CHAPTER III

REVIEW OF LITERATURE ON GOVERNMENT GROWTH

Public expenditure has become an increasingly important field of study in recent years. Although there has been tremendous growth of public expenditure in many countries in recent years, the interest of economists and more specially specialists in public finance was confined until recently, almost exclusively, to the analysis of the economic effects of budgetary policies and to the development of normative theories seeking to provide criteria which should determine the revenue and expenditure policies of a government. Recently, however, because of the considerable broadening of the impact of the public sector upon the economy, and the growing interest in the problems of economic growth, which has conferred considerable significance on this impact, some interest has been directed towards studying the behaviour of the government expenditure on the basis of empirical data and historical facts, so as to know if there are generalizations which could be made about its behaviour.

The increase in the number of the studies on the growth of government expenditure shows the concern of economists about the growth of government in various countries. In fact presently, majority of the economists believe in the proposition that a major reduction in the role of government is both a necessary and a sufficient condition for progress. Whereas the traditional theme since Pigou and Keynes had been to show how governmental action must correct for market
failure, the new thrust is to stress government failure and to view the public sector as an impediment to the market. Central to this new doctrine is the proposition that government has become too large and that constitutional constraints are needed. Many developing countries are presently engaged in critically examining the role of government in economic development. Also, the international financial institutions like IMF, the World Bank, and the Asian Development Bank have, in recent years, begun to promote projects for the restructuring of the public corporate sector in particular and public sector in general. The general trend is to move towards a relatively slim (and hopefully efficient) public sector. This is largely prompted by the apparent failure of government on a number of fronts like (i) inefficiency of state enterprises/monopolies stifling competition and competitiveness, (ii) rapid (and to some degree unjustified) growth of government employment with civil servants pursuing their own growth objectives, (iii) failure of macro-economic demand management and continued balance of payments problems (iv) state's welfare practices not assisting in sustained poverty alleviation, (v) limited achievements of centralised economic planning because of lack of effective implementation and (vi) the breaking down of law, order, peace and stability.

It is important to emphasize here, that this move towards a reduced public sector size and an enhanced share for private sector is not an isolated phenomenon of the non-communist world. Recent trends in Eastern Europe and USSR and the various economic reforms in China also are pointers to the likely eventual demise of state intervention in production and distribution of most goods and services.
SECTION I

Role of the State and Public Expenditure Policy:

(i) Role of State in Mature Market Economies

We have mentioned about the role of government in capitalist countries in our first chapter. As mentioned there public expenditure analysis in these mature market economies is primarily focussed to identifying the causal factors affecting its growth with a view to evolve appropriate measure to control the growth of government (Forte and Peacock, 1985). In these countries, as mentioned earlier, public expenditure is largely demand determined (Peacock 1985) and consists of mainly the public consumption expenditure and current transfers. Even after the Keynesian analysis brought to the fore the importance of public expenditure policy in maintaining high levels of employment and incomes the emphasis has been to offset the deficiency in the effective demand. Under normal full employment demand condition or when supply bottlenecks exist, increase in government expenditure growth assumes enormous significance. It is important to note that the emphasis in these countries is mainly to control the volume of government expenditure and not so much to alter its composition. Also, it is presumed that the expenditure control measures designed to limit overall spending are more likely to succeed than those which attempt to discriminate (Peacock, 1985).


3. Ibid.
Among development economists, the view is expressed time and again that for the economic development of the developing countries, a strong government is important. In developing economies, public expenditure is essentially determined by government's urge to accelerate economic growth. Development economists like Rosenstein-Rodan, Nurkse and Kuznets tried to identify the major causes of economic backwardness, and thereby suggest strategies for economic progress for the backward economies. These economists assumed that the state would have to play an important role in raising an economy out of its backwardness. The success of Keynesian activism in fighting the Great Depression in the Western countries, the success of the Marshall plan in engineering the quick reconstruction of the War-damaged economies of Western Europe and the achievements of the Soviet industrialization drive in the 1930s had created a virtual intellectual consensus in the world on the power of the "visible hand".

Kuznets (1955), on the basis of time series data on the national products of different countries, showed that the process of economic development was always accompanied by a shifting of the labourforce from low-productivity agriculture to high productivity manufacturing and argued that industrialization required a higher rate of capital accumulation. Nurkse (1953) wrote about the problem of capital accumulation in a poor country. In his famous doctrine of the "vicious circle of

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poverty'', he said that poor societies remained poor because with low per capita income they could not supply enough savings to increase their stocks of reproducible capital. Rosenstein-Rodan (1943)\(^6\) analyzed the demand side of capital formation. According to him, the structure of these backward economies was such that there were not enough incentives for investors to choose the right pace or pattern of capital accumulation. Rodan said that in a poor economy the size of the market for industrial products was small and people need to spend most of their incomes on necessities. Scitovosky (1954)\(^7\) concluded that only externalities arising from inter-temporal dependence amongst firms presented a serious impediment to the growth of a backward economy, if it were to be propelled by a price-guided system. The implication of the Scitovosky formulation was that the market mechanism could be relied upon to take care of the production problem of an economy, but investment allocation required state intervention.

As a result of these strong arguments from the development economists, the state emerged in the role of an investment planner in a developing country. It was implicitly assumed that once the productive capacities were created through investment planning, the subsequent problems of getting output, employment and income out of these investments would resolve themselves automatically. This line of analysis led almost every developing country to set up a planning agency to formulate investment plans based on economy-wide quantitative models. It was therefore thought that the increase in the levels of expenditure, specifically, the


investment expenditure - both physical and human - is imperative to enhance the rate of capital formation.

The problem in these countries was not perceived to be one of deficiency in consumption demand, but of low levels of savings and investment. Therefore, in these countries, it was not so much the growth of public expenditure as its composition that the policy makers were concerned with.

(iii) Role of the State and Public Expenditure Policy in India:

In India, the role of the State and in turn, the public expenditure policy, was largely guided by the material and ideological considerations that prevailed on the eve of independence. The enormous urge to rapidly improve the standard of living of the people and a strong feeling of patriotism and more importantly, anti-imperialism provided the impetus for active state participation in the self-reliant development strategy adopted during the post-independence era (Bhagwati and Desai)\(^8\). It was argued that if the country had to rapidly progress without foreign dependence, active state participation in the developmental process was necessary.

In India an active state participation was considered both obvious and necessary, given the low levels of saving and investment, weak industrial base, lack of infrastructure, obsolete technology, scarcity of skilled manpower and the virtual non-existence of entrepreneurial class. Thus the strategy of rapid industrialisation with particular emphasis on the development of basic and heavy industries necessarily assigned a key role to the public sector. This was dictated as much

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by ideological considerations as it was by necessity, for, when the country embarked on development planning, the private sector neither had the necessary funds nor the resources in terms of managerial or scientific skill to undertake the risks involved in the large investment with long gestation period (Bhagwati and Desai, 1970). It was presumed that raising the levels of domestic savings, creating a strong and diversified base of capital and intermediate goods industries, ensuring adequate physical and financial infrastructure, incurring huge research expenditures required to achieve technological self-reliance and its continuous upgradation, were possible only by assigning 'commanding heights' to the public sector. However, due to the wars with Pakistan, two successive monsoon failures in the mid-sixties, and the steep increase in oil prices along with substantial increase of expenditures on wages and salaries, goods and services, subsidies and interest payments and priority to current items of expenditure, the public capital accumulation received a serious set back. A severe constraint on the growth of public investment expenditures was posed by the inability of the public sector itself to generate the required level of savings (Chakravarty, 1987).

In such a situation, containing the rate of growth of current expenditures and making the expenditures purposive and cost-effective assumes immense significance. If, however, expansion of government activity leads to greater social welfare, the increase in public expenditure need not be a matter of concern.


10. Chakravarty, Sukhmoy, Development Planning - The Indian Experience, New Delhi, Oxford University Press, 1987
But, in actual practice, welfare maximising government are very few as the public choice literature shows and therefore exercising control over government expenditure is necessary.


The main theme of the World Bank's World Development Report 1991 was the interaction between governments and markets. The Report contends that a consensus is gradually forming in favour of a market-friendly approach to development. It also emphasises the fact that when markets and governments have worked in harmony, the results have been spectacular, but when they have worked in opposition, the results have been disastrous.

In the case of various countries that have achieved rapid development in the postwar period, the report notes that the extent and efficiency of the state's involvement in the economy has been critical.

In the chapter on "Rethinking the State", the report states that governments everywhere tend to tailor economic policies to balance conflicting interests. In many developing countries, for many years in the past, economic policy has been subordinated by the Governments to securing the support of influential groups. Government expenditures had grown along with government interventions in industrial and service sectors. These caused budgetary and balance of payments problems in the 1980s. "Government failure" has been substituted for or superimposed on market failures. Moreover, "Excessive intervention breeds
corruption weakens a government's ability to carry out its functions efficiently. Corruption can seldom be reduced unless its larger underlying causes are addressed. It flourishes in situations where domestic and international competition is suppressed, rules and regulations are excessive and discretionary, civil servants are underpaid, or the organization they serve has unclear or conflicting objectives". (World Bank, 1991: 131-132).

The Report also suggests a package of market-friendly reforms, which has following components: (i) investing in people (expanding primary education, alleviating poverty and controlling population growth through better education, health care and family planning); (ii) making markets work (strengthening price signals, deregulate markets, and upgrade infrastructural investments and key institutions); (iii) opening up trade and technology (liberalizing trade and building institutions for technological development); (iv) fostering macro-economic stability (low and stable inflation which requires financial discipline in the public sector); and (v) environmental policies.

SECTION II

Review of the Theories of Growth of Government

In this section we briefly provide a review of the theories of growth of government.

Explanations of government growth are numerous. However, as Buchanan has suggested, there are some obvious explanations of the growth of government
activity. Two factors affecting this growth are population increase and inflation. If the number and type of services provided to the public are constant, one would expect that, as more people are born the number of government employees would increase and correspondingly government expenditure would grow. Borcherding analyzed total (local, state and federal) government expenditures in the United States over the period 1870 to 1970 in order to determine the extent to which inflation, population and affluence would account for the growth of government spending. He estimated that population increase was responsible for about 25 percent, increases in the employees of government services approximately 12 percent, and per capita income increases for around 25 percent. Thus the basic problem is to provide an explanation for the growth that occurs over and above that attributable to population, inflation, and affluence. Many themes and explanations, and affluence. Many themes and explanations have been developed on this topic which we discuss now. We have subdivided these theories into seven categories: (1) Wagner's "Law" of government growth, (2) Baumol's unbalanced growth hypothesis, (3) explanations based on "displacement" principles or structural changes in the economy-mainly that of Peacock and Wiseman (4) Director's "Law" of interpretations of growth, which center on the role of the voter (5) models that focus on political behaviour (6) studies that emphasize the importance of bureaucrat, and (7) external factors. There is a considerable overlap


among these categories, for, a given study may contain elements of more than one explanation of the growth phenomenon. The boundaries among the various categories can, therefore, not be clearly defined. Moreover, no claim is made that the survey provided is exhaustive, though it is highly representative of the research in the field.

(1) Wagner's “Law”

In surveying explanations of government growth, it is most appropriate to start with Wagner's Law of Increasing Government Activity developed by the German economist Adolph Wagner more than a century ago. Using the historical approach Adolph Wagner tried to establish generalization about the behaviour of government expenditure. It was based on the data collected from some European countries (eg. Prussia, Bavaria, Britain, North America, Switzerland) where a correlative growth of community output and public expenditure was observed. Consequently it came to be argued that the data supported the existence of some kind of general “Law” relating the growth of output per head and the growth of government spending. Wagner argued, based on his empirical findings, that government expenditure must increase at an even faster rate than output. Thus in his own words “The Law of increasing state activity is the result of empirical observation in progressive countries, at least in the Western European civilization, its explanation, 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, ... But in the long run the desire for development of a progressive people will always overcome these financial difficulties".14 Thus growth in public expenditure derives from growth in state activity as a consequence of social progress. Wagner distinguished between three types of state activities to explain the existence of the law. These were the maintenance and enforcement of law and order internally and externally, participation in material production and the provision of such economic or social services as postal, education and banking services. However 'Wagner's law is merely a statistical observation based on his own very special view, of the nature of the state as a political entity, his conviction of the general superiority of public corporations to private enterprises and his view that it is the duty of the state to behave in this way.15

There is agreement that Wagner's basic assertion was that increasing government activity and expenditure is inevitable in a progressive state, i.e. a nation in which the subsistence needs of the population have been met. As the law is interpreted by Allen Kelly16, low-income societies are preoccupied with the provision of basic needs for survival such as food, shelter, clothing etc. However, when income rises


above this level, wants including government services, enter the preference functions of citizens so that the income elasticity of demand for public services become positive and public goods increase relative to private goods.

Although the basic notion espoused by Wagner seems simple enough, he did not state his hypothesis precisely, and various translations of his work have been given different interpretations. In general terms, however, research has concentrated on the measurement of the elasticity (E) of the government expenditure (G) with respect to some measure of income (I), $E_{G,I}$, that is, the percentage change in government spending associated with a one percent change in income.

Wagner's hypothesis has been tested with data from both developed and developing countries, and found to be true. However, as argued by Toye\textsuperscript{17}, Wagner did not succeed in explaining why this feature is so generally found, neither in showing possible changes in governmental spending in times of social retrogression such as wars or depression. Also, because Wagner's "Law" is the generalization about development in the very long run, it is difficult to use it for developing world, where for most countries relative time series data is available for 20 to 30 years only.

Bhanoji Rao\textsuperscript{18} argued that the crucial significance of Wagner's hypothesis is in providing a direction of causation that runs from economic growth to government growth.


Ved Gandhi has pointed out that there are basically five different interpretations of Wagner's Law. First, Peacock and Wiseman asserted that “Government expenditure must increase at an even faster rate than output”, which implies that the elasticity of government expenditure (G) with respect to GNP, \( E_{G,\text{GNP}} \), must exceed one if Wagner's Law is valid. Others, including Gottman and Mahar, Musgrave and Bird have accepted this interpretation of the appropriate specification of the law.

Second, Hook, Emi Verveka, Andic and Verveka, and Pryor have adopted slightly modified version of the Peacock-Wiseman specification by computing the elasticity of government expenditure with respect to national income (Y) rather than GNP. In this case \( E_{G,Y} \) must be >1 for the law to be valid. The third alternative statement of the appropriate test of Wagner's Law was proposed by Goffman who stated that “as a nation experiences economic development and growth, an increase must occur in the activities of the public sector and that the ratio of increase, when converted into expenditure terms would exceed the rate of...”


increase in output per capita. Fourth, Michas has suggested that the appropriate elasticity is that of per capita government expenditure with respect to per capita output, or $E_{(G/Pop)}'(GNP/Pop)$, which should exceed unity. Finally, Musgrave, Pryor and Wagner, and Weber have argued that the correct elasticity to test Wagner's Law is $E_{(G/GNP)}'(GNP/Pop)$, i.e., the elasticity of government expenditure relative to output with respect to output per capita.

Based on various empirical studies conducted to test the validity of Wagner's law, Bird summed up the issue by stating that "... any historical stage theory such as Wagner's Law is inevitably systematically biased through the choice of the factors on which interest is focussed and the assumptions made about their role in the historical process. Essentially this law is not a theory at all but rather a kind of philosophizing about history." Wagner and Weber have observed that, "it would seem time to cease treating the amassing of data on government growth as an end in itself and instead use such data as ingredients in the development of positive theories of government behaviour."


In sum, the empirical evidence of Wagner's Law is, at best inconclusive, even though the statistical techniques have a consistent bias in favour of the proposition.28

(2) Baumol's Unbalanced Growth Hypothesis

Baumol has hypothesized that the economy is characterized by "unbalanced" growth.29 He asserted "that economic activities can be grouped into two types: technologically progressive activities in which innovations, capital accumulation, and economies of large scale all make for a cumulative rise in output per man-hour and activities which, by their very nature, permit only sporadic increases in productivity (non progressive).30 Baumol also contended that government services were highly labour intensive, and therefore, the government would be unable to adopt many improving technologies. Such a dependence on labour inputs in public sector would lead to lower rates of productivity increase than the output produced in the private sector. Therefore, the unit costs of government services will increase relative to unit costs in the private sector. The implication is that increasing per unit costs will increase government costs and thus public sector expenditures. Thus we observe the phenomenon of increasing productivity in the private sector of the economy alongside stationary or even declining productivity in the public sector. This unbalanced relationship between the rates of productivity-


30. Ibid. pp.415-416
increase for the two sectors ensures that, in real terms, the relative costs of
goods and services supplied governmentally increase. In order to maintain a
labour force, wages and salaries in the public sector employments will have to be
roughly equivalent to wages and salaries obtainable in the private sector. But the
latter, wages and salaries in the private sector will tend to increase as productivity
increases, without necessarily causing an increase in the prices of private sector
output. When governmental employers find it necessary to offer matching wages
and salaries, but without accompanying increase in productivity, the unit costs of
goods and services supplied governmentally must rise relative to the costs of
marketed goods and services. Thus because of the low productivity and also low
price elasticity of demand for publicly supplied goods and services, there is growth
in government spending.

(3) Displacement, Ratchet Effect and Structural Change:

The displacement effect was first formulated by Peacock and Wiseman in
connection with a study of British government expenditure for the period 1890-
1955. While rejecting Wagner's conclusions, Peacock and Wiseman adopt his
historical approach and study the behaviour of British public expenditure by looking
at the relevant time-series data and the historical facts. Wagner was interested
only in the secular growth of public expenditure in relation to national outputs
whereas Peacock and Wiseman are primarily concerned with the time pattern of
expenditure growth. They interpreted their data to indicate that government
spending grew over time, not at a constant rate, but roughly stepwise.

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31 Alan T. Peacock and Jack Wiseman, The Growth of Public Expenditure in the United
Kingdom (rev.ed; London: George Allen and Unwin, 1967)
Furthermore, the movement from one step or plateau to another coincided with two world wars. Peacock and wiseman therefore proceeded to consider "how far the growth in expenditure can be explained simply as a direct and inevitable consequences of war for the continuing level of government spending in postwar periods.\textsuperscript{32} This led to their famous "displacement hypothesis". The important finding of Peacock and Wiseman is that "although British government expenditure declined after the wars, it does not return to the pre-war level, .... and the share of government expenditure in national product remains much greater after the wars, than it was immediately before them.\textsuperscript{33} This upward shift in the level of government expenditure in relation to national output they call the "displacement effect". Thus according to Peacock and Wiseman the growth of government is limited by the tax revenue that can be expediently raised; and the tax burden, which citizens regard as acceptable, increases dramatically during times of crises, such as wars, or dramatic social dislocations, e.g. the Great Depression. Their plausible explanation of the displacement hypothesis is based basically on the concept of the "tolerable burden of taxation". "People will accept, in a period of crisis, tax levels and methods of raising revenues that in quieter times they would have thought intolerable and this acceptance remains when the disturbance itself has disappeared. As a result, the revenue and expenditure statistics of the government show displacement after periods of social disturbance. Expenditure may fall when the disturbance is over but they are less likely to return to the old level. The state may begin doing some of the things it might formerly have wanted to, but for which it had hitherto felt politically unable to raise necessary

\textsuperscript{32} Ibid. p.36

\textsuperscript{33} Ibid. p.25-26
revenues. At the same time social disturbances may themselves impose new and continuing obligation upon a government as the aftermath of the disturbance (for example, the provision by a government of war pensions), as the result of the government being obliged by the disturbance to assume functions that it cannot easily return to others (for example, the wartime provision by government of services formerly financed by private charity), and as a consequence of changed ideas induced or encouraged by the disturbance itself. Thus a shift in people's ideas about the tolerable burden of taxation due to a social upheaval may give rise to a shift in the level of public expenditure with relation to national output. However, Gupta argues that (1) the displacement effect hypothesis was deduced from their statistical observations of the time pattern of growth of public expenditure in the United Kingdom only. Before one can make any generalization, this needs to be tested for a number of countries; (2) even in the case of the United Kingdom, no quantitative measurement and test of significance of that effect was attempted; (3) the displacement effect refers only to the shift in the level of government expenditure in relation to national output, while no attempt was made to investigate the effect, if any, of a social upheaval on the rate of growth of government expenditure.

Meltzer and Richard, criticizing the displacement theory of government growth, argued that, although government does expand in wartime, the converse is not true, that is, government grows even during "normal" periods, "It is true that

34. Peacock and Wiseman, op.cit.

government grows in wartime, it is not true that government requires a war to
grow, argues, Meltzer and Richard, and therefore they largely dismiss the
displacement hypothesis altogether. Pluta's objection to Peacock and Wiseman's
argument is similar to that of Meltzer and Richard: Government growth can occur
in the absence of social upheaval also. Harold Demsetz has argued that most
explanations of government growth are "unsatisfactory for very basic reasons". He
argues that displacement hypothesis is not true because it is "excessively
mechanical" and leaves important questions unanswered. Thus Demsetz focusses
on an important issue, the distinction between factors that facilitate the growth of
government or make growth possible and the cause of growth itself. Though social
dislocation theory, he argues, may explain why voters lower their resistance to
additional taxation which makes it possible for government expenditures to
increase, the theory does not explain the root cause of government expansion.
Thus Richard Bird argued - "To sum up, Peacock and Wiseman stressed the
crucial role of war and the expansion of government activities associated with war
as the chief way in which the assumed socio-cultural limit on revenues could be
altered, thus permitting an expansion of non-war expenditures after the war is
over. Their original argument was defective both in the vagueness of its
formulation and because its empirical support, in the form in which they presented
it, is negligible .... Further improvement waits on greater specification of the

36. Allan H. Meltzer and Scott F. Richard, "Why Government Grows (and Grows) in a

37. Joseph E. Pluta, "Wagner's Law, Public Sector, Patterns, and Growth of Public

hypothesis and more attention to the process of public decision-making. ... In short, the final verdict on the "displacement effect", whether in Canada, or elsewhere, cannot yet be handed down because an appropriate hypothesis has not yet been rigorously formulated and tested".  

SECTION III

Theories Based on Public Choice Perspective

The above discussion on the growth of government concentrated on the traditional theories of growth in public expenditure. However, several other theories have been provided by various economists as the possible explanation for growth of government expenditure. These theories are mainly discussed in the realm of public choice perspective. We discuss them below and in the process we will also be examining the behaviour of government itself.

Politicians and Government Growth

In order to overcome the deficiencies in the above theories, Demsetz has offered an alternative explanation based upon the specialisation of economic activity. He argues that "specialization of economic activity brings political action to the fore as an instrument by which wealth can be redistributed. The main reason for historic growth in the size of government is that the fraction of the economic activity that is accounted for by specialized production has been on the increase ever since

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the industrial revolution. This has increased the number of instances in which government is called upon to affect the redistribution of wealth." The further argued that the growth of government has accelerated in recent years, even though the pace of specialization has not. Therefore he asserted that the driving force behind the recent relative growth of government is the "political entrepreneur", who has been able to come into existence because of the development of radio and television that made available to political entrepreneurs a truly effective, low-cost method of communicating. The political entrepreneur obtains votes and, presumably, is able to increase his self-interest by using the media to form individuals into special interest groups, such as minorities and the poor. In return for government policy, which transfers wealth to these special interest groups, the politician receives political support. Thus Demsetz argued that though structural change in the economy is the motive force for government growth, it can explain a portion of the growth in government size. The growth of government which accelerated greatly since the 1950's, according to Demsetz, is mainly because of the political entrepreneur. Government may grow during wars and other social upheavals, but the evidence also shows that dramatic growth can also occur in relatively normal periods.

Supporting Demsetz's hypothesis and contrary to the assumption that government is a benevolent entity maximising social welfare, the recent development in public choice theory postulate that it is at best indifferent and at worst malevolent. More recently, Buchanan and Tullock and Downs have come out with the notion of the

40. Demsetz, op.cit. pp.6-7
41. Ibid, p.25
utility maximising representative. Since then a large and rapidly growing literature on the economics of political decision-making has developed. According to Silberman and Durben, "The fundamental assumption in this literature is that "political man" like "economic man", is a utility maximizer. That is, the "political man" responds in a predictable way to variations in total (marginal) costs and benefits. He balances expected benefits against expected costs in the consumption of goods allocated by the political process as well as in the consumption of goods produced within the context of market system.

The classical economists looked at State with a lot of skepticism and therefore advocated minimum state intervention in situation where market failure was possible. Then came the great depression of 1930's and the success of Keynesian activism in fighting the Great Depression in the western countries, the success of the Marshall Plan in engineering the quick reconstruction of the war damaged economies of western Europe and the achievements of Soviet industrialization drive in the 1930's had created a virtual intellectual consensus in the world on the power of the invisible hand of the state. Early development economists like Rosenstein-Rodan, Nurkse, Kuznets, Scitovosky and others argued that market


failures were so much extreme in developing countries as to make their economies different not only in degree but in kind from industrial countries. Market failures in these countries were thought to result from structural rigidities, which were defined as a lack of responsiveness to price signals. It was therefore concluded that "governments should take leading role in the allocation of investment, control the commanding heights of the economy, and otherwise intervene to compensate for market failures". 45

However, 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 question but that government failure significantly outweighed market failure. 46

The discussion in the above paragraph, though a slight deviation from the theme, drives home a very important point that governments need not necessarily maximise social welfare by intervening in situation of market failures. In order to bring out more clearly the motives behind the role played by government [and therefore people who run it] it would be interesting to provide comments from one of the early works on this, that of Anthony Downs 47. In the fields of public finance and welfare economics various economists have given statements about


the proper role of government in the economy. The intuitive conclusion from Professor Abba P. Lerner\(^\text{48}\) is that the government's proper function is to "maximise the total satisfaction in the society". Adolph Wagner regarded redistribution of income as a duty of the state. Hugh Dalton, in The Principles of Public Finance, argues that "most of the operations of public finance revolve themselves into series of transfers of purchasing power ... from certain individuals to public authorities, by way of public expenditures, to other individuals ... The public finance which helps to do this in the way that is socially most advantageous secures the maximum social advantage". Behind all these prescriptions quoted lurks a single conception of government, viz. Government is that agency in the division of labour which has its proper function - the maximisation of social welfare". Dalton further argues that "every agent in the division of labour is assumed to have a private motive as well as a social function. This ability springs from the self interest axiom, which states that in general man undertakes economic activity primarily to further their own private aims and only secondarily to provide benefits for society (i.e. for other men). From the point of view of society as a whole, the object of each man's action is the discharge of his social function. But from his point of view, he acts to attain his private ends, which are often unrelated per se to that function".\(^\text{49}\) Therefore, when we theorise his behaviour, we should not limit ourselves to describing his social functions, we should also show how he is motivated to carry it out. Every economist recognises this state of affairs when he is talking about private

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\(^{48}\) Abba P. Lerner, "The Economics of Controls", New York, the Macmillan Company, 1944, p.32.

\(^{49}\) Anthony Downs, op.cit.
economic agents, because they are human and the realities of human nature must be accounted for in any economic analysis. Ipso facto, the same type of reasoning must be applied to every institution run by men. However, economic theories of government behaviour universally fail to assign any motives to the men in government. They, in describing government's role in society, merely describe its proper function. No mention is made about the incentives which might cause that function to be carried out by the men who run the government. Yet those incentives are vital, because their operation determines in what way the function of government is discharged. However, overlooking this facts amounts to assuming that governments are not institutions run by men, but are depersonalized, frictionless machines, which operate according to mathematical rules, e.g. they carry out the will of the majority. Being machines, they have no private motives. Being frictionless, their particular process of operation do not affect their outputs. Obviously, no economist believe that this machine theory accurately describes real world. There is no reason to assume a priori that the men who run governing apparatus always carry out the policies citizens choose. Every economic theory of government must assume that the governors carry out their private ends. Furthermore, these ends are probably the same in all societies: power, prestige, income and the excitement of the political game, of course, the political structure of each society determines how government can be expected to behave therein. Thus it is necessary to develop models which unify politics and economics.50

After the works of Anthony Downs, number of theories linking economics and politics, to explain the role of government, have been developed. In Albert

50. Anthony Downs, op.cit.
Breton's theory of Representative Democracy, the government is the party in control of the legislature. In the country with a parliamentary system, the party with parliamentary majority is allowed to form the government. The governing party has an objective function, which includes the probability of being reelected but can also include variables such as personal pecuniary gains, personal power, his own image in history, the pursuit of the lofty personal ideals, his personal view of the common good and so on. To achieve these goals, the governing party takes advantage of its position as a monopoly supplier of certain highly desired public goods, e.g. defence, police and fire protection, highways.

The Downs-Breton theory of representative government offers one possible explanation for the rapid growth in the size of government. From the above discussion it follows that an elected representative is a political entrepreneur whose motivation, like that of the private-sector entrepreneur, is to seek advantageous exchange. Vigorous competition occurs when politicians face re-election, because incumbents competing for votes find it in their interest to offer constituents an attractive array of public goods and services. Nordhaus has asserted that "........ within incumbent's term in office there is a predictable pattern of policy, starting with relative austerity; in early years and ending with potlatch right before elections". It has been argued that, in order to maximise


52. Albert Breton, op.cit, p.124


plurality, (since election requires vote plurality), politicians pursue ideological policy only when public confidence is high, otherwise they must pursue policy agreeable to the voters, i.e. it manipulates the policy variables at its disposal to increase its plurality. Usually this is achieved through expansionary fiscal policy and as elections draw nearer, stronger economic policy actions must be used to ensure an increase in popularity. Thus, the politician has been an important part of the growth process. The theory of government growth which focusses on the politicians as one of the prime mover in the expansion process is based on two assumptions. First, the self-interest of the politician is enhanced by getting elected to office where pecuniary (salary and office expense allowances) and non-pecuniary (power and prestige) benefits can be enjoyed. Secondly, and more important, is the assumption that the likelihood of (re) election is increased when the politician advocates a larger public sector or public spending as voters (or perhaps organized groups of voters i.e. the interest group) favour higher levels of expenditure and employment and are attracted to candidates who advocate more and more and larger government programmes.

Bureaucracy and Government Growth

Once the government, i.e. legislature and executive, decide what government output are to be provided and in what quantities, they must actually be bought. Although some government outputs are bought directly from private industry, most government funds are channeled through a public bureaucracy.

Bureaucracy, in general today, is in essence a black box and it is only relatively recently that economists have turned to the study of bureaucracy. The first economic approach to the study of government bureaucracy was provided by Mises, Tullock, and Downs⁵⁶. These early works on bureaucracy emphasised the utility maximising nature of government bureaucrats and also stressed that wasted resources and excessive spending are the result of inadequate constraints on bureaucratic behaviour. Government may, therefore grow, not only because increasing expenditures are demanded by citizens, interest groups or legislators but also because they are demanded by bureaucracy supplying government programmes. The government bureaucracies are an independent force, which possibly may lead to increasing government size. More systematic efforts to study the bureaucratic behaviour is that of William Niskanen.⁵⁷

One of the key characteristics of a government bureau is the non-market nature of its output. Indeed a bureau does not supply a number of units of output as such but levels of activities from which output levels must be inferred.⁵⁸ There is a measurement problem inherent in so many of the goods and services public bureau provides which makes monitoring very difficult. Therefore, Niskanen argues that, it is relatively easy for government bureaucrats to maximise utility by producing an output that maximizes the budget. Budget maximisation takes place

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because the utility enjoyed by bureaucrats increases as the bureau’s budgets increase. The monitoring problem is intensified by the bilateral monopoly of the bureau-sponsor relationship. The monopoly nature of the most bureaus also frees them from the competitive pressure to be efficient and denies the funding agency an alternative source of information by which to gauge the efficiency of the monopolist bureau, thus compounding the monitoring problem inherent in the nature of the bureau’s output. Since bureaucrats cannot lay claim to a government agency’s fiscal residual as private entrepreneurs claim profits, any residual must be obtained directly through budget increases. Because government bureaucracies promise output and services in exchange for a budget, bureaucrats produce a total output well beyond the socially optimal amount. Niskanen also lists the following possible goals of a bureaucrat: salary perquisites of the office, public reputation, power, patronage, output of the bureau, ease of making changes and ease of managing the bureau.

If bureaucrats try to maximise budgets, the question is how the bureaucracy get the legislature to buy this higher budget? As argued by Niskanen, two characteristics of the legislature - bureaucracy relationship work in favour of the bureaucracy in achieving this end. First, as mentioned earlier, the legislature and the bureaucracy are typically in a bilateral monopoly situation. Whereas the bureaucracy obviously needs legislature in that legislature must approve all expenditure measures if the bureaucracy is to be sustained, the legislature also, at least in the short run, is in equal need of the bureaucracy. If bureaucracy refuses

60 Ibid.,p.24
to supply any output, allows a significant deterioration of quality, or the like, it may be the members of the legislature that bear the hostile reaction of the citizenry at the next election, not the bureaucrats. The bureaucracy’s ability to expand the budget beyond the amount the legislature or citizen’s demand, depends in part on its ability to misrepresent the true prices and quantities of publicly provided goods. The ability to misrepresent is likely to depend, in turn, on the size and complexity of the budget itself. The bigger the bureaucracy is, the more difficult it is for outsiders to monitor its activity and the more insiders there are who are working to increase the size of the bureaucracy.\footnote{Anthony Downs, Op.cit., pp.3-20.}

The theories of government growth emphasizing the bureaucratic behaviour based on utility maximization add a new dimension to the study of government and can be considered as one of the many reasons for growth in government expenditure in the last two to three decades.

**Interest Groups and Government Growth**

In this section we try to explain the way in which the evolution of the discussion on the forces governing public expenditure growth has incorporated the study of interest groups (in the wide sense of the term this includes bureaucrats, politician, trade unions, the farm lobby, the military lobby, the corporate lobby etc.) and how utility maximizing propensities of these groups and those of its members affect the taste for public sector expansion, given the constraints which affect the maximizing process. This study of the relationship between government expenditure
growth and interest groups is done by the extension of the public choice approach to the analysis of the growth of government in the form of the study of the behaviour of the voter-interest group.

Public-choice, as defined earlier, is the economic study of non-market decision making, or simply the application of economics to political science. The subject matter of public choice is same as that of political science; the theory of the state, voting rules, voter behaviour, party politics, the bureaucracy, and so on, the methodology of public choice is, however, that of economics. The basic behavioural postulate of public choice, as for economics, is that man is an egoistic, rational, utility maximizer.

The development of public choice as a separate field has largely taken place within the last four decades, the earliest being probably A Bergson's 1938 article and Kenneth J. Arrow's book. It focuses on the problems of aggregating individual preferences to maximize a social welfare function or to satisfy some set of normative criteria, i.e. on the problem of which social state ought to be chosen, given the preferences of the individual voters. This research on the optimal methods of aggregation has spurred interest in the properties of actual procedures for aggregating preferences under different voting rules, which is analogous to establishing equilibrium under various voting rules. Many different types of voting rules under the realm of game theory have been discussed by

various authors. Muller has provided an excellent discussion of various voting rules in his book.63

Many economists have adopted an explanation which identifies the influence of special interests as the cause of government growth. Several theorists have contributed to this explanation. From the viewpoint of a representative democracy, the most widely used and discussed voting procedure is the majority rule. The pioneering public choice analysis on the question of government size was provided by the 'Virginia School' of political economy and above all by Grodon Tullock and James Buchanan.64 Tullock described a community of 100 farmers in which access to the main highway is via small trunk roads, each of which serves only 4 or 5 farmers. The issue comes up as to whether the entire community of 100 should finance the repair of all of the trunk roads out of a tax on the entire community. Obviously one can envisage a level of repairs and set of taxes on the individual farmers under which such a proposal would be unanimously adopted. But under majority rule it is to the greater advantage of some to propose that only one half of the roads are repaired out of a tax falling on the entire population. Thus, one can envisage a coalition of 51 of the farmers forming and proposing that only the roads serving them are repaired out of the community's general tax revenue. Such a proposal would pass under majority rule and obviously involves a redistribution from the 49 farmers who pay taxes and receive no road repairs to 51 farmers whose taxes cover only slightly more than

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one half of the cost of the road repairs. In the above example redistribution in favour of 51 farmers takes place because of the inclusion of a quasi private good in the public budget as a means of bringing about redistribution. This process of redistribution was first discussed by James Buchanan. 65 Yoram Barzed and Deacon have taken up the specific case of education as a private good purchased and supplied as a public good and have illustrated both the allocational inefficiencies and redistributive properties of this activity. 66 Education is an example of a good which can involve redistribution from the bottom to the top (or middle) of the distribution. Also, distribution may occur on the basis of criteria other than income (e.g. occupation, sex, race, geographic location, recreational preference, political affiliation etc.). What is required for redistribution to take place under majority rule is that the members of the winning coalition be clearly identifiable, so that the winning proposal can discriminate in their favour, either on the basis of the distribution of the benefits it provides, or the taxes it charges. Thus, whatever form it takes, the fact is that the majority rule creates the incentive to form a coalition and redefine issues to achieve the redistributonal gains. 67 Another kind of voting process widely used in many democratic countries is the 'plurality' rule (choose that candidate who is ranked first by the largest number of voters). However, like the majority rule, the plurality rule takes into account only the information about the voter’s first preferences, how the other candidates stand in their preference ordering is not revealed.


The implicit argument in the discussions on the interest groups therefore is that
interest groups favour government outlays of a quasi-private good nature and that
log-rolling leads to a coalition of interest groups, which introduces a package of
quasi-private goods into the public budget in the manner first described by
Tullock.\textsuperscript{68} Hence the size of government becomes excessive. Muller and Murrell
have provided an interesting study on the role of interest groups in increasing the
size of government.\textsuperscript{69} The process by which a party gains power in a democratic
government is analysed in a different manner than the usual analysis using
median voter position. Parties are envisaged as woores of interest groups in
which a core of groups will adhere to the party in question on ideological
grounds. However, this agreement over ideology may not necessarily provide
assurance that the party will obtain office and therefore it is necessary to attract
other interest groups to form agreements over volume and pattern of public
spending and finance that will have net effect of adding to voting strength. The
parties seeking support will of course, try to minimise negative impacts on the
voter interest groups. The parties seeking support will rely on the technique of
fiscal illusion\textsuperscript{70} or on the transfer of the burden to the currently unenfranchised, for
example, by running deficits which have to be paid off by future generations.
Muller and Murrell however, without relying on these arguments, show that,
provided an interest group is successful in obtaining benefits targeted to it (for
example transfer in money expenditure such as pensions or transfers in kind

\textsuperscript{68} Gordon Tullock, op.cit.

\textsuperscript{69} Muller and Murrell, 1985, in Francisco Forte and Alan T. Peacock (ed.), Public

\textsuperscript{70} James Buchanan, Public Finance in a Democratic Process: Fiscal Institutions and the
such as subsidized public housing), those who would otherwise have opposed these benefits, but have lost out in election process, will not be disposed to campaign for a return to the status-quo, but will favour increased total government spending. Muller and Murrell, using Lindhal's model of determination of the level of government output, show, how at a given tax share, an interest group is able to influence the nature of the public output. They also show that once an interest group has succeeded in introducing a private or quasi-private good into the public budget, all members of the society will agree that there should be an increase in total government expenditure over what it would have been without the new good.

Some economists have adopted an explanation which identifies the influence of special interests as the cause of government growth. It is argued that the political parties have every incentive to offer special benefits to minority groups (tax relief, subsidies, protection, and the like) and in this way to build up electoral support. Minorities have a corresponding incentive to organise themselves and press for an expansion of these benefits, which is likely to be forthcoming, as parties compete for group support. The result is that government grows beyond the size which voters would collectively choose. Yet, voters are unlikely to perceive this. With economic exchanges, the parties involved incur most of the costs and benefits and so take them both fully into account. But, in the case of political deals, politicians and pressure groups can monopolise the benefits while the costs are automatically borne by the general public of consumers and taxpayers. This unbalanced distribution allows the beneficiaries of each government intervention to avoid most of the costs, thus generating a powerful constant bias towards government growth. An important element in this explanation is the constitutional framework within
which the process takes place, since this will largely determine the balance of benefits over costs to the politicians. Generally speaking, the fewer the limitations on political initiatives, the greater will be the scope for profitable exchanges with special interests, and the faster government will tend to grow. Where governments have discretion over the money supply, they can and will use inflation to conceal some of the costs of their deals. Where they need not balance expenditure with taxation, they will also use budget deficits to transfer some of the financial costs to future generations of taxpayers. Another constitutional factor is the size of the electoral coalition required to produce a legislative majority. Very often, governing parties or party coalitions do not need an absolute majority of votes to form a government: this reduces the minimum size a coalition needs to achieve in order to win and so makes the likelihood of a democratic system being taken over by such coalition that much greater.

This explanation of government growth has been greatly reinforced by Mancur Olson’s analysis of the formation and activities of interest groups. Like the Virginia School, Olson utilises microeconomic methods. Olson argues in The Logic of Collective Action that an equilibrium between a multiplicity of pressure groups will lead to an expansion of government, as each group makes the receipt of special favours the condition of its consenting to similar favours for the others. Olson also notes that such an exchange of deals is likely to be inefficient, however fair, since the resulting intervention will usually be of the kind which protects their beneficiaries from market forces. The reasons for this are fully explained in

Olson's later work, "The Rise and Decline of Nations". Here Olson refers to pressure groups as 'distributional coalitions' since they nearly always find that they can benefit more by redistributing the national product towards themselves through anti-competitive arrangements than by increasing the size of the national product by adopting efficient practices. Olson's analysis thus supports not only public choice conclusion that modern democracy causes government to grow, but also Samuel Brittan's generalisation that democratic intervention tend to inhibit competition and so reduce economic growth. Samuel Brittan has written of 'the economic contradictions of democracy', brought about by 'the generation of excessive expectations' and 'the disruptive effects of the pursuit of group self-interest in the market place, which threaten to destroy liberal democracy itself.

F.A. Hayek now regards interest groups as the central force driving democracy down the 'road to serfdom': 'Democratic government, if nominally omnipotent, becomes as a result of unlimited powers exceedingly weak, the playball of all the separate interests it has to satisfy to secure majority support.

Most recently, Milton and Rose Friedman have written of the 'iron triangle' of three classes of mutually supporting interest groups, namely, legislators,

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bureaucrats and beneficiaries, impose a ‘tyranny of the status quo’ which prevents governments from implementing tax and expenditure cuts.75

The survey of explanation about government growth in this chapter is by no means complete, but it does provide an overview of the types of approaches that have been adopted by various investigators.