CHAPTER I

INTRODUCTION

Public finance is the study of how government policy, especially tax and expenditure policy, affects the economy and thereby the welfare of its citizens. In fact, the influence of government on the operation of the economy is immense. As is well known, the government expenditures and taxes today play a very important part in our everyday lives. The total volume of government spending provides some indication of the involvement of government in national economic affairs. The total expenditure of the Government of India in 1989-90 was Rs. 1400319 millions. This sum was 31.81 percent of GNP, indicating that government policies directly influence the allocation of nearly 32 per cent of the nation's total income. In India, after independence, government budgets have been growing relative to national income. In 1950-51, total government expenditures were only 9.81 percent of GNP at Market Price. By 1989-90, this ratio had reached 31.81 percent, thus increasing by more than three times. The same is true of the growth of government spending at the state level. For example, the expenditure of the state government in Gujarat, which was only 12.9 percent of SDP (State Domestic Product) in real terms in 1963-64 increased to 19.8 percent of SDP in 1980-81 and to 26.98 per cent of SDP in 1992-93. Therefore the study of the growth of public expenditure becomes important. Many studies have been undertaken to analyse the trends in public expenditure of the central government. A few studies have also been undertaken on the problems of state finances in India. However, studies
specifically analysing the trends and growth of public-spending at the state level are very few. Therefore we have chosen this topic to analyse the various aspects of the growth of public-spending at the state level; specifically of one state, viz., Gujarat.

Though this study, is confined to the analysis of only government expenditure, it is extremely important, for it is through the public expenditure policy that the public sector allocation is predominantly determined in a planned economy. Besides, expenditure policy can be employed also to influence the resource allocation in the private sector.

This chapter is divided into three sections. In section one we briefly provide a justification of the role of the state. In section two, we discuss the importance of government intervention in the situations of market failure. In section three we discuss, what is now termed in the literature of public finance, as government failure. The chapter ends with a brief statement about the chapter scheme of this study.

SECTION I

Role of the State: A Theoretical Perspective:

If a price system is efficient, what role is there for government policy? It is important to remember that, efficiency is not the only criterion by which an economic system may be judged. A case can clearly be made for government to redistribute incomes in the interest of equity. In some instances paternalistic government policies may be warranted. In addition, a price system itself requires certain governmental action
if it is to attain an efficient allocation of resources; property rights must be defined, contracts must be enforced, and antitrust measures may be needed to ensure that markets are competitive. And still another role can be rationalized because of the existence of public goods and externalities.

Thus government intervention in resource allocation in market oriented economies are generally directed towards the classic case of market failure. Therefore, over and above ensuring internal and external security, providing infrastructure and public utilities are the main functions of the government. In some countries, government also influences resource allocation through a system of incentives and directives. As a result, government expenditure in these countries is largely demand determined. In contrast, in low income countries there is a strong supply-side rationale for the public sector to interfere in the allocation of resources. This is due to the fact that these countries have very low levels of savings and investment, underdeveloped factor and product markets, scarcity of skilled labour, and virtual absence of an entrepreneurial class. These countries also have highly skewed income distribution and therefore allocating resources to cater to the prevailing demand pattern of the society would only result in the allocation of already scarce resources for the benefit of higher income groups.

The socially desired allocation in an economy can be achieved (i) through the public sector participation in economic activities and / or (ii) by directing private sector allocation to desired channel through various regulatory devices and incentives known as indicative planning, as practiced in France. The physical, fiscal and financial controls are the instruments through which the pattern of private sector allocation can be influenced. Any analysis of the governmental
role in the developmental process of an economy should therefore encompass, not only the role of the public sector per se, but also the effect of various governmental regulations and controls.¹

Here a broad overview of the role of the state in an economy is provided in terms of the three different types of effects that government tax and expenditure policies may have on the operation of the economy.² These are as under:

(1) **Allocation:** Almost all government policies have an effect on allocation of resources. In other words, the mix of goods and services produced by the economy is altered as a result of government policy. For example, if the government spends money to build tanks and missiles, it bids resources, i.e. manpower and capital, away from the production of other goods and services. As a result, economic resources are reallocated so that more tanks and missiles are produced and fewer other goods and services are provided. Economic resources are scarce, and using these resources to produce one type of good necessarily implies sacrificed production of other goods.

One of the most important issues in public finance is the determination of exactly how each of the vast array of government tax and expenditure

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policies affects the allocation of resources. How much more goods and services do we get and at what cost as a result of smaller quantities of other goods and services? To understand these allocative effects of government policies, we must know how the policy operates and how the economic behaviour of people is influenced by the policy.

(2) Distribution: Over any period of time, the economic system produces a certain mix of goods and services that is consumed by its citizens. Not only is the total output of goods and services of interest but also the manner in which it is distributed among the public. Government policies often affect both the mix of goods and services and the distribution of these goods, that is, the distribution of real income.

While trying to determine the distributional impact of any policy, one is attempting to answer the fundamental question: Who is benefited and who is harmed by the policy? In fact, most policies benefit certain persons and groups at the expense of others. It may so happen that, in some cases, this may be intentional and in other cases it may be unintended. Economic analysis is often essential in determining how government policies affect the distribution of real income. In some cases the effects are more obvious than in others. However, questions pertaining to the distributional effects of policies are not easy to answer, though they are very important from the point of view of social justice.

(3) Stabilization: The overall level of expenditure and taxes along with monetary policy, can have important effects on the aggregate level of employment, output, and prices. Stabilizing the economy at high and perhaps growing
levels of output and employment is today considered a major responsibility of the government.

Thus one of the reasons for government intervention is to allocate resources for desired uses, distribute national income in a socially desired manner and stabilize the economy at higher level of income and employment. However, the most important reason put forward for justifying government intervention is the problem of "market failure". What follows is the discussion on the role of government under conditions of market failure.

SECTION: II

Market Failure and the Role of Government

The competitive price system can produce an efficient allocation of resources if there are no public goods or externalities. Public goods have peculiar characteristics that make it unlikely that private markets will provide the efficient quantity. When this happens, market failure is said to occur. The modern economic rationale for many types of government interventions is based on the inability of the private system to function efficiently in such situations. Therefore, it is important to discuss the nature of public goods and externalities and then consider their affect on the allocation of resources.

The Nature of Public Goods

The term Public good does not necessarily refer to a good that is provided by the government. Instead, it refers to a good (or service) that has two
characteristics, regardless of whether or not the government provides it. These two characteristics are non-rival-consumption and non-exclusion.

**Non-rival Consumption**

A good is non-rival in consumption when, with a given level of production, consumption by one person need not diminish the quantity consumed by anyone else. In other words, a number of people may simultaneously consume the same good. Non-rival consumption is sometimes also referred to as collective consumption or indivisibility of benefits. National defense is one of the most clear cut examples of a good that is non-rival in consumption. It is important to note that this characteristic, however, does not mean that people are necessarily benefited to the same degree. Weather forecasting, pollution abatement, and some public health measures that reduce the spread of disease are other examples of goods or services that are non-rival in consumption.

By contrast, most goods and services are rival in consumption. For example, for a given level of production of sugar (or cloth, watches, shoes, houses or cars), the more one person consumes the less will be available for others. In these cases, consumption is rival because there is a problem in deciding how to ration output among the competing (rival) consumers. The price system resolves this problem by allocating a larger quantity to individuals who place a higher value on the goods i.e. people who are willing to pay more for it. With a good that is non-rival in consumption, there is no rationing problem. Once the good is produced, it can be made available to all consumers without reducing any individual's level of consumption.
Non-exclusion

The second characteristic of a public good is non-exclusion. Non-exclusion means that it is impossible, or prohibitively costly, to confine the benefits of the good, once produced, to selected person. A person will benefit from the production of the good, regardless of whether or not he or she pays for it.

The existence of public goods creates problems for a price system. Once a public good is produced, a number of people will automatically benefit, regardless of whether or not they pay for it (because they cannot be excluded), so it is difficult for private producers to provide the good.

Due to the high cost of exclusion, once the defense system is built, each will receive protection, regardless of whether he or she participates in its funding. But the possibility of being able to benefit from the defense system without bearing any of its cost gives each citizen an incentive to withhold any voluntary contribution. Each behaves as a free rider, attempting to avoid bearing any cost in the financing of a public good. It should be emphasized here that, the larger the group, the more severe is the potential free rider problem and hence the more likely it is that a public good could not be financed by voluntary contributions. In fact, in the case of a public good, choosing not to contribute is the most rational behaviour.  

Because this is true for every person, few, if any, people will contribute, and the good will not be provided. Therefore, when the benefits of the public good

3. For detailed analysis of the relationship between group size and the free rider problems see: James Buchanan, The Demand and Supply of Public Good, Skokie, Ill, Rand McNally, 1968, Chapter 5.
are non-rival over a large group, even though it is in the people's interest to have the good provided, (that is even though the benefits exceed the costs) it is unlikely that the good will be provided. The failure of the price system to function efficiently in providing public goods is a major economic justification for government intervention.

**Externalities**

Sometimes in the process of production, distribution or consumption of certain goods, there are harmful or beneficial side effects called externalities that are borne by people who are not involved in the market exchanges. These side effects of ordinary economic activities are called external benefits when effects are beneficial and external costs when they are harmful.

The term externality stems from the fact that these effects are outside, or external to the price system, and so their impact is not determined through mutual agreement among all those affected. Immunization against a contagious disease is an example of a consumption activity involving external benefits. Similarly, maintenance of a person's lawn or home may also produce external benefits for neighbours. External costs are also quite common and best example can be found in the area of pollution. Driving an automobile or operating a factory with a smoking chimney pollutes the atmosphere that other people breathe, thus the operation of a car or factory imposes costs on people not directly involved in the activity. The only difference between externalities and public goods is that external effects are the unintended side-effects of activities undertaken for other purposes. For example, people do not pollute because
they enjoy breathing a polluted atmosphere—they simply want to transport themselves conveniently in a car from one place to another.

Externalities generally lead to an inefficient allocation of resources, or market failure, just as public goods do. Market demands and supplies will reflect only the benefits and costs of the participants in the market, the benefits and costs that fall on others will not be taken into account in determining production.

The discussion above shows that externalities and public goods generally lead the price system to produce inefficient results. This conclusion, therefore, implies that it is possible for government to intervene with a policy that will lead to a more efficient allocation of resources. Implicit in the above discussion is the assumption that the government, being a benevolent entity maximises the social welfare. But here it is important to emphasise the fact that the existence of market failure, however, does not mean that government intervention will always invariably improve the situation. In fact, the public choice literature which has emerged as an important branch of study of political economy in recent years, on the contrary, postulates that the government is at best indifferent and at worst, even malevolent.

The theory of public choice is the study of how governmental decisions are made and implemented; as such it basically involves an analysis of the political process. Public choice theory tries to explain what government actually does (or will do under different circumstances), as distinct from an attempt to prescribe what government should do. This approach is based on the premise that individuals attempt to further their own interest in their political activities just as in their economic activities. Thus the view that people are schizophrenic—behaving in a greedy and materialistic way in their market transactions but in a
public - spirited and altruistic way in voting booth is explicitly rejected. Here, therefore, government expenditure growth is explained in terms of the collusive behaviour of politicians and bureaucrats to maximise their gains (Downs, 1957, Breton, 1974 Niskanen, 1971, Brennen and Buchanan, 1977). Another public choice explanation for the growth and changing composition of government expenditures is given in terms of the operation of various pressure groups in the polity (Olson, 1982)\textsuperscript{4} In the Indian context, Bardhan (1985)\textsuperscript{5} for example explains the growth of subsidies in terms of the relative pressure exerted by the three proprietary classes, namely, the rich farmers, the industrial capitalist class and the professionals including the white collar workers.

SECTION: III

Significance of "Government Failure".

The functioning of private markets have been studied for many years by the economists. Therefore the circumstances under which markets function well and under which they function poorly are fairly well understood. When markets produce inefficient results, "market failure" is said to occur.

The early development economists recognized the role of government in providing "social overhead capital" or "infrastructure" to facilitate economic development. However, most analysis focused on a second role: they believed that government should undertake activities that would compensate for "market

\textsuperscript{4} Mancur Olson, Jr., "The Logic of Collective Action" (New York Schocken Books, 1968).

\textsuperscript{5} Bardhan Pranab, "The Political Economy of Development in India", (Oxford University Press, New Delhi, 1985).
failures'. These were regarded as being so much more extreme in developing countries as to make these economies different not only in degree but in kind from industrial countries. In these countries, therefore, market failures were thought to result from "structural rigidities", which were defined as a lack of responsiveness to price signals. It was therefore concluded that government should take leading role in the allocation of investment, control the commanding heights of the economy, and otherwise intervene to compensate for market failures. In fact some believed that development economics was different because markets did not function.

However, in relatively recent years, economists have begun to study how the political process actually functions. The result of this inquiry is the emerging theory of public choice. It has become clear that there is such a thing as "government failure", that is, government's enacting policies that produce inefficient and/or inequitable results as a result of the rational behaviour of participants in the political process. In fact, by 1970s and early 1980s, governments in most developing countries were mired down in economic policies that were manifestly unworkable. Whether market failures had been present or not, most knowledgeable observers concluded that there had been colossal government failures. In many countries, there could be little doubt about the contention that government failure significantly outweighed market failure. For example, this includes exceptionally high-cost public sector enterprises. It was found that government investment programmes were highly inefficient and wasteful, government controls over private sector activity were pervasive and costly, and government public sector deficits, fuelled by public sector enterprise deficits, excessive investment programs and other government expenditures, led to high rates of inflation. There was also deterioration of
transport and communication facilities, which raised costs for many private sector activities. As by-products of these failures, large scale and visible corruption often emerged. Many of the programs and policies that had been adopted with the stated objective of helping the poor had in fact disproportionately benefited the more affluent members of society. Therefore, one of the lessons of experience with development is that governments are not omniscient, selfless guardians and corrections are not costless.

The public choice approach to the analysis of political decision making should therefore lead to a major alteration in the way government is viewed. Just as we should not think that private markets always function efficiently, it is equally incorrect to picture government as always operating to reflect accurately the public interests. Therefore, one has to keep the possibility of government failure in mind while evaluating the market. Both, the market and the political system are processes for allocating resources and distributing incomes, and each has defects. The fact that the market is inefficient does not imply that government will do any better. It is always possible that government intervention will make a bad situation worse. However the converse of this is also true. In situation in which the government has performed poorly, it does not follow that the market will necessarily function better. Thus in deciding whether the market or the government will produce better results, one has to choose between two imperfect mechanisms. Therefore, the forces that shape both, market and government, outcomes must be understood in order to make wise decision.

The last part of the above discussion very clearly brings out the fact that there is an urgent need to have a second look at the role of government in an economy. Few aspects of economic policy are more important than public
expenditure. However, most public discussion of government expenditure has consisted either of general denunciations of high government expenditure and big government or else criticism of this or that particularly wasteful government expenditure. One reason for this traditional neglect of the analysis of government expenditure in public finance was the feeling that the level and structure of this expenditure were determined politically and were thus beyond the economists' proper orbit of study. Of late, however, economists in all the countries have started questioning the need for ever growing public sector and growth of government in general. Thus 'what "government" does, has become an important issue for discussion during last few decades and therefore growth of government (measured in terms of growth in public expenditure) has become one of the very important topics of study among the economists. The present study is one such attempt to see to what extent we can understand in some meaningful way the pattern of behaviour of government expenditure in the state of Gujarat.

The chapter scheme of the present study is as follows:-

**Chapter 2** provides an overview of the trends in budgetary imbalance in the state economy.

**Chapter 3** provides a review of literature on growth of government and its causes. The discussion begins with the earliest theory on increase in government expenditure provided by German economist Adolph Wagner. The hypothesis on growth of government given by various economists like Buchanan, Gordon Tullock, Niskanen, Richard Bird, Musgrave Allan and Peacock, Brennen, Bansal, Breton Albert, Anthony Downs, Trey, Manure Olson,
and others have been discussed here. Studies on growth of government related
to Indian economy by economists like Pranab Bardhan, John F. Toye, Rudolph
and Rudolph, M.Govind Rao and Tulsidhar, have also been discussed here.

Chapter 4 discusses the nature of database and methodology used in the
present study, while in Chapter 5 we study the trends of the public expenditure
in Gujarat in general.

Chapter 6 provides a detailed analysis of the changing composition of public
expenditure in terms of economic and functional classification of government
budget. It gives an idea about the direction in which government is growing. In
Chapter 7 an attempt is made to measure the relationship between the growth
of government expenditure and state Domestic Product by estimating income
elasticities of government expenditure. Chapter 8 provides an analysis of
determinants of government expenditure. Chapter 9 provides an analysis of
causality between economic growth and government growth. For this purpose
causality test is carried out between SDP and public expenditure and its various
components. Here, we also briefly review the other studies on causality
between government expenditure and National Income.

Chapter 10 gives a summary of the study and highlights its main findings. It
also discusses the major policy recommendations.