquid assets which can be sold in the market whenever the bondholders need money. So public debt increases the volume of liquid assts in the country. Secondly the larger quantity of such liquid government bonds can result the failure of monetary policy. For example, when national bank tries to control inflation through monetary policy tools like bank rate, the commercial banks can increase their cash reserves by selling government bonds.

7. **Effects on Money Market.** The government has to compete with the private sector for fund. Usually if the rate of interest paid by private sector on borrowing is high, the government also will have to rise its interest rate to attract public funds. On the other hand if the state tries to borrow from commercial banks and national banks, more than what is available at current rate of interest it results in currency expansion.

1.3 BURDEN OF PUBLIC DEBT

There has been considerable confusion as regards the burden of public debt. Two extreme views have been held, the traditional view and its counterarguments. The traditional view is that public debt, as in the case of private debt, imposes a real burden on the community. This opinion is based on the following assumptions:

(a) Public debt necessitates a transfer of funds from the private sector (individuals and companies) to the Government in the form of additional taxation;

(b) Public debt is a more costly method of financing public expenditure than taxation because of the additional cost of interest payments;

(e) Public debt tends to transfer the burden of a particular outlay to future taxpayers; and

(d) Excessive borrowing by and huge public debt of the Government, may undermine the creditworthiness of the Government.

The traditionalists, therefore, conclude that public debt should be kept to the minimum and should be redeemed as early as Possible. The other extreme view-held by some modern writers – is that internal public debt is not burdensome, since payment of interest and the use of taxes to meet the same involve simply a transfer of funds between people within the country. People will be receiving interest from the Government for the bonds they hold

but will be paying taxes to meet interest obligations of the Government. In other words, it is almost like transfer of funds from one pocket to another, or from one individual to another. The result is that the internal public debt does not impose a real burden on the community. Both these apparently conflicting views on the burden of public debt can be easily shown to be wrong. For this Purpose, it would be convenient and useful to adopt Dalton's distinction between direct and indirect burden of public debt and between money burden and real burden of public debt. We can, therefore, speak about four types of burdens of public debt, *viz.,*

(a) Direct money burden,

(b) Direct real burden,

(c) Indirect money burden, and

(d) Indirect real burden.

(a) Direct Money Burden. Public debt involves payment of interest and repayment of the principal by the government, who will have to raise the necessary amount by way of taxes. The direct money burden of public debt consists of the tax burden imposed on the public and it is equal to the sum of money payments for interest and repayment of principal. Actually, in the case of an internal debt, there can be no direct money burden because all the money payments (taxes) and receipts (interest) cancel out. Suppose the government of Ethiopia collects taxes to the extent of Birr 1000 million a year from the general public towards its debt services. This amount is transferred from the public to the government. But the latter distributes this amount to the general public by way of interest on its loans. Thus servicing of internally held public debt is reduced to a series of transfers of wealth between parties – total receipts will necessarily be equal to total payment. There would, therefore, be not net direct money burden in internal debt. On the other hand in the case

of an external debt, money payments by the debtor nation (say Ethiopia) are to external creditors (say, Americans); these constitute clear direct money burden of public debt on the debtor nation.

(b) Direct Real Burden. When we refer to monetary transfers between taxpayers and creditors we are speaking about the direct money burden. But when we refer to the distribution of taxes and public securities among the public, we are referring to the real burden of public debt. We know that people hold public securities (and get interest from the Government) but they also pay taxes towards the cost of the debt service. If the proportion of taxation paid by the rich towards the cost of the debt service is smaller than the proportion of public securities held by them, while on the other, if the proportion of taxation paid by the poor and middle income groups towards the cost of the debt service is greater than the proportion of public securities held by them, there is a direct real burden from public debt. In this case, public debt has been responsible for worsening inequality of *incomes.* Suppose, on the other hand, government bonds and securities are held by the working classes and the middle income group (and, therefore, they receive the interest) while the taxation towards the cost of debt service is paid by the rich (by way of income tax and the other highly progressive direct taxes) then public debt actually tends to decrease the *inequality* of incomes in the country. In this case there is actually no direct real burden but there is a *direct real burden to the* community. Thus whether internally held public debt imposes a direct real burden or provides a, direct real benefit will depend upon the distribution of taxation on the one hand and ownership of public securities on the other, among different sections of the community. Dalton argues that in most modern capitalist or mixed economies, with large inequality of incomes, internally held public debt will generally result in transfer of money from poorer to richer sections of the community and hence will impose a direct real burden because:

(i) the bulk of the government bonds and public securities will generally be held by the richer sections of the community, directly or indirectly, (through their ownership of banks and insurance companies which hold public securities among their assets); and

(ii) even the most progressive of taxation cannot fall so heavily on the rich as to counterbalance, among the richer classes, the income derived from public securities.

We may now refer to the direct real burden of external debt. In the case of external debt, there is a transfer of payment from the debtor country to the creditor country. The direct real burden refers to the loss of economic welfare which these money transfers involve. In case the money payments for servicing external debt are made by the richer classes, the direct real burden will be less; if, on the other hand, they are contributed by the poorer sections of the country, the direct real burden will be much more.

(c) Indirect money and real burdens. Heavier taxation to meet debt charges may reduce taxpayers' ability and desire to work and save and thus check production. Heavy debt charges may also force the government to economies on public expenditure as might promote production. In case these adverse effects of taxation could be neutralized by some favourable effects of public expenditure, the indirect burden of public debt can be cancelled out. In practice, however, this may not be possible. In the case of external debt, indirect money and real burden arise from checks to production because of additional taxation (to pay for debt charges) and to possible economies which government may effect in desirable social expenditure.

Burden of External Debt

In one sense, the burden of a *foreign* debt is similar to that of domestic debt. That is, the government will have to pay it through additional taxation. But, while in domestic debt,

interest payments and the repayment of loans are available to local nationals; in the case of foreign debt they are available to *foreigners.* In another sense, the total money burden of an *external* debt is more because there is the additional transfer problem. That is, the government will have to find necessary monetary resources to pay off the *external* debt and besides will have to secure foreign currencies too (after all, *foreigners will* have to be paid in their currencies). The transfer problem, therefore, requires that during the term of the loan, the balance of trade must become favourable. In other words, a regular payment of interest and principal to foreign countries will be possible only if the export value exceeds the import value by at least the obligations arising from the loan.

But external debt can mean a certain impoverishment of the economy. The payment of interest and debt redemption to *foreign* Countries means a corresponding exhaustion of national income and makes greater demand on the gold and foreign exchange resources of the country. This is what has been referred to as the transfer problem in the previous paragraph. But properly speaking, there is no impoverishment involved. What actually happens *is* this: originally, when foreign loans were made, they entered the debtor country in the form of machinery, raw *materials* and other essential goods, for which no corresponding exports were made at that time. After the lapse of a certain *time,* the debtor country manages to secure excess of exports over imports to pay for the external loan. In this case, there is no actual impoverishment of the economy involved but goods are paid for goods. But if the external debt would really deprive the citizens of a debtor country of a certain amount of, goods and services, this would be a net direct real burden of an *external* loan.

However, there is one sense in which an external loan can be a source of trouble to a debtor country. The transfer problem necessitating the creation of an export surplus means

"an exhaustion of the country's future capacity to import," which is of vital importance for development. But if the foreign loans are floated only when it is absolutely essential and when internal resources are utilized as far as possible, and if the foreign loans are used to increase the total national product, including goods specially meant for export, there is no reason why the debtor country should suffer in the future.

An underdeveloped country which borrows abroad for the development of social and economic overheads and basic industries will find that the benefits outweigh the burden of repayment of the loan. Thus, an external loan for development purposes is not a burden but a profitable venture. This is exactly like an internal loan meant for development purposes.

Measurements of debt burden.

There are various ways of estimating the burden of public debt. Three simple methods are suggested.

1. The first method is to consider the ratio of aggregate public debt to national income i.e., P/Y , where P is the quantum of public debt and Y is the national income. If changes in the quantum of public debt are greater than the change in the national income, the net relative burden can be said to have increased. This is the simple, yet commonly adopted method.
2. The second method considered the interest paid every year on public debt as proportion of national income i,e., I/Y where 'I' is the interest payment or debt service charges and 'Y' is the national income. This method gives an idea of the extent of burden from the point of view of debt service charges.
3. The third method considers the ratio of debt service charge (I) to total public expenditure in a year I/E where 'I' is interest payment on debt and 'E' is public

expenditure. This method has the advantage of comparing the cost side i.e. interest charges in relation to benefit side i.e. public expenditure.

Can the Future Generation be made to bear the burden of Public Debt?

It is often contended that the burden of public debt can be shifted "to make posterity pay" the debt of the present generation. The argument assumes that taxation imposes a direct burden on the present generation while government borrowing does not impose such a burden. Suppose public expenditure is financed out of taxes, the benefit of public expenditure as well as the burden of taxation will fall upon the present generation. On the other hand, in the case of debt financing of public expenditure, the benefit of public expenditure will accrue to the present generation but the burden of taxation to pay for the interest and repayment of principal will fall upon the future generations. Financing of investment projects such as construction of irrigation works, rail and road construction, etc., though borrowing is sought to be justified on the ground that *(a)* the benefit of public debt accrues to future generations, and *(b)* the burden of servicing and repaying public debt would, therefore, be borne by the future generations. This line of thinking is obviously wrong and cannot be maintained.

In the first place, real resources required by the government for war, economic development or any other purpose have to be obtained now and at the immediate cost of the present generation, whether they are derived from taxation or borrowing. Borrowing is only an alternative to taxation for diverting real resources from private sector to the government. The present generation will have to transfer these resources to the government either through taxes or through loans and will, therefore, have to suffer a loss of resources. In other words, the present generation will have to bear the burden of public debt and the question of shifting it to the future generations does not arise.

Secondly, there is no direct money burden of public debts on the future generations. As we have seen earlier, the burden of taxation to pay for public debt is cancelled out by the receipt of interest from the government. While some groups in the future pay taxes some others will receive interest. The question of shifting the burden to the future generations is actually confusing.

It is, however, possible to argue that under tax financing, the present generation will have to curtail its consumption, but in the case of debt financing there will be no such reduction of consumption. The assumption here is that those who are paying taxes do so out of their current income and, therefore, reduce their consumption expenditure but those who are subscribing to public debt do so out of their savings. Debt financing leaves in the hands of public debt owners bonds and other securities which they consider as part of their wealth. While tax financing makes the general public poorer and, accordingly, reduce their consumption, debt financing does not have such a result since the owners of public debt do not feel that they are poorer. In fact, they have bonds and securities in lieu of funds transferred to the government. Under debt financing, therefore, consumption is not likely to fall. In this sense, tax financing imposes a real burden on the present generation, while debt financing does not impose such a burden on the future.

Suppose, the present generation reduces its savings to subscribe to public debt, and suppose further that as a result of reducing saving and capital formation, the capital stock of future generation is reduced. In such a case debt financing can impose a heavy indirect burden on the future generation. On the other hand, if the present generation reduced its consumption, to subscribe to public debt, saving and capital formation would not be affected and the future generation would not be burdened through inheritance of reduced

capital stock. The above analysis is defective since the expenditure side of the government is ignored. If the government resorts to debt financing for planned economic growth and accumulation of capital stock, the benefits will be available to the future generations and there will be no real burden from such debt – for the loss of welfare through taxation will be more than made good by benefits from government investment.

Only in the case of external debt the burden of public debt can be passed on to the future generations. When a country raises resources in foreign countries for war, the present generation receives additional resources and, therefore, need not curtail its consumption or saving. The future generations will have to pay the interest and also repay the principal, and hence the burden of external debt is on them. But in case the country has borrowed in a foreign country for development purposes (as in the case of India), the future generations may not feel the burden on account of increased productivity which external borrowing has made possible.

Generally, therefore, the burden of public debt cannot be shifted from one generation to another. We cannot "make posterity pay". Nor is it normally correct to make the future pay for policies taken now for which the future has no control or influence.

Can a Country Become Bankrupt?

Sometimes people assert that with mounting public debt, the nation would become bankrupt. This is partly true and partly untrue. If bankruptcy means inability to return the amount borrowed, a country can never become bankrupt, however much its domestic debt may have gone up. The government can always honor its obligations either through higher taxation or through printing of money. It has the option to impose a heavy capital

levy and pay off the debt at one stroke. Even repudiation of public debt – though morally indefensible – will be justified, since, after all those who receive interest payments from the government will have to pay taxes to enable the government to pay the interest. Will it not be better to cancel the debts altogether or at least scale down considerably so that interest receipts as well as tax payment will be proportionately cut down? In any case, a government does not become bankrupt because of its internal debt.

Debt Trap: However, there may be circumstances when a government may not be able to honour its obligations to foreign countries. When interest on foreign loans and repayment of debt amount to a considerable figure and when adequate export surplus has not been built up for various reasons a debtor country may be unable to honour its obligations. Either it can ask for postponement or raise new foreign loans to repay the old ones. This has come to be known as the "debt trap." Many South American countries are caught in this trap. Only in extreme cases, it may repudiate external loans. Repudiation is an extreme measure, since the country loses its creditworthiness in the international capital markets and will never again be able to borrow from foreign sources.

6.4 REDEMPTION OF PUBLIC DEBT

Experience shows clearly that mounting public debt has a demoralizing effects of the people apart from the fact that the public is subjected to higher rates of taxation. Besides, public debt consists mostly of unproductive or dead-weight debt – war debt is a good example of such debt – the sooner it is paid off, the better both for the government as well as for the public. The various methods available to the government to pay off its debt are:

(i) Repudiation of Debt. Repudiation of debt means simply that the government refuses to pay the interest as well as the principal. Repudiation is not paying off a loan but destroying it. Normally, a government does not repudiate its debt, for this will shake

the confidence of the general public in the government. However, in extreme circumstances, a government may be forced to repudiate its internal or external debt obligations. For instance, internally the country may be facing financial ruin and bankruptcy and externally, it may be faced with shortage of foreign exchange. Generally, a government may not repudiate its internal debt lest it should lead to internal rebellion: those who have lent to the government would obviously rise against the government. However, the temptation of a government to repudiate its external debt obligation may be strong at certain times. Of all the methods of redeeming debt, repudiation is the most extreme.

(ii) Conversion of Loans. Another method of redemption of public debt is known as conversion of loans, that is, an old loan is converted in to a new loan (in a broad way, conversion is the same as refunding debt; *i.e.,* repayment of a debt through a new loan). Conversion may be resorted to:

(a) When at the time of redemption of a loan, the government has not the necessary funds, and/or

(b) When the current rate of interest is lower than the rate which the government is paying for its existing debt, so that the government can reduce its *interest* obligations. Conversion of a loan is, always done through the floating of a new loan. Hence, the volume of public debt is not reduced. Really speaking, therefore, conversion of debt is not redemption of debt.

(iii) Serial Bond Redemption. The government may decide to repay every year a certain portion of the bonds issued previously. Therefore, a provision may be made so that a certain portion of public debt may mature every year and decision may also be made in the beginning about the serial number of bonds which are to mature each year. This system enables a portion of the debt being paid off every year. A variant of this type of bond redemption is to determine the serial number of bonds to mature every year through lottery. While under-the first variant, the bond-holders know when the

different sets of bonds would mature and could take up the bonds according to their convenience, under the second variant, the bond-holders are uncertain about the time of repayment and they may get back their money at the most inconvenient time.

(iv) Buying up Loans. The government may redeem its debt through buying up loans from the market. Whenever the government has surplus income, it may spend the amount to pay off government loan bonds from the market where they are bought and sold. It is a good system, provided the government can secure budget surpluses. The only defect of this method of canceling debts is that it is not systematic.

(v) Sinking Fund. Sinking fund is probably the most systematic and, therefore, the best method of redeeming public debt. It refers to the creation and the gradual accumulation of a fund which will be sufficient to pay off public debt. Suppose the government floats a loan of Birr10 billions, redeemable in say, 10 years, for the purpose of road construction. At the time the government is floating the loan, it may levy a tax on petrol, the proceeds of which would be credited to a fund known as the sinking fund. Year after year, the tax proceeds as well as interest on investments will make the fund grow till after 10 years it becomes equivalent to the original amount borrowed; at that time, that debt will be paid off. One danger of the sinking fund methods is that a government, in need of money, may not have the patience to wait till the end of the period of maturity but may utilize the fund for purposes other than the one for which originally the sinking fund was instituted.

(vi) Capital Levy. Public debt may be redeemed through a capital levy which, as we have seen earlier, may be levied once in a way with the special objective of redeeming public debt. It is generally advocated immediately *after* a war for the following reasons:

(a) Heavy public debt is incurred during a war to prosecute it and hence is quite heavy immediately after war.

(b) War debt is unproductive and is a dead weight on the community necessitating heavy taxation year after year. It will be better to wipe it out *once* and for all by a special levy.

(c) Due to war-time inflation, businessmen, producers and speculators would have amassed large fortunes and hence it is easier for them to contribute to a capital levy and, in a sense, it is just they bear a part *of* the war burden.

(d) Redemption of public debt through capital levy will leave the higher *income* groups almost in the same old position, since they will be receiving back from the government what they had paid by way of a special levy.

Redemption through a special levy is said to be superior to the method of the sinking fund, as it is levied only once, while for purposes of the sinking fund, taxes have to be imposed year after year. The greatest merit of capital levy is that it will reduce heavy tax burden which will otherwise be necessary to redeem public debt. But the danger of a capital levy is that the government may be tempted to resort to it too often.

(vii) Redemption of External Debt. The redemption of external debt can be made only through accumulating the necessary foreign exchange to pay for it. This can be done by creating export surpluses. Towards this end, foreign loans should be carefully invested in those industries which have high productive potentialities and which will promote exports directly. At the same time, the exportable surplus should consist of goods which can be really taken by foreigners. Temporarily, of course, redemption of an old debt can be made through the floating of new loans.

Of the various methods available to a government to payoff its debt, the most common and- sensible method is to redeem part of the public debt every year, so that the debt may not go on mounting.

6.5 PUBLIC DEBT IN A DEVELOPING ECONOMY

Public borrowings may be for short and long periods but we are interested only in long-term borrowings for purposes of investment. Since voluntary loans come from voluntary savings, the scope for domestic borrowings will be limited. The reasons for this are not far to seek: low income levels of the masses, very low savings of the peasants and the middle classes, the perpetual attempt towards higher consumption, etc. The small minority of the rich does save a considerable portion of their incomes, but these savings are not generally available to the government. The only good source for the government is the banking system and the financial institutions. But the banking system is still undeveloped and the financial institutions are too few to be significant.

Even though domestic borrowings may not be of much importance during the initial years of economic development, its importance would grow as time passes. With increased tempo of economic development incomes rise and savings also rise. The government tries to stimulate savings through educative propaganda, tax concessions and exemption, etc. Besides, the government promotes the setting up of a sound banking system and a well-organized money and capital market and a whole set of financial institutions/financial intermediaries. These institutions help in the mobilization of savings and make them available for investment.

Public Borrowings from Foreign Sources

A developing country borrows from three foreign sources: Foreign capital markets, foreign governments and international institutions. In the past, governments generally floated loans in foreign capital markets and expected the foreign nationals to subscribe to them. But nowadays the demand for funds is so large and political and other difficulties are so numerous against private foreign investment that prospects of investment of funds by foreign nationals and institutional investors in government securities seem to be not

attractive. The government of a developing country can lessen political and social unrest and economic instability by appropriate measures but it would be difficult to convince foreign nationals and make them accept government bonds as riskless. After all, the repayment of interest and principal over the long period implies a high degree of risk and what guarantee can there be in the promises of a government which may be overthrown by another in no time.

In recent years, advanced countries are taking great interest in the economic development of underdeveloped and developing countries. Intergovernmental loans are becoming very significant these days. Besides, international institutions, such as the World Bank and the I.D.A, Asian Development Bank (ADB) etc., are important sources from which developing countries draw for purposes of development. But these institutions insist upon certain minimum conditions before granting loans and many developing countries may not be able to fulfill them.

Conditions Necessary for Foreign Loans

Foreign loans enable a developing country to secure capital and technology which it cannot get internally and which are so essential for economic development. But the total burden of a foreign loan is higher than that of an internal loan of equal extent, because the former involves also a transfer problem. Besides, debt redemption to foreign countries means a corresponding exhaustion of national income and moreover makes greater demand on the gold and foreign exchange treasures of the country. It is essential therefore, that great care is taken in the matter of securing foreign loans. It is but natural that certain internal conditions are fulfilled so as to justify foreign loans.

(a) The foreign loan should be used to stimulate economic growth directly. This will

facilitate repayment later.

(b) The foreign loans should be invested in such a way that the country secures a favourable balance of trade in the future. This is necessary, as we have pointed out earlier, because foreign loan involves a transfer problem, *viz.,* the necessity to transfer from the debtor country to the creditor country. This would further necessitate the excess of exports over imports.

c) Foreign loans will be justified only if the productive resources of the country are insufficient to bring about a planned pace of growth. This is so because the gross burden of foreign borrowing is higher than that of domestic borrowing.

A backward country is not justified in borrowing from abroad unless internal sources are inadequate and there could be proper use of loan proceeds. The existence of an adverse balance of payments alone cannot be a sufficient reason for borrowing. It is not really necessary that foreign loan should be used on projects which will increase exports and check imports and thus help in remedying adverse balance of payments. What is required basically is the development of the total national product and not be development of exports only. However, there may be circumstances under which even a temporary adverse balance of payments may have serious adverse effects on economic development. Foreign borrowing will be justified here, again, not to remedy adverse balance of payment but to prevent internal disturbances.

Public Debt management

Public debt management refers to important policy decisions to be made with regard to public debt. This is an important aspect of modern public finance as it is now accepted that public debt is

an active fiscal tool just like taxation and public expenditure, all of which have varied effects on the economy. Hence the floating and repayment of debt should be carefully planned. The forms of public debt, the terms of loan with regard to interest and duration, the ownership pattern are all crucial issues in management of public debt. In short public debt management is concerned with the policy decisions on the structural characteristics of public debt.

Objective of public management

Public debt management can help the Government to achieve several goals. Important objectives of public debt management in this respect are:

1. It should not have any adverse effect on the economy, especially on willingness and ability to work and save
2. During inflation public debt management should aim at curtailing aggregate demand
3. During depression it should help to raise aggregate demand in order to improve employment.
4. Public debt management can help to secure funds during War.
5. It should go hand in hand with monetary policy to strengthen the money market.

Principles of public debt management

Phillip E. Taylor points out that a general principle of public debt management should be to get loans from the public without undue coercion or force. The raising of loans by the government as well as its redemption should not interfere with the smooth functioning of the economy. The government should not enter the loan market when it is not convenient to do so. Accordingly following principles of Public Debt management can be stated.

1. **Minimum interest cost.** The first principle of public debt management is that the government should keep the interest cost of the loan at the minimum. If the interest is low, it will impose less burden of taxation at the time of redemption

2. **Satisfaction of investor's needs.** Public debt should be managed in such a way that the needs of different types of investors should be satisfied with regard to the type of securities as well as general terms. The terms of loan should attract the public to invest in government securities.
3. **Funding of short-term debt into long-term debt.** Public debt management should enable the Government to convert short-term loans into long-term loans. But such funding operations should not harm economic stability because the conversion of short-term loans into long-term loans will necessarily result in a rise in the interest rates. This rise in interest rate on Government securities will affect the volume of private investment. The low demand for short term securities will reduce their interest rate and may even make such funds go out of the country.
4. **Co-ordination of public debt policy with monetary and fiscal policy.** Public debt management should not clash with monetary or fiscal policy. The Government may want to keep interest rates low. So it might advise the central bank to follow a cheap money policy of low interest rates. This will encourage inflationary trends. Such a problem can be avoided if there is a proper co-ordination of public debt policy with monetary and fiscal policy.
5. **Composition of public debt and maturity.** If the public debt programme results in a large proportion of short-term debt held by commercial banks, there will be a high degree of liquidity in the market. This can generate inflation. If the holders of such liquid assets try to monetise their debt obligations before maturity, controlling inflation will be difficult.

An analysis of the objectives and principles of debt management makes it clear that debt management is a subtle art. The basic requirement of an efficient public debt management is that from the time of floating the debt to its redemption, the strains and friction are kept to the minimum. Public debt has become an important instrument of fiscal policy and public debt management should be coordinated with general economic policy to realize maximum social advantage.

Short notes questions

1. Explain public debt? What is the difference between taxation and public borrowing?
2. Explain the differences between public debt and private debt.
3. Explain the importance of public debt in developing economy like Ethiopia.
4. Explain the methods of estimating debt burden.
5. Does deficit finance always lead to inflation?
6. Discus the different methods of redemption of public debt.
7. Explain the effects of public debt on the economy of a country
8. Explain the nature of the burden of public debt.
9. Explain the various classification of public debt.
10. What are the objectives of public debt?

CHAPTER SEVEN

DEFICIT FINANCING

Distance students, in this chapter we will discuss four sections: 1) the meaning of deficit financing. 2) Objectives of deficit financing. 3) Effects of deficit financing. 4) Limits of deficit financing.

Learning objectives

After discussing these sections, you should be able to

- Know the meaning and different methods of deficit financing.
- Discuss the objectives of deficit financing.
- Explain the effects of deficit financing.
- Explain deficit financing and capital formation
- Discuss deficit financing and economic growth.

7.1 MEANING OF DEFICIT FINANCING

Deficit financing has become an important tool of financing government expenditure. In simple terms it means the way the gap between excess of government expenditure over its receipts is financed. However the concept of deficit financing is interpreted in different ways in the western countries.

In the western countries whenever the public expenditure is greater than its revenue receipts, it is financed through public borrowing or creation of new money. Whenever there is deficit in the current account, its financing becomes deficit financing. Even public borrowing is a way of deficit financing.

In the modern sense public borrowings to finance excess of public expenditure over revenue is included in the capital account of the budget. After including these borrowings in the capital account, there may still be a deficit in the budget. The method adopted by the government to finance this overall budget deficit in the current and capital account together is known as deficit financing.

Thus budget deficit and deficit financing are two different concepts. Budget deficit is a narrower concept, referring to excess of public expenditure over current revenues. Most countries adopt a wider concept of deficit financing whereby any method adopted to bridge the budget deficit even after borrowings, becomes deficit financing. Further in the narrower concept, the budget deficit is managed through market borrowing out of public saving. So it is non-inflationary. But in the broader sense of deficit financing, it refers to borrowing from the banking system. Hence it is inflationary in character.

Different Methods of Deficit Financing

Governments can adopt three methods of deficit financing and the impact is different in each case. Firstly governments can borrow from non-bank investors or commercial banks. This is considered non-inflationary as it tends to replace private expenditure. For example when government borrows from commercial banks, their liquidity is reduced so that it reduces loans to the private sector. Thus the government borrowing from commercial banks replaces private expenditure and hence it is non-inflationary. If the non bank investors get loans from the commercial banks against their fixed deposits and use it to lend to government it would be inflationary.

In the second case when the government draws from its cash balances with the central (National) bank it is not inflationary. But in the third method when the government borrows from the central bank against its securities, the central bank creates new money by resorting to the printing press. This would again result in a secondary reaction of expansion of bank credit. This type of deficit financing by loans from central bank tends to be highly inflationary.

7.2 OBJECTIVES OF DEFICIT FINANCING

Deficit financing has been ascribed an important role in fiscal policy on account of increases in public expenditure on various accounts. The different objectives of deficit financing make it clear.

1. **To finance wars**. Deficit financing has been found to be the simplest and quickest method to finance huge War expenditures. War time emergency makes it difficult for government to raise urgent resources through its usual methods of taxation and public borrowing. The funds obtained through deficit financing are used by the government to purchase goods and services to fight war. This raises the aggregate demand. Resources are mobilized by the government not for productive purpose but for war efforts which is unproductive. Thus the rise in aggregate demand and non-availability of sufficient goods result in an inflationary price rise. The experience of Germany during the two world wars is a classic example of the harmful effects of Wartime inflation. During First World War, the German paper Mark depreciated so much in value that one gold Mark could not be purchased by even one billion papers Mark. Similarly during Second World War, the ratio of gold to paper currency became as low as 0.01 per cent on account of deficit financing. However, wartime emergency requires a quick mode of financing. Hence deficit financing cannot be avoided. Precautions should be taken to control private demand.

2. **To fight unemployment during depression**. Keynes advocated deficit financing as an important tool of solving the problem of involuntary unemployment during depression. This unemployment during depression occurs due to lack of effective demand since private spending is low. Therefore the only way to combat unemployment would be for the government to invest in public works programmed to create employment. Further during depression welfare payments to be made by the government would also increase. Government cannot get finance for this expenditure out of taxation or public borrowing as taxable capacity and ability to contribute to government loans is very low during depression. Hence the government has to borrow from the banking system. Thus deficit financing becomes the best mode of financing anti-deflationary expenditure.

Keynes suggested that the investment undertaken by the government will result in a multiple increase in incomes via the multiplier effect. However the operation of the multiplier may not be that successful in underdeveloped countries as there is unutilized or idle capacity in both agricultural and industrial sectors. Supply of working capital is also very low. On the other hand marginal propensity to consume is very high. Thus Keynes' multiplier may actually raise the aggregate demand instead of raising the aggregate supply. Hence deficit financing to combat unemployment in underdeveloped countries requires great caution in handling so that inflationary pressures are not generated.

3. **To promote economic development**. Deficit financing can go a long way in promoting economic development in underdeveloped countries. There are two issues to be discussed here. First refers to the way in which deficit financing can be used to finance development projects. Second whether deficit financing for development results in inflationary potential. The major obstacle to development in these countries is low rate of capital formation which is not enough for sufficient investment to provide jobs for the large number of unemployed. With increasing population the level of unemployment also increases necessitating greater capital formation. Low incomes of people reduce the taxable capacity as well as ability to save. For the same reason, government cannot raise resources through public borrowing too. Hence deficit financing becomes the only way of mobilizing required resources, in developing countries.

Deficit financing can help to stimulate the rate of investment indirectly. Deficit financing for development first of all increases incomes and thus savings too. It results indirectly in forced saving too because when the government purchases goods and services for its projects, people do not get them. So the reduced private spending results in larger saving.

If the government uses deficit financing to undertake productive projects then output would increase and it may not be inflationary. But there are certain rigidities in the

developing countries which do not result in complementary factors for investment. Firstly there is a lack of entrepreneurship and technical know-how. Secondly there is no adequate infrastructure such as organizations, market communications etc. These market imperfections fail to increase effective supply along with increasing demand and these causes rising prices.

Further elasticity of supply is not the same in different sectors of the economy. For example elasticity of supply tends to be low in agriculture than in industry. In the initial stages of development if the government expenditure is directed towards these sectors whose elasticity of supply is low, it is certain to increase incomes and demand in these sectors but lack of supply response would raise prices. In all these cases, if deficit financing used for development schemes results in inflationary price rise, the government should carefully raise taxation to siphon off the excess purchasing power in the hands of the people.

Another way in which deficit financing can promote development is when it increases the incomes of the entrepreneurs whose propensity to save is high. In fact this may result in greater inequality of income. But in the initial stages, higher propensity to save of the entrepreurial class is a welcome feature in the interest of general economic development. This fits into the theory of imbalanced growth given by A.O. Hirshman.

In general it is accepted now that so long as care is taken to avoid inflationary potential, deficit financing is a very useful instrument of development in developing countries. Deficit financing should preferably be used for quick yielding projects in the initial stages so that the increase in production will control inflationary pressure. If development projects have long gestation period, deficit financing for such projects would bring in inflationary price rise. Hence in developing countries deficit financing should be carefully used in the initial stages to lay a good foundation for necessary infrastructure for development.

4. **To mobilize surplus, idle and unutilized resources**. Keynes had advocated deficit financing for the mobilization of surplus labour and other resources during depression. This argument may be applicable to underdeveloped countries only with limitations. If deficit financing is used to employ such labour in the agricultural sector in these countries, it may create inflationary price rise.

   On the other hand deficit financing is recommended for its ability to create new resources in these countries. When deficit financing raises prices in these countries, it reduces consumption and savings become forced. Thus deficit financing is recommended in developing countries for the mobilization of forced savings or for the creation of new resources, which again can be used for next stage of development. That is why W. A. Lewis said that "Inflation for the purpose of capital formation is in due course self-destructive".

5. **To finance the Plans.** In developing countries like Ethiopia which have adopted planned economic development huge resources are required for implementation of government investment. The government takes greater interest to create infrastructure, industrial development in vital sector besides transport and communication. Deficit financing is a. useful tool to finance the Plans.

6. **To serve as an alternative tool.** Underdeveloped countries suffer from low taxable capacity and low savings. Hence government's ability to raise resources gets constrained. Therefore there is no harm in resorting to deficit financing as an alternative source of mobilizing resources besides taxation and public borrowing.

7.3 EFFECTS OF DEFICIT FINANCING

Deficit financing can make or mar progress if it is not carefully planned. It has diverse effects

depending upon how it is handled. The major effects pertain to inflation and distribution of income.

1. **Deficit financing and inflation.** There are two views regarding the impact of deficit, financing on prices. The first view is that deficit financing is pro inflationary. This view holds that the first impact of deficit financing is on the creation of new money. Deficit financing is recommended for the creation of capital goods whose gestation period is long. There is increase in money incomes in this sector. But consumer goods producing sector does not respond quickly to bring more production. This results in rise in prices of consumer goods which may prove to be spiraling. The price rise will be greater if market imperfections exist as bottlenecks to increased production.

   Further, a part of the increased incomes, in the absence of sufficient goods to spend, may be channelized into commercial banks who may use it for further credit creation. In fact in developing countries the inflationary pressures are due to monetary expansion after deficit financing. Inflation then tends to be demand-pull type while deficit financing in developed countries causes cost-push type of inflation on account of long-term gestation projects.

   The poor developing countries are not well equipped in terms of monetary and fiscal policy to control inflation. Hence there is a possibility that unabated inflation on account of deficit financing may hinder economic development of these countries.
   The second view holds that deficit financing is not necessarily inflationary because public sector has emerged as a dominant sector in these economies. If this additional finance is utilized for productive purposes, it need not be inflationary. Deficit financing is required to provide finance for increasing output at stable prices. If deficit financing is not resorted to there may be a decline in prices which will have an adverse effect on output and employment.

W. A. Lewis points out that there are three stages in the impact of deficit financing. In the first stage, only capital goods industries are created through deficit financing and as they have long gestation, prices rise steeply. In the second stage, the rise" in prices makes people reduce consumption which results in forced savings which increases investment. In the third stage, the capital formation of the first stage begins to bring consumer goods to the market which helps to lower prices. Therefore deficit financing is 'dangerous and painful' only in the first stage. In Lewis' view inflationary potential of deficit financing is therefore self-destructive. Others however point out that if the consumer goods are not increased in the second and third stages due to some constraints, inflation becomes rampant.

2. **Effect on distribution of income.** Deficit financing has certain undesirable effects on the distribution of income. Deficit financing provides incentives to entrepreneurs through larger profits on account of rising prices. But the same rising prices reduce real incomes of the wage earning class. This leads to a distribution of income in favour of the profit earning classes. Hence inequality of incomes widens. This is very much against the social objectives of equitable distribution of income and wealth.

Thus an analysis of the objectives and effects of deficit financing proves that it is a double-edged sword. Its effects can be good so far as it promotes capital formation and does not allow for a steep increase in prices. Its effects can be harmful if the inflationary potential goes uncontrolled, bringing about adverse effects on distribution of incomes and wealth, thus increasing inequality. The exact impact of deficit financing depends upon the mode of deficit, governments' attitudes and policies, reaction of the private sector and growth of the public sector.

Deficit financing can be a very useful and effective fiscal tool for development in under developed countries if it is used only for capital formation to channelise resources into productive areas. The mild price rise on account of deficit financing in the early stages acts

as an incentive to entrepreneurs to increase productive activity. Such a functional rise in prices is harmless.

7.4 LIMITS TO DEFICIT FINANCING

It is now recognized that deficit financing is a bad master but can be a good servant *i.e.,* it should be handled carefully without using it excessively. This raises the question as to what is the safe limit for deficit financing. Several factors are to be considered in determining the safe limit.

1. **Growth rate of the economy and money supply.** The money supply should expand to facilitate the growth rate of the economy. Suppose the total money supply in the economy is 4,000 million Birr and the growth rate of the economy is 5 per cent, it requires an additional money supply Birr. 200 billions per annum to sustain the growth rate. Hence deficit financing can be used to create Birr 200 billions per annum. But since it is used for productive assets creation, deficit financing can be even more than 5 per cent of the money supply. Thus even 7 or 8 per cent expansion in money supply on account of deficit financing need not be inflationary in developing countries.

2. **The efforts made by the government to mobilize its resources.** Deficit financing should be used only as a last resort after all alternative source of finances are exhausted. The public will not mind the effects of deficit financing when they know that the government has undertaken all efforts to mobilize other resources and only when they are exhausted, deficit financing is adopted.

3. **Control of incomes and prices.** Deficit financing to finance government projects enters the income stream in the form of wages and salaries. It is this increasing incomes and wages which exert an inflationary pressure. Hence a proper control over income and prices acts as a control over the inflationary potential of deficit financing.

4. **The growth of monetized sector.** It is the existence of a large nonmonetised sector which aggravates the inflationary potential of deficit financing. The extent to which the non-monetized sector is brought into the ambit of monetized sector, acts as a safe limit to deficit financing.

5. **Increase in the production of public sector**. Deficit financing is incurred to finance public sector projects. If their production increases, this increase in production will cushion the inflationary potential of deficit financing. It is for the same reason deficit financing should not be incurred for unproductive purposes.
6. **Promotion of imports**. Deficit financing is bound to increase incomes in the initial stages which causes and increase in demand for goods and services. Since production does not increase immediately in the early stages, the inflationary pressures can be kept within safe limits by permitting import of goods. This of course depends upon the foreign exchange reserves to the country.

7. **Restriction on credit** A large portion of new money created through deficit financing may reach the banking sector in which case it gives them an opportunity to create credit further. Restriction on credit can limit inflationary pressures.

8. **Direct and indirect control**. Government should adopt various measures to control prices directly and indirectly. Direct control refers to the control of prices beyond the stipulated levels. It is a type of administered prices. Indirect controls result in government's improving the public distribution system to supply goods to the people at reasonable prices.

9. **Public spirit of cooperation and toleration.** Some economists point out that "The role of public understanding and public cooperation is a factor in tending to diminish the price effect of deficit financing". Unless the government enjoys the public cooperation, it will have to face open, popular and political opposition to further use of deficit financing when

the prices rise excessively. The spirit of tolerance on the part of public acts a limit on government's use of deficit financing.

In the final analysis the state of the economy, the purpose for which deficit financing is incurred, the control over money expansion, prices and incomes, the magnitude of the deficit financing, are all factors /which, limit the government's powers to resort to deficit financing excessively.

Short Note Questions

1. Discuss the objectives of deficit financing
2. Explain the effects of deficit financing.
3. Why deficit financing is the feature of developing countries?
4. Distinguish between deficit budgeting and deficit financing
5. Does deficit financing help developing countries like Ethiopia? Explain.
6. Does deficit financing necessarily lead to inflation?
7. Express your view on the limits of deficit financing.

CHAPTER EIGHT
PRINCIPLES OF FEDERAL FINANCE

(Principles of allocation of resources between Federal and State governments)

Distance students, in this chapter we will discuss three sections, namely

1) Principles of Federal finance, 2) Problems of Federal finance,

3) Different forms of inter-governmental financial transfers

Learning objectives

After studying these sections, you should be able to:

- Discuss the principles of federal finance
- Explain the norms of federal finance
- Explain how the revenues are distributed among the center and the states by the constitution
- Explain the fiscal imbalances in federal finance (vertical and horizontal imbalance)
- Know how to remove the imbalance

In a federal set up, the federal-State financial relations are based on the principle of federal finance. The world federation connotes the union of two or more states. In a federation we have on the one hand, the Federal Government and on the other the Constituent States. Federation may be defined as a "form of political association in which two or more states constitute a political unity with a common government, but in which these member states retain a measure of internal autonomy." According to the Encyclopedia Britannica, "federation is a form of Government in which the essential principle is that there is union of two or more states under the central body for

certain permanent objectives." Sir Robert Farn defined, "a federation as a form of government in which sovereignty of political powers is divided between the central and local governments, so that each of them within its own sphere is independent of the other." Thus, in a federation, there is constitutional divides on of powers, functions and resource between the federal and the state governments. The two sets of governments are independent so far as their own functions and resources are concerned.

8.1 PRINCIPLES OF FEDERAL FINANCE

Prof. B.P .Adakar, in his celebrated book on principles and problems of federal finance lays down three principles which should govern the working of federal finance, system. These principles have been discussed as follows:

10. **Independence and responsibility** – In the first place Prof. B.P. Adarkar said that "full freedom of financial operations must be extended to both federal as well as state governments in order that they may not suffer from a feeling of cramp in the discharge of their normal activities and in the achievement of their legitimate aspirations for the promotion of social and economic advancement." It means that central and state governments must each have under it, its own independent central financial resources sufficient to carry out its exclusive functions. In other words, central and state governments should be financially independent within their own sphere. Besides, each government should take the responsibilities of taxing, borrowing, and raising resources in their spheres for performing their functions. The authority which has a pleasing job of spending money should also do the unpleasant job of raising it. Thus, "taxing autonomy and spending autonomy should go hand in hand."

    However, there are some who believe that, if every level of government is to raise the money that it was going to spend, then there would be great disparity in quality and

quantity of public expenditure from state to state. State with wealthier population and richer tax resources will be able to fulfill their social obligation much better than the poor ones." In an under-developed country certain practical considerations such as uniformity in tax rates throughout the federation, promotion of economic growth and maintenance of internal and external stability, balancing economic and social development in all regions, etc., cannot be ignored. In other words, the advocate of this view intends that taxing autonomy should lie with federal government while spending autonomy with the states.

Theoretically speaking the case of centralization of revenues in the hands of the federal governments appears to be very sound in the case of under developed countries on the ground of economy and efficiency and balanced economic growth.

However, the practical point of view should not be totally ignored. If too much dependence of State government on central government for finance is accepted then the former may be reduced to the status of spending agencies of the federal government and may not feel as partners in progress. It is, therefore, concluded that central government and state governments both should be autonomous in the sphere of raising resources and performing their functions effectively, but periodical adjustment in these aspects is necessary for the successful working of both governments.

11. **Adequacy and elasticity** – The principles of adequacy means that the resources of central and the state governments should be adequate so that each layer of government can discharge its obligations laid upon it. It stands for sufficiency of resources for the discharge its obligations laid upon it. It stands for sufficiency of resources for the discharge of functions and duties assigned. Thus, Sir Johan Latham, former Chief Justice of Australian High Court said "If a federal system with real independence in the state is to continue, the state must have financial resources under their own control reasonably adequate to meet their responsibilities."

Besides to adequacy, there should be elasticity in the financial resources. It means that resources should be capable of expansion in response to rapidly growing needs and responsibilities of the government concerned. Otherwise, the Federal Finance Scheme will become an obstacle in time s of economic and defense crisis. For this, each layer should have considerable initiative and freedom to raise finance.

12. **Administrative economy and efficiency –** For the success of central-state financial relations, it is very much required that the administrative cost should be minimum and there should be no frauds and evasion in matter of finances. It should also be taken into account that at the time of allocating resources as to whether a certain source can be better administered by federal or state government. Corruption and inter-regional smuggling are to be avoided and the resources of revenue are to be fully exploited.

Some other principles: Besides these principles, some scholars on the subject of central-state financial relations have added a few more principles in view of the needs and present conditions, especially of under-developed countries.

13. **Principle of equity –** Equity is an important canon of taxation laid down by Adam Smith. The applicability of this principle in federal system is important, because in the assignment and allocation of functions, there is an opportunity for inequity to creep in and may spoil the entire structure basically. Different state of a federation may have disparity in the level of economic development and, therefore, according to this principle, the burden of taxation will be in equally distributed as the marginal sacrifice will be different in different states. The marginal sacrifice of the tax-payers of richer states will be less as compared to those of the poor states. Therefore, a need may arise to adjust the federal and states taxes in such a way that the marginal sacrifice of the federal and state taxation taken together is equal or nearly equal to every person, no matter in which state he resides. Therefore, there should

be proper adjustment between federal and state taxation so as to make the tax burden on all citizens equitable as far as possible.

14. **Principle of integration and coordination** – The whole financial system of federation should be well integrated and each layer of financial system of federation should not be taken as completely isolated from the other layers of financial system. Integration of financial systems of federal and state governments is essential in contemporary federations. This should be done in a way that promotes working of federal financial system. The coordination of federal state should not be in taxation alone but in every aspect of finance. "The coordination of federal state and local finance should, however, be concerned not only within taxation. It should also embrace the current budgets, capital outlay programs and credit operations of various authorities and should be accompanied with a coordination of administrative activities as well."

15. **Principles of accountability** – freedom and democracy are sister institutions in a federal system. Therefore, in federal system such government should be accountable to its own legislative for its having and spending decisions and should make these decisions with due regard for their effect on other government.

16. **Principle of uniformity** – The financial system in a federation should be such as to enable each regional government to provide an adequate level of public service without resort to higher rates of taxation substantially than those of other regions.

17. **Principle of fiscal access** –This canon implies that the resources should grow with the increase in functions and responsibilities. The state governments should have access to develop new sources of revenue to meet their financial needs. There should be no bar on central and state governments in developing new sources of revenue within their own

prescribed fields to meet the growing financial needs. It implies that resources should grow with the increase in responsibilities.

The problem of federal finance should not be over shadowed by dogmas or rigid principles but should be solved by an approach of reality and pragmatism, so that healthy financial relations may develop. The conditions differ from time to time and, therefore, a fixed division of financial resources cannot be applied. Thus, division of resources should be subjected to flexibility and adaptability. There can be no final solution to the allocation of financial resources in a federal system. There can be only adjustments and re-allocation in the light of changing condition. Thus, rigidity should be replaced by dynamism and changes be made according to the needs of different layers of the government. "The importance of flexibility or adaptability in the distribution has been widely recognized." Flexibility seems to be sine-qua-non of a rational system of federal finance. According to Dr.Gyan Chand, the system of federal finance should be designed to meet the needs of changes that may have to be introduced in the interest of harmony and efficiency. It should be based on a large measure of general consent. It can, however, be concluded that central and state governments should collaborate in such a way that ensure maximum utilization of national resources, accelerated economic development, reduction in disparity and augmentation in production and productivity.

8.2 PROBLEMS OF FEDERAL FINANCE

In a unitary government there is centralized public finance; but in a federation two constitutionally independent fiscal systems operate upon the fiscal resources of the individual citizens.

There is multiplicity of taxing and spending authorities in a federation. Thus, in a federation, fiscal structure is decentralized, and wheels with it's the wheels operate in the financial machinery.

Hence, it may be called multi-unit public finance. Thus, the federal finance faces the problem of "financial arrangement between the federal government and states. This is of crucial importance for them, for they govern the effective powers of the center and regions in the field of economic affairs and the nature of their future development.

Thus, in federal system, the functions and duties of the state are divided between the central government and several state governments and they are generally defined in the constitution. The allocation of function and resources between the central and state governments, however, differ from country to country. The general principle on which the allocation of functions and duties are based is "whatever concerns the nation as a whole, principally external relations and inter-regional activities should be placed under the control of the central government and that all maters which are primarily of regional rather than common interest should remain in the hands of the regional government." It should however, be noted that functions and duties should be allocated in such a way that each layer of the government gets those functions and duties which it is able to perform. In other words, the main criterion in the allocation of functions is whether a particular function can best be discharged by the centre or by the states and the allocation should be made accordingly. Thus, following this principle, generally external affairs, foreign and inter-regional trade, shipping, inter-regional communications, defense, post and telegraph, etc, are assigned to the central government. Subjects of local interests such as education, health services, public works, social services, internal law and order, etc, are assigned to the state government. Broadly speaking, the functions which are of national importance have generally been assigned to the Central Government and those which are of local or regional importance have been assigned to the State Governments.

It should, however, be kept in mind that these functions cannot be strictly separated in present times. There is no function in which both central and state governments are not interested. For instance, the central government is equally interested in the developmental functions like education, public health, etc. Similarly, state governments can not ignore defense,

communication, etc. Thus, there should be a close coordination between the policies of central government and state governments. In any case, the interests of central government should not come in conflict with state governments. Thus, James A. Marxwell rightly said that "the practice of cooperative federalism does not correspond to the theory of separation of functions." Here, he also quotes, Morton Gordzins saying that "colors are mixed in marble cake, so functions are in the federal system."

Allocation of functions may create problem in the allocation of resources between central and state governments corresponding to their requirements. Therefore, "the fundamental problem of federal finance is that ensuring that the division of revenue between central and regional governments corresponds with the distribution of function in order that teach government may have the functional capacity to carry out its responsibilities as far as possible." This is a difficult problem which generally arises, in a federal set up. It is not easy to allocate functions between federal and state governments and when they are allocated, it is still harder to allocate resources between them, because both functions and the responsibilities for financing them over-lap. Besides, functions and responsibilities are dynamic in character. For instance, the responsibilities of the state government may be comparatively fewer fifty years back than what they are at present. Accordingly, the financial requirements of the state may be less at that time than what they are at present. And the same may be true for the central government. Thus, the success of federal finance depends upon the efficient solution of these problems and adjusting it with changing circumstances.

Problem of Imbalance in Financial Resources

Causes of imbalance:

It has been observed that the problem of imbalance in the allocation of financial resources and functions between center and all state governments generally arise because almost all important and elastic sources of revenue like customs, income tax, corporation tax, etc., are allocated to the federal government on the consideration of administrative efficiency. On the consideration of autonomy, state governments are assigned expenditures on social and developmental items. Thus, in practical life, it has been found that federal revenue grow more quickly than state revenues and state expenditures grow more quickly than the federal, while resources have increased in the account of Federal Government, need for spending has increased in the account of regional government. As a result, the federal government has the resources and the state have responsibilities. Hence there is imbalance in the federal financial system.

This imbalance has let to a general strain. Even in a well established federation this problem exists. This has been due to the fact that federal and state governments had limited functions and utilize resources of revenue which were fairly separate. The scope of government now has expanded everywhere and the original division of functions and resources has been characterized as belonging to the 'Horse and Buggy Period'. With the expansion of functions, central government began to encroach upon the tax revenues of the regional government and the regional governments in turn have been faced with growing maladjustments between resources and functions.

There is one other aspect of this problem; there are differences in the levels of the economic development leading to marked disparities in income and wealth of the constituent units. In this context Mr.K.V.S. Sastri said that "the question of financial imbalances is made worse by the fact of inter-regional inequalities in economic development and fiscal capacity." Thus, for bringing nation-wide uniformity in economic and social development, there will be greater than average financial strain for the poorer states in a federation, and, therefore, the ideal of "welfare state" may suffer. Thus, financial resources are in paucity, where they are needed most.

With the growth of activities of the modern state on the one hand and the lop sided allocation of financial resources on the other, it becomes inevitable to make adjustments into the financial system of federation. However, there cannot be any final solution to the problem. There can, however, be adjustments, reallocations or transfer of resources in the light of changing circumstances.

How to Remove Imbalances

The financial imbalance between federal and state governments may be corrected either by transferring some functions from states to central government or by transferring some resources from federal governments to state governments. However, no developing society can afford a rigid division of powers and functions. If there are great inequalities in the economic and social development to different constituent units, and it is desired in the national interest to mitigate them, the federal government may undertake the functions which lie in the sphere of regional governments; Switzerland provides an example of such adjustment. Functions, such as social security, can easily be transferred to federal government. This was also to bring uniformity in the standard of social service. But this step may generally be opposed by state government on the ground of interference with autonomy.

The problem of imbalance between federal and state governments can be solved by transferring certain federal taxes to the state governments. But, this is opposed on ground of uniformity of rates and administrative efficiency. However, if it is thought highly important to maintain the rights of the states vis-à-vis those of federal government, one should favor as much financial autonomy for the states as possible. States should not starve for funds or be always looking at center for help. Thus, the financial imbalance between federal and state governments should be removed.

This imbalance of financial resources between the central and state governments can be solved by transferring funds from the center to state governments. The practice is very common in almost all the federations. The common wealth grant commission of Australia observes that "we have an accepted practice of transferring large and increasing sums from commonwealth to state governments primarily because the commonwealth can raise the money more easily." Thus, by transfer of funds from the federal to states government, the financial balance is achieved. Therefore, inter-governmental financial transfer constitutes an integral part of the system of federal finance in maintaining financial equilibrium. It may assume various forms, which have been discussed as follows.

8.3 FORMS OF INTER-GOVERNMENTAL FINANCIAL TRANSFER

1. Distributive Pool Method, or Distribution of Tax Proceeds, or Tax Sharing:

According to this method, pre-determined proportions of the proceeds of certain central taxes are combined into a single pool, and the contents of this pool are then allocated percent wise to different states on a pre-determined basis. Three problems are involved in putting this method into practice, which taxes should be shared, what proportion of these taxes should be assigned to the regional government, and how the share of each state should be determined.

The taxes to be shared are mentioned in the constitution of the federation concerned. As regards the proportion of the shared taxes to be assigned to the states, it may also be provided for in the constitution itself. In India and certain African Federations a commission, set up in terms of the constitution, decides the share of taxes to be assigned to the states. In Canada, it is a matter of five-yearly agreements between federal and provincial governments. In this respect, Indian provisions have flexibility. The finance commission fixes the proportion according to the needs of the state and it has been increased by the succeeding finance commissions.

It should, however, be noted that, if the proportion of shared taxes to be assigned to the states is laid down in the constitution, it will make the system rigid, as changes in the constitution can not easily be made.

The other problem is concerned with the determination of each state share in the distributive pool. However, this is a tough problem. In Ethiopia the House of Federation determines the share of each state and in India and certain African Federation, this is determined by an Independent Finance Commission on the basis of such factors as the size of population, economic and social backwardness and contribution of each unit in the divisible pool. Thus, allocation to the states from the distributive pool should be done according to the principle of need, keeping in view with the size of population, economic and social backwardness, responsibilities which the government has to perform.

In Ethiopia, a combination of both the principles (i.e., population and contribution) is followed. For instance, the proceeds of income tax from the divisible pool may be allocated to each state, 80 percent on the basis of population and 20 percent on the basis of collection. It is done, because population is not only considered as the criterion of needs of the state but per-capita income and contribution has also been given due consideration.

Advantages and Disadvantages:

1. Distributive pool method has certain advantages. In the first place, the superior position of the central government is maintained without destroying autonomy of the regional governments.
2. Secondly, the method has the merit of simplicity
3. Thirdly, the method is helpful in distributing the proceeds in equitable and efficient manner. In this context the requirements of the centre as well as those of the component

states can be met in the most equitable and efficient manner, by distributing the proceeds after these have been collected by the central government, rather than by dividing power of tax collection between centre and states which would not only means high costs of decentralized collection and large scope for evasion but also varying rates of taxation in different areas and rigidity of distribution in the face of changing requirements.

4. Regional governments would be encouraged to undertake those activities for which Federal Government would be interested in those activities of individual states which will bring them on equal footing.

5. Fifthly, the share of regional government will expand with the expansion of tax revenue of the central government.
6. Lastly, it involves some measures of redistribution of national wealth.

But, this device also suffers from certain defects. For instance, there will be fluctuations in their share, upward as well as downward and the regional government may not have the capacity to react to these changes. In this context, Harold M.Grove said that "this technique is attractive for those who attach supreme importance to logical and simple mechanism, but encounters impressive objections. It involves a high degree of centralization as to both levies and administration. The fiscal independence of the regional units under sharing is about the same as that of minor son placed upon a revocable allowance by a generous father."

2. Loans:

Loans play a special role in federal set up. Loans can be given by the center to the states or by states to the center. However in almost all the countries, the common practice has been-loan given by center to the states At the same time the state governments should follow economy while spending the loans

3. Supplementary Levies

According to this method the principal tax is levied by the federal government and supplementary tax is levied by the regional governments or vice versa. Generally, regional governments levy supplementary tax over the principal tax levied by the federal government. States add a percentage to the national levy for their own use. "It secures an integrated tax and is administratively efficient, since assessment and collection will be the responsibility of the federal government." It should, however, be noted that a ceiling has to be put over the state's supplementary levy, so that the tax burden may not become heavy or may not exceed 100 percent.

4. Grants:

If taxation devices are insufficient to correct the imbalance between revenues and expenditure of the regional governments the other obvious solution is grant from the federal to the regional governments. The system of grants is an effective instrument for bridging the gap between revenues and expenditure of the regional governments. It is a device for making the constitution more flexible and is a means of modifying the distribution of tax burden. The grants may be on a number of bases, there may be general grants or grants-in-aid and special grants. A new technique of giving grants is a matching grants system or specific purpose or conditional grants system or shared cost programs. In almost all the federations, there is provision for federal grants to the regional government.

Grants-in-aid are given to fill up the gap between the revenues and the expenditures of the regional governments. Generally, budgetary needs of the regional governments are the criterion for giving such grants. Different states may be given different amounts of grant in aid. Such grants leave the state budgeting unfettered, as their amounts may be utilized by the recipient units as they desire.

Principles governing grants-in-aid

According to Alven H.Hansen and H.S.Perloff, the following principles should govern the grants in aid to the states-

i. Grants should be distributed among the states on the basis of their relative financial resources, i.e., those with the greatest need and least resources should receive the largest per capita grants and those with the least need and greatest financial capacity should receive the smallest per capita grants so that each government unit may provide the minimum program without undue strain on its resources.

ii. The federal funds distributed should be sufficient to permit satisfactory service through out the entire nation

iii. The grants should be distributed in a manner to stimulate the state to make reasonable efforts to support the services out of their own resources. Care should be taken that lack of interests of effort on the part of the states is not encouraged by grants.

iv. The federal aid should be distributed in such a manner as to permit full opportunity for the states to achieve a balance in the support of the various functions and to make adjustments to particular local situation.

Special grants are given to enable the weaker states to function at a minimum standard based on the standards normal to the federation as a whole.

Such grants help in removing the inequalities of financial resources between different constituent units of federation. The grant should be given by the federal to the regional governments to remove inequalities in per capita expenditure on such items of expenditure as education, public

health, etc., between different constituent units. Such grants may be given either at the discretion of the federal government or on the recommendations of independent commission.

Specific-purpose or conditional grants are known as matching grants in the U.S.A. and India and shared cost programs in Canada. Such grants are given for a definite program and the federal government meets a definite proportion of the cost of the program, the rest of the cost is met by the concerned regional government from its own resources. Such grants are not statutory and hence, not compulsory. The philosophy underlying such grants is that though the activities concerned are best administered at the state levels, but federal government should try to promote their expansion and improve the quality of these services by participating financially in these projects.

5. Inter Government Financial Institution:

Most of the federations have established inter-governmental financial institution for consultation and cooperation between two layers of government and to make a regular process of adjustment in the financial arrangements to meet new conditions. Such an institution may deal with the problems concerning tax revenue and grants determination, public, borrowing, coordination and settlement of financial disputes. In Australia, there are two bodies, commonwealth grants commission for determining grants and loan council for coordinating public borrowing.

In India, there is a constitutional provision for the appointment of Quinquennial finance commission. Settling up of such an institution on permanent basis is of great importance because "the economic and financial inter-penetration of the different levels of government which is inevitable in contemporary federation, inter-governmental financial institution instead of encroaching on the federal principle, may be a necessary means to maintaining effectively the federal financial balance according to the changing conditions." Thus each federation should device an inter-governmental institution most appropriate to its special conditions.

Recent trends in federal finance

The federal government is made responsible for promoting economic development of the federation. For this, it needs sufficient powers. According to F.G.Carnell, there is need under modern conditions to endow federal government with ample powers so that they may undertake social and economic responsibilities expected of a 'modern central government' social services like unemployment insurance, sickness insurance, invalidity, old-age, widow's and orphan's pension, etc., require uniformity in standards and have to be based on uniform principles. They, therefore, demand regulation by federal government and cooperation of all the regional governments for their uniform implementation. Hence, more dependence on the centre and more powers to the centre are imperative. These trends have affected federal finance and certain other trends also have developed in financial system also. They have been given as follows:

1) The federal government mobilizes the resources for development; the regional governments execute the development schemes. Thus, federal government has emerged as the most formidable fiscal and financial agency having substantial taxing powers and large resources, while states have emerged as helping hands of the federal government in the task of national development.
2) There has been increasing transfer of resources from the federal government to regional government in recent years. The state governments are now considerably more dependent on federal payments than they used to be formerly. Without such dependence state finances fall for short for achieving the objectives of national programs.
3) The federal government has acquired a large measure of control over the public expenditure policies of the states because a large portion of state expenditure is financed through the central transfer of funds.
4) The federal government gives disproportionate amount of aid to poorer states for a variety of political, economic and social reasons.

In bringing about these changes in trends of federal finance the influence of changing social, economic and political, concept has been equally potent. No system of federal finance would long survive which is incapable of being adjusted to the changing needs of the federal community.

Questions for discussion

1. Explain the norms of federal finance.
2. What are the guiding principles regarding allocation of resources (fiscal adjustments) between the Center and the state governments.
3. Critically explain the fiscal imbalances in federal finance.
4. Write a brief notes on grants-in-aid, tax sharing, supplementary taxes and loans.
5. Discuss the difference between vertical fiscal imbalance and horizontal fiscal imbalance.

CHAPTER NINE

FISCAL POLICY

In this chapter we will discuss five sections namely, 1) meaning and objectives of fiscal policy, 2) fiscal instruments, 3) compensatory fiscal policy, 4) discretionary fiscal policy, 5) limitations of fiscal policy.

Learning objectives

After studying these sections you should be able to:

- Discuss the meaning of fiscal Policy and its objectives in the developed and developing economies
- Explain how various fiscal instruments can be used to achieve economic development
- Critically examine the performance of fiscal policy in Ethiopia
- Explain how fiscal policy helps in achieving the objectives of full employment

- Discuss the importance of fiscal policy during inflation and depression
- Understand the limitations of fiscal policy.

9.1 MEANING FISCAL POLICY

Fiscal policy is defined by Arthur Smithies as "a policy under which the government uses its expenditure and revenue programme to produce desirable effect and avoid undesirable effects on the national income, production and employment". This definition acknowledges that the government expenditure and taxation are the two fiscal tools which can have desirable as well as undesirable effects on macro variables like income, production and employment. Otto Eckstein defines fiscal policy as "changes in taxes and expenditure which aim at short run goals of full employment, price level and stability". This definition adds two more goals of fiscal policy *viz.,* price level and stability. Urusula Hicks broadens the scope of fiscal policy. She defines it as a policy "concerned with the manner in which all the different items of Public Finance ... may collectively be geared to forward the aims of economic policy". Thus besides public expenditure and taxation, public debt can be included as the third element of fiscal policy. Gerhard Colm therefore defines fiscal policy "as the conduct of the government expenditure, revenues and debt management in such a way as to take fully into account the effect of these operations on the allocation of resources and the flow of funds, and thereby their influence on the levels of income, prices, employment and production".

Fiscal policy differs from monetary policy in its mode of operation, Gardner Ackley points out "unlike monetary policy these measures involve direct government entrance into the market for goods and services (in case of expenditure) and a direct impact on private demand (in the case of taxes)". Thus the impact of fiscal policy on aggregate demand is direct while the monetary policy can affect the aggregate demand only indirectly through the banking sector.

Fiscal Instruments

Government expenditure, taxation and public borrowing are three fiscal tools which act as levers to bring changes in income, employment and prices.

Public Expenditure

Government expenditure incurred in any way results in an increase in wages and salaries of its employees in the form of interest payment on debts or results in welfare payments like pensions or social security benefits. They tend to increase the disposable incomes of the people which cause an increase in the aggregate demand for goods and services. Thus an increase in government expenditure increases aggregate demand while a decline in public expenditure decreases aggregate demand. Therefore during inflation public expenditure should be reduced to control the demand-pull inflation. During depression public expenditure gains much importance. Keynes had established that the Great Depression of 1930s was caused by deficiency of aggregate demand. Private investment will be sluggish during depression. Expenditure on public works programmes must be increased to raise aggregate demand.

Government expenditure on public works programme or welfare benefits either way result in an increase in incomes. This increase in incomes causes an increase in consumption. Increase in consumption again results in the secondary increase in income. This income-consumption effect goes on and the initial increase in public expenditure brings about a multiple increase in income. This can be illustrated with the help of government expenditure multiplier.

$$Y = C + I + G \quad \text{..........}(1)$$

where, $C = a + bY$

$I = \bar{I}$ where $\bar{I}$ is autonomous

$G = \overline{G}$ where $\overline{G}$ is autonomous

$$Y = a + bY + \bar{I} + \overline{G} \text{ ....} (2)$$

$$Y - bY = a + \bar{I} + \overline{G}$$

$$Y(1-b) = a + \bar{I} + \overline{G}$$

$$Y = \frac{a + \bar{I} + \overline{G}}{1-b} \text{ ....} (3)$$

Now if there is a change in government expenditure by ΔG, then new equilibrium income will be

$$Y + \Delta Y = \frac{a + \bar{I} + \overline{G} + \Delta G}{1-b} \text{ ....} (4)$$

$$= \frac{a + \bar{I} + \overline{G}}{1-b} + \frac{1}{1-b} \times \Delta G \text{ ....} (5)$$

Subtracting (3) from (5) we obtain the change in income,

$$\Delta Y = \frac{1}{1-b} \Delta G \text{ ....} (6)$$

$$\therefore \frac{\Delta Y}{\Delta G} = \frac{1}{1-b} \text{ (government expenditure multiplier) ....} (7)$$

The value of $\frac{1}{1-b}$ is equal to the ordinary investment multiplier of Keynes. Therefore it can be presumed that the government expenditure also results in changes in income via ordinary multiplier.

This concept of government expenditure multiplier helps to show its usefulness as a fiscal instrument. If the marginal propensity to consume 'b' is 0.75, the value of government expenditure multiplier would be 4. Thus if there is inflation and there is need to reduce aggregate demand by Birr 400 billion, the government must plan to reduce its public expenditure by Birr 100 billion. A reduction of Birr 100 billion of public expenditure will operate through a multiplier value of 4 to reduce incomes ultimately by Birr 400 billions. Similarly, during deflation, if there is need to increase' aggregate demand by Birr 400 billion, public expenditure should be increased by Birr 100 billion

Taxation Policy

The effect of taxation is different from that of public expenditure. An increase in taxation reduces disposable incomes. This reduces their Consumption and savings. An increase in taxation reduces aggregate demand while a decline in taxation increases it. During inflation therefore taxation should be raised to reduce the disposable incomes of the people. This will help to control inflationary pressures. During depression taxation should be reduced to leave more disposable incomes to encourage people to spend.

The operation of taxation as a fiscal instrument can also be made clear through the tax multiplier concept. Taxes tend to reduce the disposable incomes of the people. Hence,

$$Y = C + \bar{I} + \overline{G}$$

$$C = a + bY_d$$

where $Y_d = (Y - T)$

$$\therefore \quad Y = a + bY - bT + \bar{I} + \overline{G}$$

$$Y - bY = a - bT + \bar{I} + \overline{G}$$

$$Y(1-b) = a - bT + \bar{I} + \overline{G}$$

$$Y = \frac{a - bT + \bar{I} + \overline{G}}{(1-b)}$$

If taxes are changed by ΔT, then

$$Y + \Delta Y = \frac{a - b(T + \Delta T) + \bar{I} + \overline{G}}{1-b}$$

$$= \frac{a - bT + \bar{I} + \overline{G}}{1-b} + \left(\frac{-b\Delta T}{1-b}\right)$$

Subtracting equation (9) from equation (10), we get

$$\Delta Y = \frac{-b\Delta T}{1-b}$$

$$\therefore \frac{\Delta Y}{\Delta T} = \frac{-b}{1-b} \text{ (tax multiplier)}$$

If the marginal propensity to consume is 0.75, the value of tax multiplier would be 3. The negative sign shows that an increase in taxation will lower incomes. It is interesting to note that the value of tax multiplier is less than the value of government expenditure multiplier. This has important policy implications. If the aggregate demand of Birr 400 billion has to be increased during depression, government must plan for an expenditure of Birr 100 billion with an expenditure multiplier of 4. But instead of expenditure it decides to make use of tax policy then, it should reduce taxation by Birr 133.33 billion as the tax multiplier is 3. Thus the extent of fiscal operations through taxation has to be much larger than that under public expenditure.

This analysis can be further extended to find out what happens if the government uses both tax and expenditure changes. The question is what would be the effect on the economy if the government finances all its expenditures with the help of taxation only. The classical economists had called the effect of such a balanced budget to be neutral. But the evolution of the concepts of tax and expenditure multipliers helps to understand that the impact of balanced budget cannot be neutral because

$$\text{Tax multiplier} = \frac{-b}{1-b}$$

$$\text{Expenditure multiplier} = \frac{1}{1-b}$$

Hence when taxes equal expenditure the multiplier effect would be

$$\frac{-b}{a-b} + \frac{1}{1-b} = \frac{1-b}{1-b} = 1$$

It means that the balanced budget multiplier is equal to unity. In other words, even when all expenditure is financed through taxation in a balanced budget, it would cause an increase in income to the full extent of additional expenditure. This explodes the classical belief of neutral

effects of a balanced budget. On the other hand even a balanced budget has expansionary effect. Therefore when there is inflation there should be a surplus budget while during depression a deficit budget. At the level of full employment, even a balanced budget can be expansionary to cause inflationary pressures.

Government Borrowing

The third fiscal tool is government borrowing. Public debt policy influences aggregate demand through the volume of liquid assets. When government floats a loan there is a transfer of liquid funds from the private sector to the government which reduces the purchasing power of the private sector. At the time of interest payments and repayment of debt, there is transfer of funds from the government to the private sector which increases the purchasing power in the hands of the private sector.

9.2 OBJECTIVES OF FISCAL POLICY

Fiscal policy is now considered an important instrument to achieve the macro economic goals. The classical economists had believed in automatic full employment and so they advocated laissez faire. There was no need for government interference in the economic system. Taxation was to be minimum to meet the requirements of the government expenditure on law and order and defence only. They advocated a balanced budget. Thus minimum taxation to meet only essential public expenditure and balanced budget were the principles of sound public finance in classical theory.

In sharp contrast to such a passive role for fiscal policy, modern economists like Keynes assigned an active and positive role to fiscal policy. Fiscal policy should be used to regulate and control the economy with the help of fiscal tools like taxation, public expenditure and public borrowing. This was called the principle of Functional finance.

The concept of Functional finance has been developed by A.P. Lerner. Functional finance evaluates fiscal policy by its effects on the way it functions in an economy. According to the principles of Functional finance, fiscal policy must first remove the factors that cause inflation and deflation so that economic stability can be maintained. Secondly, the purpose of borrowing is not to raise money only but to make people hold more bonds, and less money. Hence public borrowing should be used to control purchasing power in the economy. Thirdly taxation is also to be used not only to raise revenue for the government but also to control purchasing power in the hands of the people. Fourthly, any excess of government expenditure over its revenue should be met with by public borrowing. But if borrowing is not possible, it should be covered through deficit financing or printing of new money, more so in depression.

Thus Functional finance assigns an important role to fiscal policy *viz.,* to control cyclical fluctuations in the economy by avoiding inflation and deflation and also to achieve and maintain full employment and price stability. It means budget need not be balanced. Thus the principle of functional finance replaced the principles of sound finance.

Musgrave however feels that there can be no simple set of principles to demarcate fiscal policy. There are actually a number of unrelated issues. Musgrave hence points out that fiscal instrument should be used (1) to secure adjustments in/the allocation of resources (2) to secure adjustments in the distribution of income and wealth and (3) to secure economic stabilization.
This theoretical development has considered the conditions of developed countries while setting forth general objectives of fiscal policy. The objectives of fiscal policy in developed countries are bound to be different from developing countries. In the developed countries the major objectives are full employment, economic stability and a high and stable rate of growth. In developing countries besides these three, the major objective is to stimulate capital formation and encourage investment, to achieve economic development. Hence the major objectives of fiscal policy may be identified as follows.

1. Full employment.

Full employment is a common objective of fiscal policy in both developed and developing countries. Fiscal policy should aim at reducing the extent of unemployment and under-employment. Public expenditure on social overheads, and public sector enterprises all help to create employment opportunities. Tax holidays and subsidies to start industries in rural areas help to generate employment.

Public expenditure for implementing public works programmes like road construction and other construction activities was recommended by Keynes to reduce unemployment during depression. He advocated government spending to compensate for the deficiency in private spending so that such expenditure would result in employment. Public expenditure used for Integrated Rural Development Programme is highly commendable for their effects on generation *of* employment.

2. Price stability.

Price stability is an important objective for all countries in general. Fiscal policy should aim at avoiding both recessions and inflation. Generally, mild rise in prices is considered as an incentive for capital formation and investment but high rate *of* inflation would remove the gains *of* development. There will be an imbalance between aggregate demand and aggregate supply. Increasing public expenditure is bound to increase the purchasing power in the hands *of* the public but structural rigidities will not permit a quick increase in production. Hence inflationary pressures are bound to occur in the course *of* economic development. But it may not be possible to curtail public expenditure as it is very much required in a developing country in the absence *of* private investment. Hence fiscal incentives in the from *of* tax concessions to industries, tax holidays to newly started industries subsidies to encourage production *of* essential goods will help to increase production, India has tried all these measures to encourage production in essential fields. Subsidies for fertilizers and other agricultural inputs to help farmers are another example to increase agricultural production to stabilize prices.

In general lowering *of* public expenditure is not advisable in developing countries to fight inflation. So also an increase in taxation may not be possible as taxable capacity is low. Further, these economies may be in need *of* tax concessions to encourage production. Hence in times *of* inflation, fiscal policy should be supplemented by monetary policy to control inflation.

3. To accelerate the rate of economic growth.

A high rate *of* growth along with price stability is the third important objective *of* fiscal policy especially in a developing economy. All the three fiscal instruments of taxation, public expenditure and public borrowing should be used with a view to encourage production, consumption and distribution *of* goods. They should be aimed at increasing national income as well as percapita income.

Fiscal instrument should be directed to increase the productive capacity *of* the economy. Tax instrument should encourage investment and discourage consumption in order to increase production. For instance it may be necessary to reduce the high rate *of* tax on richer sections *of* the people to encourage capital formation. Supply side economists advocated tax incentives to encourage production.

4. Optimum allocation of resource.

Resources are scarce in a developing economy. Hence optimum allocation *of* such scarce resources becomes a primary objective *of* fiscal policy. Public expenditure can be undertaken in desired areas where private resources will not flow. Similarly tax exemptions and concessions can help to attract resources towards needy sectors. So also high taxation will drive away resources from such fields. For example high capital gains tax on speculative -dealings in land share etc., may be necessary to

curtail inflationary pressure. Kaldor recommended gift tax in order to reduce inequalities *of* income being encouraged through transfer *of* property. Fiscal policy may have to be used to achieve direct curtailment of consumption and socially unproductive investment.

5. Equitable distribution of wealth and income.

Extreme inequalities of income and wealth are harmful to economic development. Such inequalities exist in a large extent in developing countries. Redistributive public expenditure and redistributive tax policy can help to reduce such inequality in income and wealth.

Redistributive public expenditure policy requires that government should spend in a way which would benefit low income groups. Public expenditure on free education, welfare schemes all help to improve the standard of living as well as the productive capacity of the poorer people.

A redistributive tax policy should require highly progressive taxation. Richer sections can be highly taxed and tax exemptions can be given for the poorer sections. Similarly heavy indirect taxes can be levied on luxury goods since they are consumed by the rich. However high rate of taxation in order to bring equitable distribution should not reduce the incentives to save and invest. Hence tax concessions can be given to even richer sections provided they are invested in proper channels.

6. External stability.

Fiscal policy can be used to achieve external economic stability. Fluctuations in international trade can cause instability in national income due to the operation of foreign trade multiplier. There should be a built-in flexibility in the budget so that the revenue and expenditure of the

government will play a compensatory role to stabilize such external fluctuations. Tariff policy can help here. During inflation heavy import duty on import of consumer goods and luxury goods can be levied. During depression government should spend for public works programme. Fiscal policy to minimize international fluctuations requires deficit budgets in depression and surplus budgets in inflation.

7. To promote capital formation and investment.

Fiscal tools can be effectively utilized to promote savings and capital formation. Tax rebates, subsidies and tax concessions should be given for encouraging investment in the private sector. In early stages of development, government expenditure must be incurred to create social overhead capital like transport and communication, power generation etc., such measures would increase the social marginal productivity of investment and help the growth- of private investment also.

8. To remove regional imbalance.

In a developing economy, regional imbalance in development can hinder progress. Fiscal policy can be geared to develop such regions where development is lacking. Tax concessions may be given to industries started in backward areas. Public expenditure may be used to start industrial estates with all facilities to encourage entrepreneurs to start industries in such areas.

These objectives of fiscal policy make it very clear that fiscal instruments have an active role to play not only to achieve economic stability and full employment but also to promote economic development. Fiscal policy assumes a new significance in the face of the problem of capital formation in underdeveloped countries. The U.N. Report *on* 'Taxes and Fiscal policy' points out,

"fiscal policy is assigned the central task of wresting from the pitifully low output of underdeveloped countries sufficient savings to finance economic development programmes and to set stage for more vigorous public investment activity".

9.3 COMPENSATORY FISCAL POLICY

Compensatory fiscal policy refers to the way the government plans a budget surplus or deficit to compensate spending by the public in the economy. It became prominent after the success of Keynes' prescriptions to fight the great depression of 1930s. The underlying principles of compensatory finance are:

1. If there is unemployment as during depression, the fiscal policy should be geared to increase the level of aggregate demand.
2. During times of inflation, the level of aggregate demand should be reduced to make it equal to the value of available output.
3. If there is full employment, fiscal policy should maintain the level of aggregate demand so that there is neither inflation nor unemployment.

4. Anti-deflationary fiscal policy.

During depression the economy suffers from unemployment, falling income and shrinking economic activity. Economic activity is low because aggregate demand is low and people are not spending. People do not spend because of low incomes and unemployment. This vicious circle has to be broken through fiscal policy. The right type of fiscal policy is one which raises aggregate demand. This can be done in two ways. Fiscal policy should be directed to make people spend

more. Secondly if private spending does not increase, government should increase its expenditure to compensate for the deficient private spending.

In the first case all fiscal instruments can be used to stimulate private expenditure. For example private consumption can increase if they have more disposable incomes. For this tax rates should be reduced or some taxes which affect consumption adversely can be abolished. Sales tax should be abolished and excise duties on goods must be reduced. Public expenditure should be incurred on schemes which would raise the incomes of the poor. Public borrowing should not be resorted to as people cannot contribute to it. Rather depression is the time to make redemption of public debt if possible so that funds flow to the people to enable them to spend or invest.

Similarly private investment expenditure can be stimulated. Private investment is low during depression because marginal efficiency of capital is low. Therefore business and corporate taxes should be reduced. Firms which increase their investment to provide more employment during depression should be given tax concessions. Public debt redemption during depression will increase funds in the hands of richer sections who are the investing class of people.

Though all these fiscal measures can help to increase private expenditure on consumption and investment, it may not really bring in the desired result. When business prospects are gloomy, private investments may not come forth at all. Similarly private consumption expenditure may take a long time to react. Therefore the best and the only way to bring a turning point is for the government to increase its expenditure. Infact this remedy suggested by Keynes succeeded so well in U.S.A. in bringing recovery during the Great Depression in 1936, that has been responsible for the development of the theory of compensatory fiscal policy.

The government can increase its expenditure in two ways. Firstly it can spend for social security benefits in the form of unemployment allowance, free meals etc. But Keynes pointed out that it may solve poverty but not unemployment. It also hurts human dignity to live on doles. What

people require during depression are jobs. When they work they get incomes to spend. Therefore the second set of measures refers to increase in public expenditure on public works programmes.

Keynes' 'General Theory of Employment Interest and Money' projected public works programme as antidepression device. Public works programme covers constructive activities like road and railway development, construction of buildings, irrigation projects etc. Such activities serve the twin purpose of giving jobs and incomes as well as creation of long-term assets for the economy. If nothing is possible it was even suggested that government can spend money to make people dig holes today to be filled up by another batch next day. The keyword is provision of jobs during depression' to enable people to have earning capacity. This initial increase in public expenditure would result in a multiple increase in incomes through multiplier effect.

Keynes suggested that the government should keep a plan for such public works programmes ready so that it can be implemented as soon as the signs of depression appear. Infact the timing of public works programme to be started at the right time is very crucial in anti-deflationary fiscal policy because the right action and the right quantum of expenditure can help to nip the problem in the bud. If the schemes are started after the problem is aggravated, it may require a much larger public expenditure. Such an injection of fresh purchasing power in the form of an increase in public expenditure is known as pump priming. This increase in investment may set in motion a process of recovery from the conditions of depression. It is like a little water poured into a pump to prime it; it may supply an end less flow of water. Similarly if the government spends some money, the flow of economic life would continue smoothly forever.

There is however some limitations in implementing public works programme. It is often difficult to forecast the signs of depression. Hence the public works programmes may not be started at the appropriate time, thus raising the burden of public expenditure. The government may not have funds to spend, as tax revenue is bound to be low during depression. For this Keynes suggested that such schemes can be implemented through deficit financing. Further

public works programmes are implemented by the central government in a federal set up. The whole programme may get delayed as it takes time for the central government to assess the problems of different areas. This recognition lag will cause a decision lag which may delay the success of the schemes. Most important of all, the government should slowly withdraw such expenditure as the economy recovers.

Inspite of all these problems it cannot be denied that government interference through public expenditure is the best way to initiate a recovery during depression. This philosophy was responsible for the implementation of the New Deal Programme by the President Roosevelt in U.S.A. in 1936 and within three years, the economy was well on the road to recovery.

5. Anti-inflationary fiscal policy.

During inflation prices rise due to excess of purchasing power over available output. Therefore fiscal policy should be geared to reduce aggregate demand. This can be achieved through a surplus budget *viz.,* public revenue is more than public expenditure.

The suitable anti-inflationary tax policy is one where tax rates are increased and new taxes are introduced so that there is a reduction in the disposable income of the people. Income tax helps to reduce the disposable incomes of the people and reduce their purchasing power. Income tax rates can be easily raised during inflation. Expenditure tax can be introduced. However tax incentives can be given to entrepreneurs as it would increase production. Tariff policy may be suitably changed to allow for greater inflow of imported goods to meet the domestic demand.

Just as tax policy is useful to reduce private spending, public expenditure should also be curtailed during inflation. Some schemes which are not required can be given up. Such schemes which can be undertaken at a later date without any adverse effect can be postponed. Government should reduce payments made to social security. A reduction of public expenditure in productive

channels may have harmful effects in the long run. Hence the curtailment of public expenditure during inflation should occur in unproductive channels.

Public borrowing should be increased so that funds flow from the private sector to the government, thus reducing aggregate demand. Hence compensatory finance recommends surplus budget during inflation.

Fiscal Stabilizers and Flexibilities

The success of fiscal policy especially compensatory fiscal policy depends upon the existence of flexibility in the economic system.

Built-in-flexibility is very important in a fiscal system for the success of fiscal tools. Built-in-flexibility refers to the automatic adjustment in the public expenditure and taxes with reference to inflation and deflation without giving rise to any deliberate action on the part of the government. For example if progressive system of tax rates is adopted, tax revenues would automatically go up as national income increases. Modern fiscal system has several such built-in stabilizers. When national income declines income tax and corporation tax automatically bring less revenue. Pub1ic expenditure on unemployment insurance, welfare schemes, automatically increase during depression. Thus falling revenue and increasing expenditure cause a deficit budget. Fiscal instruments which contain such ability to respond to increase and decrease in national income are called Automatic Stabilizers.

As automatic built in stabilizers, direct taxes, corporate profit tax, capital gains tax etc. are better than indirect taxes like excise duty and sales tax, because they are taxes on goods and hence consumption rises less than proportionately in relation to income.

Public expenditure if it responds quickly to changes in income can act as a good stabilizer.

Modem governments are quick to provide welfare benefits as and when problems arise. Thus unemployment allowances during recession, support prices for agricultural products, all involve automaticity during recession resulting in much needed transfer of purchasing power into the hands of the people. Similarly during inflation as situation improves such welfare payments taper down.

Built-in-stabilizers provide a cushion to the cyclical changes in income. Any government action involves delay and hence automatic stabilizers start functioning at the appropriate time without delay. However the effectiveness of built-in-stabilizers depends on the elasticity of public expenditure. It is bound to succeed only at a high level of taxation and expenditure; otherwise the impact would not be felt.

9.4 DISCRETIONARY FISCAL POLICY

Discretionary fiscal policy refers to deliberate changes on the budget such as changes in tax rates or public expenditure or both. It is of three types.

(i) Varying tax rates
(ii) Varying public expenditure
(iii) Varying welfare payments and public works.

The success of discretionary fiscal policy to control inflation or deflation depends upon the proper timing and forecasting of the action.

Discretionary fiscal policy suffers from one major defect, that it is susceptible to all lags *viz.,* recognition lag as well as decision lags. By the time the government recognizes the problem of inflation or deflation and decides to take action, the problem would have become worse. Further discretionary action taken may not be suitable for the situation. Thus fiscal instruments may be used for expansion while contra-actionary forces are required. In this respect automatic stabilizers

are better than discretionary fiscal action as they begin to operate as and when the contractionary or expansionary policy is required.

However automatic stabilizers alone cannot stabilize the economy. Empirical studies have proved that automatic stabilizers can not bring in more than 50 per cent success during deflation and it is lesser during inflation. On the other hand, discretionary fiscal policy is known for its announcement effect. The very fact that the government has changed its fiscal policy helps in guiding the economy in the right direction.

Formula Flexibility

Formula flexibility combines the advantages of built-in-flexibility and discretionary fiscal policy. Here, the government spending and tax rates are linked to a certain cyclical indicator. If the indicator shows a decline, government introduces a pre planned tax and expenditure policy. Formula flexibility can work very well to control cyclical changes in income. But it is yet to be given a practical trial.

Usefulness of Fiscal Policy

The usefulness of fiscal policy to achieve the macro objectives of full employment and stability has come into prominence ever since it was used to counter unemployment during the great depression of 1930s.

The usefulness of fiscal policy to assure full employment arises from the fact that the fiscal instruments like public expenditure help to increase the level of aggregate demand to the required level. The figure below illustrates this.

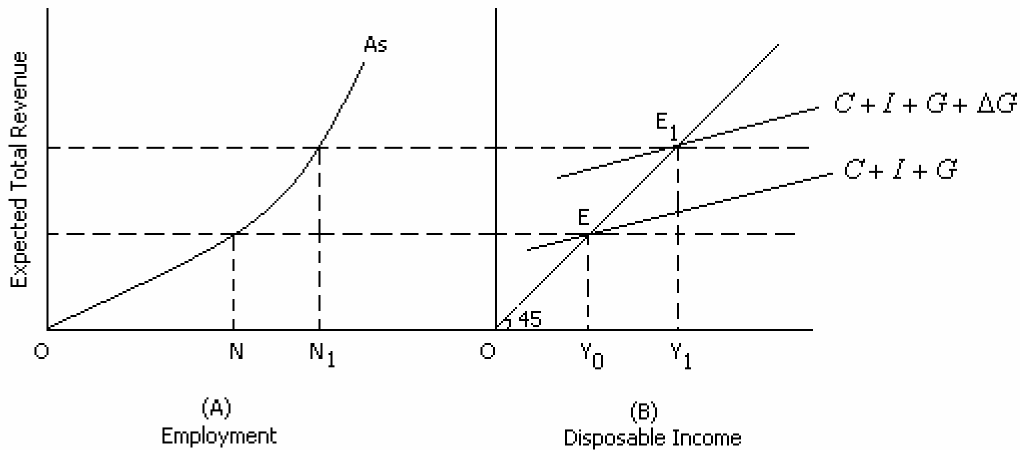

Fig. Effect of Government Expenditure on Employment

Diagram (A) shows the level of employment to be ON when the original aggregate demand is indicated by the curve C + I + G. If *N1* is the full employment level, there is unemployment to the extent on NN1. If government increases its expenditure on public works programme, it results in multiple increases in income. The shift in the aggregate demand to C + I + G + ΔG results in an income of *OY1* and the new equilibrium at Et results in an employment of ON1 thus public expenditure can be a very effective tool to raise the level of employment during depression.

Fiscal policy can be effective at times when even monetary policy fails to operate. During depression monetary policy may fail to be effective. Even if the rate of interest is lowered by the central bank, entrepreneurs may not come forward to invest as the marginal efficiency of capital is low. This is illustrated in the figure below.

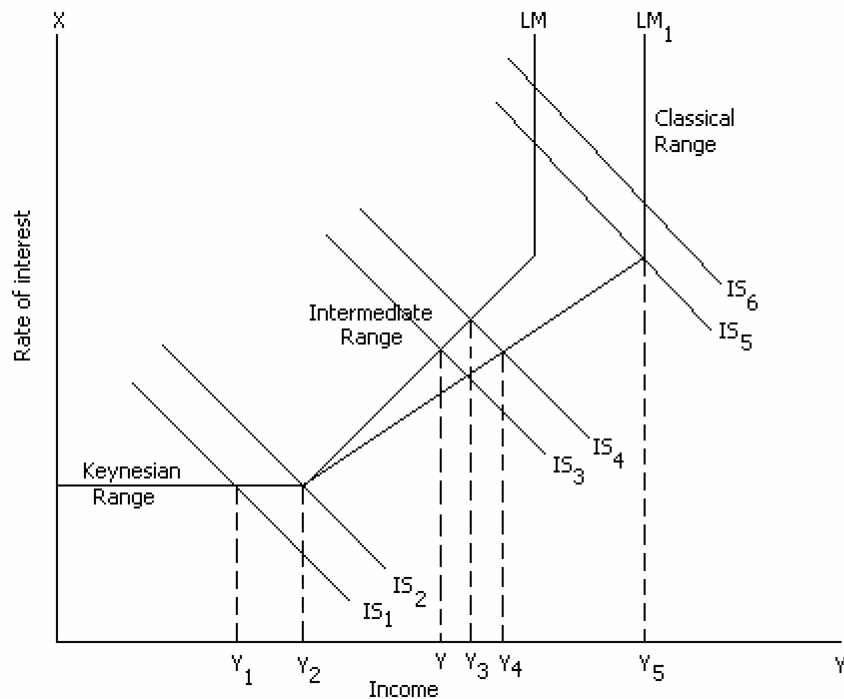

Fig. Fiscal Policy Operation

Keynesian range shows a situation during depression when the demand for money is so infinitely elastic (horizontal portion of LM curve) that monetary policy fails. In such a situation an increase in government expenditure as shown by a shift from IS_1 to IS_2 helps to increase income from Y_1 to Y_2 and thus cause an increase in aggregate demand.

The effectiveness of fiscal policy is moderate in the intermediate range of the LM curve i.e., for the same extent of shift in IS curve from IS_3 to IS_4 income increases from Y_3 to Y_4 only. In the classical range, LM_1 curve is perfectly inelastic and fiscal policy fails to operate. A shift from IS_5 to IS_6 cannot bring any increase in income beyond Y_5.

Of course the extent of effectiveness of fiscal policy in the intermediate range depends upon the elasticity of LM curve. Thus with less elastic LM_2 curve, the shift from IS_3 to IS_4 helps to bring only a small increase from Y^* to Y_3.

As an instrument of government's policy, fiscal policy can be effectively used as complementary to monetary policy. The monetary policy influences the level of aggregate income and spending in the economy by influencing the money supply and the cost of borrowing funds from banks *i.e.,* the rate of interest. Fiscal policy on the other hand affects aggregate demand through its effects upon the size, composition and timing of government spending and revenues. Thus during depression, public works programme through deficit spending should be accompanied by a cheap money policy of low interest rates. Similarly during inflation, surplus budget should be accompanied by dear money policy. Thus both fiscal policy and monetary policy can be coordinated well to achieve economic stability quickly.

Limitations

Fiscal policy alone cannot achieve the macro policy objectives. There are certain limitations:

6. Fiscal policy acts through changes in aggregate demand. Therefore it cannot bring about structural changes in the economy if the situation requires it.
7. The impact of fisca1 measures is selective.
8. The success of fiscal instruments depends upon accurate forecasting and timing as in the case of pump priming.
9. It is difficult to measure the extent of fiscal action required. The quantum of public expenditure to be raised or lowered, taxation to be increased or decreased, the extent of public borrowing or repayment of public debt are all to be carefully manipulated.
10. Fiscal instruments are supposed to bring about the required changes in aggregate demand through multiplier effect. But multiplier does not operate properly in developing countries on account of several bottlenecks. If only the value of tax multiplier and expenditure multiplier could be gauged correctly, they could have real impact on the economy.

6\. Fiscal policy suffers from different lags in the implementation of macro policy. First there is the recognition lag. The government should be able to identify the symptoms of an oncoming inflation or deflation so that needed steps can be taken. Failure to recognize the

symptoms results in not only delay in solving the problem but also increases the extent of budgetary operations. Secondly there is the decision lag. Democratic procedures and parliamentary sanctions may delay government action. Political considerations may interfere in taking useful measures. Thirdly there is the action lag. For example, government may decide to spend more, but it can be done only if there are suitable plans drawn and kept ready. This lag can be avoided if the fiscal advisers to the government have well planned anti-inflationary and anti-deflationary schemes. Fourthly even if all these are overcome, there is the outside lag for the policy to take effect. If chain reaction of a change in tax or public expenditure or public debt policy may take some months to be felt as they operate through income-consumption relationships.

There are certain specific limitations of fiscal policy in developing countries. Large extent of tax evasion, low elasticity of taxes, low taxable capacity may hinder the operation of tax policy. Similarly existence of barter economy, large extent of under employment, lack of support from the public may not he helpful for public expenditure as a fiscal instrument. Unorganized money and capital markets, lack of confidence in investing in government bonds may affect the success of fiscal policy in developing countries.

In spite of these limitations, fiscal policy and monetary policy are the twin instruments in the armory of the economic system to achieve full employment and growth with stability. All that fiscal policy requires is proper timing and action.

Short Note Questions

1. What is fiscal Policy? Discuss.
2. Discuss the objectives of fiscal Policy of developing and developed countries.
3. Explain the role of fiscal policy during inflation.
4. Explain the role of fiscal policy during depression.
5. Discuss the role of fiscal policy and income inequalities.

6. Examine the role of fiscal policy in economic development.
7. Compare the fiscal policy with monetary policy.
8. Explain how fiscal policy helps in achieving the objectives of full employment.

CHAPTER TEN
FEDERAL STATE FINANCIAL RELATIONS IN ETHIOPIA

Dear distance students, in this chapter we will discuss federal-state financial relations in Ethiopia under the Constitution of our country.

Learning objectives;

After discussing this chapter, you should be able to

- Examine the federal-state financial relations in Ethiopia
- Explain the distribution function under the Constitution of the Federal Democratic republic of Ethiopia
- Discuss Federal and State power of taxation in Ethiopia
- Know the concurrent power of taxation in Ethiopia

Ethiopia is a Federal Government; the federal- state financial relations are based on the principles of federal finance. In a federation, there is constitutional division of powers, functions, and resources between the federal and the state governments. Thus, federal-state financial relations are defined under the constitution of the Federal Democratic Republic of Ethiopia Proclamation No. 1/1995.

10.1 PROVISIONS UNDER THE CONSTITUTION OF ETHIOPIA

Under the constitution there is a three fold distribution of legislative powers between the Federal and States, viz., Federal power of taxation, State power of taxation and Concurrent power of taxation (Articles 96, 97 & 98).

The House of the Federation and the House of Peoples' Representatives shall, in a joint session, determine by a two-thirds majority vote on the exercise of powers of taxation which have not been specifically provided for in the Constitution.

Distribution of functions

There are detailed lists in the Ethiopian Constitution of Federal Powers, the State Powers and Concurrent Powers where Federal legislation prevails in case of conflicts. Thus, there are functions, which are exclusively assigned to Federal Government, others exclusively to the State Governments, some of which, where the Federal and State Governments exercise Constitutional Jurisdiction. And any thing could still be left out after mentioning Federal and State power of taxation, as a residuary item, it belongs to the Federal Government.

The Functions of the Federal Government include defense, defense industries, foreign affairs, citizenship, marine shipping and navigation, airways, post and telegraphs, National Bank, currency and foreign exchange, foreign loans, foreign and interstate trade, important industries and institution of national importance, etc.(see Article 51).

The functions of the State Governments include, public order, police, administration of justice, public health, education, agriculture, forests, fisheries and other industries etc, (see Article 52).

Distribution of Revenue

The Federal Government and the States shall share revenue taking the federal arrangement into account.

10.2 FEDERAL POWER OF TAXATION IN ETHIOPIA

6. The Federal Government shall levy and collect custom duties, taxes and other charges on imports and exports
7. It shall levy and collect income tax on employees of the Federal Government and international organizations
8. It shall levy and collect income, profit, sales and excise taxes on enterprise owned by the Federal Government.
9. It shall tax the income and winnings of national lotteries and other games of chance
10. It shall levy and collect taxes on the income of air, rail and sea transport services.
11. It shall levy and collect taxes on income of houses and properties owned by the Federal Government; it shall fix rents
12. It shall determine and collect fees and charges relating to licenses issued and services rendered by organs of the Federal Government
13. It shall levy and collect taxes on monopolies
14. It shall levy and collect Federal stamp duties.

10.3 STATE POWER OF TAXATION IN ETHIOPIA

7. States shall levy and collect income taxes on employees of the state and of private enterprises.
8. States shall determine and collect fees for land usufractuary rights
9. States shall levy and collect taxes on the incomes of private farmers and farmers incorporated in cooperative associations.
10. States shall levy and collect profit and sales taxes on individual traders carrying out a business within their territory

11. States shall levy and collect taxes on income from transport services rendered on waters within their territory.

12. They shall levy and collect taxes on income derived from private houses and other properties within the State. They shall collect rent on houses and other properties they own.
13. States shall levy and collect profit, sales, excise and personal income taxes on income of enterprises owned by the States
14. Consistent with the provisions sub-Article 3 of Article 98, States shall levy and collect taxes on income derived from mining operations, and royalties and land rentals on such operations.
15. They shall determine and collect fees and charges relating to licenses issued and services rendered by State organs.
16. They shall fix and collect royalty for use of forest resources.

10.4 CONCURRENT POWER OF TAXATION IN ETHIOPIA

8. The Federal Government and the States shall jointly levy and collect profit, sales, excise and personal income taxes on enterprises they jointly establish.
9. They shall jointly levy and collect taxes on the profits of companies and on dividends due to shareholders.
10. They shall jointly levy and collect taxes on incomes derived from large-scale mining and all petroleum and gas operations, and royalties on such operations.

Undesignated Powers of Taxation in Ethiopia

The House of the Federation and the House of Peoples' Representatives shall, in a joint session, determine by a two-third majority vote on the exercise of powers of taxation which have not been specifically provided for in the Constitution.

Directive on Taxation

10. In exercising their taxing powers, States and the Federal Government shall ensure that any tax is related to the source of revenue taxed and that it is determined the following proper considerations.
11. They shall ensure that the tax does not adversely affect their relationship and that the rate and amount of taxes shall be commensurate with services the taxes help deliver.
12. Neither States nor the Federal Government shall levy and collect taxes on each other's property unless it is a profit making enterprise.

Essay questions

1. Explain how the revenue subjects are distributed among the Federal and the States by the constitution of Ethiopia.
2. Critically examine the Center-State financial relations in Ethiopia.
3. Explain the role of the House of the Federation in the Ethiopian federal finance.
4. Discuss the fiscal imbalance in Ethiopian federation.
5. What are the criteria and the weightage given to each criterion?
6. Critically examine the performance of fiscal policy in Ethiopia.
7. Explain the meaning and importance of budgeting. Discuss how it is prepared, passed and executed.
8. Explain how various fiscal instruments can be used to achieve economic policy objectives in Ethiopia.
9. Explain the reasons for growing deficit finance in Ethiopia.
4. Critically examine the dependence of state governments on Central government.