CHAPTER - I

INTRODUCTION

The economic system of all the non-Communist Countries in the world is mixed. Economic activity in these countries is conducted by the private sector as well as by the public sector. The degree of combination of the sectors no doubt varies from country to country. Both the sectors contribute to the national product, depending upon their respective ownership of factors of production.

Today the larger part of the national product is produced and supplied by private enterprise than public enterprise and equally larger part of the national output is purchased by private consumers and investors. At the same time a considerable share of Nation's product goes towards the satisfaction of public wants. Further a substantial part of private income originates in the public budget, as for example, is the case with transfer expenditures.

Studies made by Fabricant and Culbertson for America, by Peacock and Wiseman for the United Kingdom, by Suphan Andic and Jindrich Veverka for Germany and Koshi Emi for Japan reveal that during the past one hundred years the public sector has grown considerably in importance with the result that the activities of government exercise important influence over the functioning of the entire economy. Since the World War II public sector has been assigned a very leading role in the economic development of underdeveloped countries and this has brought about a rapid expansion of the public sector in the developing economies. Thus the rapid expansion of public sector as Mrs. Hicks has pointed out is now a universal phenomenon.


6 Ursula K. Hicks: Public Finance, p. 6.
Measured in terms of consumption of goods and services, the proportion to National Product consumed in the public sector, has increased tremendously in various countries over the last six or seven decades. For example in the United Kingdom it rose from 9 per cent in 1890 to 36 per cent in 1961, in Germany it rose from 7.5 per cent in 1872 to 44.1 per cent in 1958, and in Sweden from 13 per cent in 1913 to 33 per cent in 1961. In Japan it rose from 10.5 per cent in 1880 to 33.2 per cent in 1960. This clearly shows that the consumption of goods and services in the public sector has shown a tendency to increase at a faster rate than both the consumption of goods and services in the private sector and also the production of goods and services in the economy as a whole.

Adolph Wagner a German Social Theorist, is well known for his "Law of increasing State Activity". According to Wagner, prevailing public expenditures reflect the requirement of a given historical situation. And Changes in the public expenditures reflect the underlying changes in the economic structure and development. He viewed the justification of public expenditures in terms of objective criteria, such as population growth or transportation needs.

8 Koishi Emi: Cited. p.16, Table I.
Wagner's Law states that increased public expenditure is due to the pressure of social progress. In the words of Wagner "the law is the result of empirical observation in progressive countries, at least in Western European Civilization, its explanation and justification and cause is the pressure of social progress and the resulting changes in the relative spheres of private and public economy, especially compulsory public economy. Financial stringency may hamper the expansion of state activities, causing their extent to be conditioned by revenue rather than the other way round, as is more usual. But in the long run the desire for development of a progressive people will always overcome these financial difficulties.9

In brief Wagner's Law states that for growing economies, the share of all major government expenditure increases. Wagner based this generalisation on two considerations:10
(a) The income elasticities of demand for services provided by the government are greater than unity;
(b) During the course of economic development, the public sector constantly encroaches upon the private sector.

In trying to demonstrate the first consideration Wagner divided government expenditures into two types: those dealing with justice and power function (Internal and external security) and those dealing with cultural and welfare functions (Socio-cultural and economic expenditures). Concerning the justice and power function Wagner argued that higher levels of economic development increase the strains of living and induce higher criminality; thus increasingly larger police expenditures are needed to control such crime. Further more, higher levels of economic development bring increasingly complicated trade and legal relations which in turn, require increasing arbitration on the part of the state. On an international level, military forces cast off their former aggressive aspects and assume a "Preventive" role which requires larger standing armies. Concerning the cultural and welfare functions Wagner stated that increasingly larger expenditures on education and public health are needed with higher per capita national products: the former because higher education is required for greater productivity, the latter because greater urbanisation accompanying economic development creates greater public health problems. Consumption of cultural services grows faster than the G.N.P. as the basic housing, nourishment, and clothing needs of population are increasingly met. Expenditures

11 Ibid, p.303.
on governmental administration, Wagner argued rise faster than the G.N.P. with the increasing extensions of the functions of government and with the increasing bureaucratisation of the state. 14

About the second consideration (viz., public sector encroaching upon the private sector) Wagner argued that, the encroachment of public sector upon private sector is (a) due to consolidation of state powers and (b) due to a breakdown in the market mechanism in producing certain goods and services which brings about state intervention. 15 This argument may be substantiated as follows: With the increase in economic development, the need to maintain and improve the quality of services increases. Due to the increase in the technical processes, the joint-stock companies may not be able to handle the undertakings. Private institutions may not be able to come forward due to risk and shortage of funds. The large investments can come only from the state. Therefore the state's expenditure grows. Similarly due to the development of monopolies in the private sector and profit seeking nature, price mechanism in the market may break down. State has to intervene, as the guardian of people, wherever the social benefits of the society are not provided well by the private institutions (e.g. education) and wherever the private institutions are assuming monopolies and reducing the quality of services

14 Ibid, p.304.
16 For extensive discussion and application of Wagner's Law, See Peacock and Wiseman. .C.P. cited, pp.16-20.
and goods. For example the fields of postal, railways, if they are in the hands of private individuals, they become the source of instability.\(^16\)

It appears, that Wagner's law is concerned with the Welfare State. Increased expenditures of government arise due to the role of state as a stabiliser in the economy.

What is the proof of the existence of law? On what assumptions is it based upon? The proof is historical evidence in between countries and it is based on organic theory. But the proof as well as the assumptions of law are open to criticism on the grounds that historical evidence which Wagner had chosen is inadequate, and the assumption of organic theory of state may not be applicable in the same manner to different societies. Further the assumption that State would assume the 'role of stabiliser' in the economy need not be valid in a society where the duties of the State are different - Take for example the duties of State as interpreted by Nicholson.

According to Nicholson, even though it is necessary to incur new modes of expenditure, as the society progresses, in many cases, however, the expense ought to be met not by increased taxation, but by substitution. With increase of wealth the increasing demands for education ought to be partially met at

\(^16\) For extensive discussion and application of Wagner's Law, see Peacock and Wiseman... C.R. cited, pp.16-20.
any rate, by diminished demands from the poor, as the education rate rises, the poor rate ought to fall. If such views are accepted the Wagner's Law does not operate at all.

Another thing to note regarding Wagner's Law is that it concerns only with the secular trend of public expenditure. It does not take into account the other aspects of public expenditures, such as the time pattern of expenditure growth.

Recent Attempts to fill in the lacuna:

Recently some attempts have been made to cover deficiencies of the Wagner's law. One such attempt is that of Peacock and Wiseman.

At the outset of their study itself, Peacock and Wiseman point out that they do not fully accept the approach of Wagner as it concerns with the secular growth of expenditure only. In their own words, apart from the secular trend of public expenditures "there are other aspects of the developments of public expenditures, such as the time pattern of public expenditure growth, which seem to us equally significant". 

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17 Quoted by Peacock and Wiseman: Growth of Public Expenditure in the United Kingdom, pp.19-20.
19 Ibid, p.XXIII.
Wiseman acknowledge the influences to which Wagner directs attention, but they do not regard them as inevitably causing expenditures to grow faster than G.N.P. in all societies or at all times. Indeed, if there are generalizations to be made about the relation between public expenditures and G.N.P., they should be concerned with the characteristics of social and economic change that require examination, and not with the "inevitable" results of such a change. 20

While discarding Wagner's "Organic Theory of State" Peacock and Wiseman make the following assumptions about the nature of the state: (1) decisions about public expenditure are taken politically, and so can be influenced through the ballot box or by whatever media citizens can bring pressure to bear upon the government, (2) political choices about the use of resources differ from choices made through the market system, and (3) citizens can have ideas about desirable public expenditure, which are quite different from and perhaps incompatible with their ideas about tolerable burdens of taxation.

On the basis of these assumptions, they developed and tested a hypothesis, which is spelled out below.

"When societies are not being subjected to unusual pressures, peoples' ideas about tolerable burdens of taxation,

20 Ibid, p.XXIII.
translated into ideas of reasonable tax rates, tend also to be fairly stable. Fixed, if low, rates of taxation are obviously compatible with growing public expenditure, if real output is growing, so that there may be some connection between the rate of growth of real output and the rate of growth of public expenditure. Much more rapid rates of expenditure growth are unlikely; in settled times, nations about taxation are likely to be more influential than ideas about desirable increases in expenditure in deciding the size and rate of growth of public sector. There may thus be a persistent divergence between ideas about desirable public spending and ideas about the limits of taxation. This divergence may be narrowed by large scale social disturbances such as major wars. Such disturbances may create a displacement effect, shifting public revenues and expenditures to new levels. After the disturbance is over new ideas of tolerable tax levels emerge and a new plateau of expenditure may be reached, with public expenditures again taking a broadly constant share of gross national product, though a different share from the former one.

This displacement effect has two aspects: People will accept, in times of crisis, methods of raising revenue, formerly thought intolerable, and the acceptance of new tax levels remains when the disturbance has disappeared... Expenditures which the

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Displacement effect is defined as a discontinuity in the growth pattern and produces expenditure peaks during social disturbances.
government may have thought desirable before the disturbance, but which it did not then dare to implement, consequently become possible. At the same time, social upheavals impose new and continuing obligations on governments both as the aftermath of functions assumed in war time (e.g. payments of war pensions, debt interest; separation payments) and as the result of changes in social ideas. Wars often force the attention of governments and people to problems of which they were formerly less conscious - there is an "inspection effect" which should not be underestimated.

Along side the displacement effect, there is another influence, called here, the concentration process. It is concerned not so much with changes in the responsibility of such expenditures. In many societies the functions of government are shared between a central authority and other (State and local) authorities whose powers may be protected by statute (as in legal federation) or conferred by the central government. In such countries local autonomy usually has many defenders, and its preservation is frequently a matter of political importance. At the same time, economic development produces changes in the technically efficient level of government, and also produces demand for equality of treatment (e.g. in services such as education) over wider geographical areas. These opposing pressures are reflected in the relative evolution of the
expenditures undertaken at different levels of government. Clearly, this evolution is distinct from the displacement effect, since the forces just described operate in normal as well as disturbed times. Nevertheless, given the political importance of local autonomy and the barrier it may create to change, periods of displacement are also going to be periods of interest from the viewpoint of the concentration process.22

The conclusions they have arrived at are:

(1) The persistent divergence between ideas about desirable public spending and the ideas of limits about taxation, of quieter times may be narrowed by social disturbances and produce displacement effect.

(2) People will accept, in a period of crisis, tax levels and methods of raising revenue that in quieter times they would have thought intolerable and this acceptance remains when the disturbance itself has disappeared.

(3) Expenditures may fall when the disturbance is over, but they are less likely to return to the old level.

(4) In a society where the powers and functions of the state and local authorities are protected by statute, the preservation of local autonomy is a matter of political importance. Change in division of responsibilities of state and local authorities is difficult. "But during the periods of social upheaval such as

22 Peacock and Wiseman: cit, p.XXV.
wars, the political opposition to change is weakened and the pressures for concentration can breakthrough. The approach of Peacock and Wiseman is novel and throws significant light on the probability of expenditure growth at various levels of crises and thereafter. But it is difficult to agree with all observations, when applied to different countries. Their observations may be true in the case of the United Kingdom or even as a matter of fact in any sovereign democratic republic, but they need not be valid in the case of colonial countries. In a colonial country two forces will be working in opposite directions: one is the urge of the colony to be freed from foreign rule and the other is the desire of foreign governments to lengthen their rule. In such a country—colony of foreign power—one cannot expect the second observation of Peacock and Wiseman valid.

According to them (Peacock and Wiseman) "people will accept in a period of crisis tax levels and methods of raising revenue that in quieter times they would have thought intolerable and this acceptance remains when the disturbance itself has disappeared." In so far as the acceptance of new tax levels is concerned people in a colonial country may accept, hoping that some more freedom would be granted after the crisis. But the suggestion that the acceptance of tax levels during the

23 Ibid, p.33.
periods of crisis would stay even after the crisis may not be valid. It need not be valid because (a) the foreign country which is ruling the colony would like to withdraw the new taxes proposed lest the people may find an excuse for causing trouble and demand independence, and (b) the people of colony may raise an objection to the continuance of taxes which have been promised as temporary. Even the expenditures may fall to the pre war level, contrary to the observation of Peacock and Wiseman, once the disturbance is over.

Therefore it is interesting to study the relevance of Peacock and Wiseman's approach in the case of a country which had an entirely different set-up — politically, socially and economically.

To what extent is the hypotheses tested on and established for Great Britain apply to a country like India? It is basically an answer to this question that our study has set out to find. On the basis of this study, we should be able to say whether or not the growth in public expenditure in a developing economy is likely to follow the same path as that in a developed economy.

India is an underdeveloped country, but has passed through all the important social disturbances as were witnessed in the United Kingdom. However, the political set up of India differed
markedly from that of the United Kingdom. Prior to 1947, India was not a free country; it was a dependency of Great Britain. Since the Independence, India follows basically the same parliamentary form of government as obtains in Great Britain, but unlike in Britain the political leadership is strongly committed to economic development through planning.

Over a period of roughly hundred years in India, the responsibility of expenditures of Central, States, and local authorities have changed. The significant years in the transfer of responsibility of expenditures are 1871, 1909, 1921, 1937 and 1947. The change of responsibility of expenditures or what Peacock and Wiseman call "concentration process" has been taking place over the period.

Moreover, the history of India is a very fascinating one, from the point of view of constitutional changes as well as from the point of economic and social changes. If Britain had two social upheavals (World Wars) during the past one hundred years, India passed through three social upheavals viz., two World Wars plus Independence. Independence was a social upheaval in the sense that the people's aspirations, have changed in consequence and called for necessary changes in Government's activities.24

Like any Western democratic country, India follows the constitutional procedure for its increase in the real national income. People can influence the national policy through the ballot box. The electorate through the instrumentality of parties and elections wields a considerable veto power over the formulation of national policy, and people in India enjoy a broad freedom to dissent and to organize peaceful opposition. They have substantial and reliable personal security against arbitrary government action. In other words, the assumptions about the nature of the state made by Peacock and Wiseman do hold in the case of India.

Further, the government has set before itself lofty economic and social goals to be achieved through the Five Year Plans. Three Five Year Plans have already been completed. Planning has had considerable impact on the ideas about the desirable public spending and with the ideas about the limitations of taxation inevitably lagging behind, the government confronts the problem of bridging that gap. This is a study of growth of public expenditure in all types of situations - peace time as well as the times of major social disturbances like major wars. This study may provide clues to those whose

25 John P.Lewis: Quiet crisis in India, p.8; Asia Publishing House, Bombay.
26 See the Objective of Five Year Plans. In Brief achieving higher levels of income, employment and output and reduction of income inequalities.
27 World War I and World War II.
concern is with economic policy and with the development of the public sector in the future in a developing economy.

Uptil now in India no such study has been made. Our study, in a sense, the first of its type in and for India. The study that comes closest to ours is the one made recently by K. Mukherjee to estimate the draft of public sector on real resources for the period 1900-1953. Mukherjee's study is a statistical work. It has been a great help in our study. But Mukherjee has not made any effort to go behind his statistical results to establish a theoretical link between aggregate economic activity and the activity of the public sector. While the present study covers a much longer period - it goes backward to 1872 and extends to 1966, the statistical work only subsumes the search for answer to the basic question posed above.

Today public expenditures can no longer be considered from a merely fiscal point of view, they must be considered also from the point of the whole economy. Governments have become the biggest buyers of certain products and the greatest employers in the construction business. Thus estimation of the size and composition of the public sector draft on real resource, and its growth is quite of analytical use to policy making.

28 K. Mukherjee: "Levels of Economic Activity and Public Expenditure in India" - A historical and Quantitative study". Asia Publishing House, Bombay.