CHAPTER II

PUBLIC EXPENDITURE AND ECONOMIC DEVELOPMENT
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"But look, 'the Rabbi's wife remonstrated, 'when one party to the dispute presented their case to you said""you are quite right" and then when the other party presented their case of you again said "you are quite right," surely they can not both be right? 'To which the Rabbi answered, 'My dear, you are quite right!'

--- LERNER

2.1 INTRODUCTION

From the review of literature undertaken in the preceding chapter, it is clear that there has been a secular growth in public expenditure almost everywhere over time. The outbreak of war, the control of depression and in normal times the provision of social goods of varying magnitude have been responsible for the growth in public expenditure. In the second half of the 20th century, due to political emancipation of most of the colonies of western powers, there is a growing realization for accelerating the pace of economic development in the Third World. Government expenditure is increasingly

\[ \sum_{i=1}^{n} \frac{1}{x_i} \]
interlinked with programmes of development planning. The classical theory of public finance which advocated balanced budgets and minimum of government expenditure is not tenable in the context of less developed countries. Keynesian theory of public spending, which was designed to suit the short-run situation of depression is modified and elaborated to meet the long-run context of development planning. Public spending has become more prominent than public revenue and sometimes has become the target of criticism. In this chapter, it is proposed to analyse the role of public expenditure in the allocation of goods and services, elimination of externalities, promotion of economic development and redistribution of income and wealth. This analysis is essentially theoretical whereas the empirical aspects of public expenditure are examined in the next chapter.

2.2 GOVERNMENT AS PROVIDER OF PUBLIC GOODS AND ELIMINATOR OF EXTERNALITIES

The traditional explanation for why governments exist is that they exist to provide public goods and to eliminate or alleviate externalities. Let us assume that this is the only function governments perform. Each citizen can then be postulated to have a demand for
the public goods, which is a function of the individual's income, the relative price of public to private goods, and perhaps other taste variables. If it is assumed that voting takes place using majority rule, that citizens vote directly on the government expenditure issue, and that the only issue to be decided is the level of government expenditure, then one can apply Black's median voter theorem and write government expenditure as a function of the characteristics of the median voter.\(^1\) Baumol\(^2\) has argued that we might expect a relative increase in


the price of government - provided "goods" given that many of them (education, police protection) are services. Because productivity increases come largely from technological change and this in turn is typically embodied in capital equipment, there is less potential for productivity advances in service sectors such as the government.

Although the argument has intuitive plausibility, it is not clear how far it can be pushed. Military services are quite capital-intensive today and spend vast sums on productivity enhancing research and development. Similarly, computers, xerography, and other innovations have brought productivity increases in many white collar jobs. Thus it is not apparent a priori that productivity increases in government could not keep pace with those in the private sector. But it appears that they have not. A fair consensus exists among studies of government productivity which suggest that government productivity lags private sector productivity and may in fact be zero or negative. 3.

3.c) Ross, John, P., and Jesse Burkhead, Productivity in the Local Government Sector, Massachusetts: Lexington Books, Lexington, 1974, Chapter VI.
As Buchanan has noted, lagging productivity in the government sector may be more symptomatic of the "problem" of government growth than the cause of it.

If Pommerehne and Schneider's results are assumed to confirm the existence of a Baumol effect, how much of the growth in government does that effect explain? Some parts of the government budget (for example, pure transfers, interest payments) are difficult to think of as "goods" whose price rises relative to private goods. The budget component for which Baumol's effect seems most appropriate is perhaps what the OECD characterizes as "final consumption" that is, the goods and services actually absorbed by government.

2.3 PUBLIC CHOICE AND EXTERNALITIES

Of all the economic problems requiring government action, some of the most serious arise when market generates externalities. It is here that the need for sound decisions and mechanisms for public choice and its legislature's ability to avoid short time horizons and interest-group politics is felt acutely. "An externality or spillover effect occurs when production or consumption


5. It is interesting to note that Pommerehne and Scheider estimated the Baumol effect for the OECD countries with the smallest growth in government since World War II.
inflicts involuntary costs or benefits on others; that is, costs or benefits are imposed on others yet are not paid for by those who impose them or receive them. More precisely, an externality is an effect of one economic agent's behaviour on another's well-being, where that effect is not reflected in dollar or market transactions. Public goods are ones whose benefits are indivisibly spread among the entire community, whether or not individuals desire to purchase the public good. One major example of market failure that may require collective actions is external effects. The most extreme example of an externality arises for public goods, like defence, where all consumers in a group share equally in the consumption and cannot be excluded. Less extreme examples like public health, inventions, parks and dams also show public good properties.

2.4 THE ECONOMIC ROLE OF GOVERNMENT

In a market economy, most economic decisions flow through markets, which are arrangements by which buyers and sellers set quantities and prices for commodities. Adam Smith proclaimed that the invisible hand of markets

would lead to the optimal economic outcome as individuals pursue their own self-interest. Although the market mechanism is an admirable way of producing and allocating goods, sometimes market failures lead to deficiencies in the economic outcomes. To correct these failures, the government may step into ensure efficiency, equity, and stability. The market fails to provide an efficient allocation of goods when there are imperfections of competition or externalities. Imperfect competition, such as monopoly, often leads to regulation or even government ownership of production.

Romar and Rosenthal have developed and tested a model in which bureaucrats can force voters to choose a higher level of government expenditures than the level voters most prefer under the particular set of institutional rules in which the choice is made. Consider Figure 2.1, let $U^1$, $U^2$ and $U^3$ be indifference curves for the median voter in a community defined over units of private goods $X$ consumed by the voter and publicly provided $G$. Let $B$, $B^1$ be the budget constraint line.

7. Ibid.


facing the voter. Given his or her tax share of the costs of providing G, the median voter's most preferred quantity of G given his tax share and budget constraint \( B \) \( \geq B^1 \) then is \( G_o \). If the quantity of G for the community were determined by majority rule with all levels of G as possible outcomes, \( G_o \) would be the chosen level of the public good for the community.

2.5 COMPLEMENTARY THEORY OF PUBLIC EXPENDITURE

Optimum allocation of scarce resources is central to the study of economics. In traditional economic theory market mechanism, through the interaction of the forces of supply and demand, was assigned the role for the achievement of optimum allocation of resources. According to Adam Smith, the invisible hand brings about a natural identity of interests between those of the individual and the society. The resource allocation through budgetary process was assigned only a subsidiary and complementary role to allocation through the market. Again to quote Adam Smith "the duty of erecting and maintaining certain public institutions which can never be for the interest of any individual

10. Adam Smith, Wealth of Nations, Book IV, Chapter II.
Diagram 7.1
ENVIRONMENT SIZE IN A RURFAUCRAT DETERMINED BUDGET MODEL
to erect and maintain because the profit could never repay the expense, .... though it may frequently do much more than repay it to a great society."  

This theory of complementarity of public expenditure to the market-determined allocation has an unbroken tradition running through Bentham, Ricardo, McCulloch, J.S. Mill down to Pigou. But, over the last two or three decades this theory has been abandoned when it was increasingly recognised that public expenditure has an independent role to play in shaping the national economy. This was largely the result of the after effects of the first World War and hardships experienced during the great depression of 1930s. Further, it was also recognised that the massive dose of investment required for the development of less developed economies could be purposefully administered only through a planned scheme of public expenditure. Another major influence was of the 'Keynesian Revolution' in economic thinking. The public expenditure policy as recommended by Keynes provided a practical solution to the problem of great depression. To quote Mathew 'Keynesian Revolution' in economic thinking invasted this changing attitude towards

11. Ibid., Book IV, Chapter IX.
the traditional theory of public expenditure, with an intellectual respectability and a scientific status\textsuperscript{13}

The allocation objective of public expenditure takes care of the level and distribution of investment and provision of collective wants. Of these three, it is the level and distribution of investment that is most important for public investment has its impact on other fields of public policy such as employment, stability and growth.

As regards the provision of 'collective wants', allocation through public expenditure is essential, because these commodities have specific characteristics like indivisibility, impossibility of the application of 'exclusion principle'. The most obvious example of a collective good is national security. Musgrave's analysis deals with a second category of public wants i.e., 'merit wants' which according to him are on the border line of collective wants and private wants. They are 'considered so meritorious that their satisfaction is provided for through the public budget, over and above what is provided for through the market and paid for by private buyers'\textsuperscript{14}. Education and health services can be


taken as examples of merit wants. Later we examine these services in greater detail in chapter V.

In less developed countries, the challenge to policymakers is to exploit the complimentarities between State and market. Strategies in which governments support rather than supplant competitive markets offer the best hope for meeting the challenge of development.

2.6 PUBLIC EXPENDITURE - KEYNESIAN AND POST-KEYNESIAN MODELS

One of the fundamental and most important propositions of the Keynesian analysis revolves round the role of investment and saving in the economy. In the classical and neo-classical setting, it is the volume of savings that governs the investment and the level of economic activity through the interest rate mechanism. In the Keynesian system savings would, by definition, be equal to investment, investment determining the volume of savings. Changes in investment bring about corresponding changes in savings through an increase in income.

Investment, together with consumption determines the level of aggregate output and employment and also savings. Thus investment claims a position of a dominant and determining variable.

The classical theory regarding the balanced budget as neutral in its effects assumed a static model of the economy and, as a result, it is not tenable in the context of an expanding economy. Besides, it has been effectively and successfully maintained by Keynes and the protagonists of functional finance such as A.P. Lerner, that an unbalanced budget would be a necessary instrument for counteracting the tendency of a market economy to remain stable at a level of under-employment equilibrium. Thus the classical model in the context of which budgetary policy was to operate was found to be unrealistic and the potentialities of fiscal policy as an instrument of stabilization were explored by Keynes and the school of functional finance. This meant that an unbalanced budget is quite compatible with equilibrium, and that a balanced budget was no guarantee for full employment equilibrium.


The policy of a balanced budget has no special sanctity for an underdeveloped country. Apart from using a policy of unbalanced budget for countercyclical objectives, the underdeveloped country may adopt it in the context of development planning in order to make up for the shortage of investible resources. Besides a policy of surplus budget on revenue account may be adopted in order to augment the volume of public savings which may be used for financing the programme of investment in the capital budget. Thus budgetary policy has to be used in an underdeveloped country as a positive and dynamic tool of economic development. Through it the underdeveloped country would seek to raise the level of investment at a rate higher than what would result due to the free working of the market mechanism, and it also becomes an instrument of raising the volume of savings in the economy.

The process of economic development of any country is a highly complex phenomenon. It is profoundly influenced by political, social and cultural factors. Therefore, economic analysis can provide only partial explanation of this process. The supply of natural resources,

the state of development of social, political and economic institutions, cultural patterns, social values and attitudes of the population and the growth of scientific and technological knowledge have a strong bearing on the process of growth of an economy.\textsuperscript{20}

\textbf{20. Economic Development has much to do with Human Endowments, social Attitude, Political Conditions and Historical Accidents. Capital is a Necessary but not a Sufficient Condition of Progress, Ragnar Nurkse, Problems of Capital Formation in Under-Developed Countries, Oxford: Basil Blackwell, 1953, p.1. Output is taken as determined by the scale and productivity of working force and of capital. The economic decisions which determine the rate of growth and productivity of working force and of capital should not be regarded as governed by strictly economic motives of human beings, W.W. Rostow, The Process of Growth, 1952, p.12.}

A study of the dynamics of economic growth leads beyond the analysis of economic factors to a study of psychological and sociological determinants of these factors, Nicholas Kaldor, An Expenditure Tax, 1955, p.180. The growth of output per head depends on the one hand on the natural resources available and on the other hand on human behaviour. The enquiry into human actions has to be conducted at different levels because there are proximate causes of growth as well as causes of these causes. The proximate causes are primarily three:

a) The effort to economize either by reducing the cost of any given input of effort or of other resources. This effort to economize shows itself in various ways in experimentation or risk-taking, in mobility, occupational or geographical and in specialization.

b) The increase of knowledge and in specialization.

c) Increasing the amount of capital or other resources per head, W.A. Lewis, Op.Cit., p.11.

Thus it is not possible to quantify all the significant variables which determine the process of economic growth of an economy. This is why the treatment of the theory of economic growth "falls into two rather sharply differentiated parts: general treatise and highly symbolic models, with a wide gap between. Neither approach taken by itself is satisfying. The former is usually deficient in analysis, and the latter is too narrow and deceptively exact." 21.

Those who have adopted the latter approach have singled out three most important and quantifiable macro-variables in determining the process of economic growth such as, (a) the proportion of a community's income devoted to saving and capital formation, i.e., the behaviour of the coefficient of investment; and (b) the rate of growth of population vis-a-vis the rate of growth of output.

The effect of saving and capital formation on the rate of growth is a function of two ratios, (a) the ratio of capital formation to the aggregate national income,

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21. Such countries have also been referred to as development countries (in preference to underdeveloped or developing) in order to emphasise that they are undergoing a particular process, watched and fostered by the U.N. and other International agencies, as well as by the advanced countries, Hicks, U.K., Development Finance, Clarendon Press, Oxford, 1965.
i.e., the behaviour of the coefficient of investment, and (b) the capital-output ratio i.e., the coefficient of the productivity of capital. If a community devotes a major portion of its output to the purpose of satisfying its current demand for consumption it will have a small surplus left for the purpose of capital formation.

The capital-output ratio determines the rate at which real output grows as a result of a certain input of capital. A lower capital-output ratio tends to lead to a comparatively higher rate of growth of output as a result of a certain volume of input of capital as compared to a higher capital-output ratio\textsuperscript{22}.

In an economy where the growth of output exceeds the rate of growth of population by a substantial margin, there would be a larger surplus available for accelerating the rate of investment as compared to one where the rate of growth of output exceeds the rate of growth of population by a smaller margin. Thus the crux of the problem of economic development in underdeveloped countries lies in a significant expansion in the rate of its capital investment, so that it attains a rate of growth of output which exceeds the rate of growth of its

\textsuperscript{22} Krishnamurthy, K., and Sharma, P.D., Capital Output Ratios and Efficiency in India, Financial Express, Bangalore, Thursday, March 1, 1990, p.5.
population by a significant margin because, only then
it will begin to improve its standard of living. As the
U.N. report has very picturesquely put it, "A rocket
or moonship must attain a definitely established 'speed
or release' before it can escape from the earth's gravita-
tional field and become a free-moving astronomical
object."\(^{23}\)

The growth model constructed by Dr. H.W. Singer which
may be regarded as a representative model in this regard
has taken these strategic factors into account. Singer's
growth equation is as follows:\(^ {24} \)

\[
D = Sp - r,
\]

where \( D \) is the rate of economic deve-
lopment, \( S \) is the rate of net savings, \( p \) is the produc-
tivity of new investment per unit of capital and \( r \) is the
rate of annual increase of population. Such a growth

\(^{23}\) a) Methods of Financing Economic Development in Under-
developed Countries, U.N., 1949, p.60.
\(^{b}\) Schultz, Theodore W., Investment in Human Capital,
\(^{24}\) Singer H.W., The Mechanics of Economic Development,
The Indian Economic Review, August 1952, pp.15-16.
\(^{25}\) The cumulative process of economic development in
underdeveloped countries has also been visualized in
terms of the compound interest as follows:

\( a \) is the annual rate of new investment as a propor-
tion of net national income, \( B \) is the addition to net
production generated on average per unit of net new
investment. Thus the rate of increase of national
income is \( a B \). If \( n \) is the net national income per
head, and \( P \) the rate of increase of population,
\( n = a B - P \). If the coefficients of \( a \), \( B \) and \( P \) remain
reasonably constant, per capita net national income
would increase in accordance with the role of compound
interest \( n = n_0 (1 + a B - P) t \) after \( t \) years. P.C. Maha-
lanobis, National Income, Investment and National
Development, 1952.
model has the advantage of bringing together some of
the important variables which are of great significance
in the determination of the rate of economic development
of underdeveloped countries.

In a full employment economy, the output would
not grow faster than the rate of growth of labour supply.
For an economy to reach full employment equilibrium
stability conditions have to be maintained. Therefore,
in an economy with full employment and in steady growth,
g = gw = gn. There is a lot of literature on this
model. Therefore we need not elaborate it in the pre-
sent context.

The application of Harrod - Domar type models to
underdeveloped countries\(^\text{27}\) has resulted in the growth
of inequality and poverty and therefore several struc-
tural approaches/models are being evolved\(^\text{28}\). Employment
oriented and basic needs oriented strategies have been

\(^{26}\) a) Harrod, R.F., Towards a Dynamic Economics, Mac-
b) Harrod, R.F., Second Essay in Dynamic Theory,
c) Domar, Evsey, Essays in the Theory of Economic
d) Diana Hunt, Economic Theories of Development: An
Analysis of Competing Paradigms, Harvester Wheat-
p.139.
evolved by the I.L.O to take care of the emerging problems of growing unemployment and poverty in the Third World.

When the planning process was initiated in India, there was a legacy of pre-independence debate on India's development problems. This debate centred around the Gandhian approach, at one pole, and the 'modernizing' approach of Nehru at the other. The Gandhian approach has always talked about the voluntary limitation of wants, the need for having self-reproducing village communities, and about issues bearing on a better balance between man and nature. Gandhi and his disciples looked more like moralizing old men than like people who could be expected to change the direction of society. Thus the modernizing school under Nehru won the day as their 'Scientism'.

Acute deficiency of material capital, low capacity to save conversion of savings into productive investment, the possibilities of increasing returns to scale in industry, the possibilities of excessive consumption by the upper income groups under the regime of market

mechanism tolering towards income inequality provided it was not excessive and could be seen to result in a higher rate of growth than would be possible otherwise were the structural constraints underlying India's development strategy. If India is to achieve a rate of growth of around 5 per cent per annum, along with single digit inflation and some alleviation of poverty, methods must be found to broaden the tax base, to use existing capital and labour resources more efficiently, and to provide adequate outlays on certain forms of public consumption such as health, education, and nutrition, while also ensuring more equal access on the part of deprived sections of the community.

The decisive role of saving and investment in the initial stages of development when labour supply will not be a bottleneck is stressed by India's Planning Commission. In India's Second Five Year Plan an attempt was made to work out the perspective part of the economic magnitudes that affect the growth in the long run, based on Mahalanobis Plan frame. The basic philosophy of

the Second Plan was to give a 'big push' to the economy so that it enters the take-off stage. It gave high priority to heavy industries sector and stressed that the key to rapid economic development lay in the growth of heavy industries. Mahalanobis took the capital-labour and output-capital ratios as mutually independent structural parameters technologically given and assumes them to be unchanged during the plan period. This assumption seems to be unrealistic especially when capital-labour ratio cannot be independent of output-capital ratio. Further even the capital-output ratio assumed in the plan period proved to be optimistic, whereas the Mahalanobis model assumed a capital-output ratio of 2:1 in actual terms it turned out to be unfavourable and touched a high figure of 3.86:1. This was the result of an allocation pattern which underplayed relative importance of labour-intensive sectors of the economy and laid greater emphasis on capital-intensive projects with long gestation period. The chief merit of the Mahalanobis plan frame was to recognise the role the state could play in the development of science and technology


through specialised research institutions as well as public enterprises in strategically important sectors of the economy.

Mahalanobis and his colleagues, notably Pant, had maintained that material balances for all the key commodities constituted the chief operating document in any plan. While there was always a powerful group within the government which did not agree with this view, especially within the Finance Ministry and to a much smaller extent within the Planning Commission, they had a rather simple quantity - theoretic view of price level dynamics. But the experience of inflation in the mid-sixties, coupled with the government's reluctance to step up investment lest it trigger off inflationary price expectations (in spite of the existence of significant excess capacity in the equipment goods sector), brought home the lesson that the problem of how best to finance a plan required very careful attention\(^{34}\).

Sukhamoy Chakravarty attributes the failure of the Mahalanobis strategy to the lack of comprehension on the part of the planners regarding the full set of

logical implications of the accelerated growth in the context of a mixed economy "This showed that the process of industrialisation had ignored certain important issues relating to the phasing of investment outlay. But probably more importantly, the inability to carry out effective land reform in the early fifties when conditions has been reasonably opportune, along with the maintenance of largely unchanged input base of traditional agriculture, meant that the agrarian transition was left largely incomplete".\textsuperscript{35}

2.7 COMPOSITION OF INDIAN SAVINGS

Aggregate savings are primarily drawn from three sources, namely, public sector, private corporate sector and the household sector. Examining the sectoral composition of savings, one finds that about two-thirds to three-fourths of the savings in the economy come from the household sector.\textsuperscript{36} This proportion has remained more or less stable throughout the planning era.

The recent trend seems to be to save in financial rather than physical assets and therefore, any further increase of savings in the economy has to come either from the private corporate sector or from the public

\textsuperscript{35} \textit{Ibid.}, p.8.

sector. In such a situation, the negative contribution of the public sector to the net domestic savings rate (which is especially prominent in the new series) must be viewed seriously and efforts should be made to correct this trend.\textsuperscript{37}

2.8 GOVERNMENT AS REDISTRIBUTOR OF INCOME AND WEALTH

The government giveth it taketh away.\textsuperscript{38} Several writers have criticized the view that government exists to provide public goods and alleviate externalities arguing that this is essentially a normative description of government a theory of what government ought to do is not a description of what it actually does. These writers argue that a positive theory of government must analyse the redistributive nature of government activity. Aranson and Ordershock\textsuperscript{39} pressed the point most forcefully, emphasizing that all government expenditures have a redistributive component. Meltzer and Richard\textsuperscript{40} have presented perhaps the simplest and yet most elegant

\textsuperscript{b) Ramachandran, K.S., More on the Savings Rate, Financial Express, June 9th, 1990, p.5.}
public choice analysis of the growth of government. Their model presumes that all government activity consists in redistribution.

Peltzman has also presented an explanation for the growth of government that depends on the shape of the redistribution of income. Peltzman did not, however, make use of the median voter theorem in developing his argument. Rather, he envisaged a form of representative government in which candidates compete for votes or groups of voters that agree to join the candidate's coalition of supporters. Peltzman reasoned that the more equal was the distribution of income among the potential supporters of candidate, the more bargaining strength they would have. Thus the candidate must promise a greater amount of redistribution the more equal is the initial distribution of income among voters. Peltzman pointed to the spread of education as an important factor increasing the equality of pre-transfer incomes and thus leading to a growth in the size of government.

The multi-dimensional character of government redistribution makes it difficult to rationalize all

government activity as purely redistributionally motivated. If all government programmes simply take from one group and give to another, and if all citizens participate at both ends of the redistributional process, who gains from the process? If some, not insignificant proportion of government activity is not purely redistributional, but say is to provide public goods. Then one again has a logical problem in explaining government growth as a result of redistributional struggles. Some additional elements are needed to complete the story. Two villains often mentioned as instrumental in the growth of government are interest groups and bureaucrats.

2.9 INTEREST GROUPS AND THE GROWTH OF GOVERNMENT

The pioneering public choice analyses of the question of government size might be regarded as Tullock's classical discussion of majority rule. Becker has developed a model of the influence of interest groups (or, as he calls them, pressure groups) that is relevant to the issue at hand. At first glance it appears that Becker is analysing the purely

redistributive gains of interest groups. Becker's paper gives insight into how interest group activity and government activity might be linked. It also demonstrates that the expenditures and taxes that interest groups bring about have more than merely redistributive characteristics. Groups whose interests have public good or externality attributes are more likely to be successful than those seeking pure redistribution. Groups whose productive activities have negative externalities are more likely to be taxed.

The stable economic and political environment in Western developed countries since World War II will have facilitated the growth in interest groups, according to Olson's thesis, and this growth in turn may help to explain the relatively poor macroeconomic performance of some countries in the 1970s and 1980s. Government growth and macroeconomic inefficiency would in turn, be tied together, unfortunately, however, the possible interrelationships of interest groups, government growth and macroeconomic performance remain largely unexplored.


Both Niskanen's 46 model and that of Romer and Rosenthal models explain why government might be larger than the legislature would prefer if it knew that unit costs of the outputs it thought it was buying, and why the level of outputs might be larger than the median voters most preferred quantity. The existence of the problem reinforces the importance of those studies that try to explain levels of government expenditure by using cross sectional data, even though these studies typically do rely on static rather than dynamic models of government size.

2.10 INVESTMENT CRITERIA AND ECONOMIC GROWTH

Several investment criteria for public investment expenditure have been propounded in the economic literature. The significant among them are minimizing the capital-output ratio, social cost-benefit analysis, social cost of investment, social rate of discount, social marginal product criterion, marginal percapita reinvestment quotient criterion, marginal growth contribution criterion, labour-absorption criterion, balance of payments considerations and social welfare function 47. It is not possible to choose any one of

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them as having universal validity for application under all circumstances for the relevance of each one of them depends on the specific social objectives to be achieved, the nature and degree of constraints involved and the time horizon over which the investment plan has been made for a given economy. In the context of the emergence of fiscal deficits in most developing countries during the 1980s investment criteria has become more crucial in securing fiscal adjustment.\(^{48}\)

2.11 STATE AND LOCAL GOVERNMENT AND DEVELOPMENT

State and local governments play an important role in providing public services. Decentralizing both spending and revenue authority can improve the allocation of resources in the public sector by linking the costs and benefits of local public services more closely. To the extent possible, sub-national government should charge for services, but, where such charges are not feasible or desirable, spending must be financed from local general revenue, loans or grants from higher levels of government.\(^{49}\) Many developing countries are actively exploring ways to increase local fiscal autonomy to improve public sector efficiency and reduce total government deficits.


\(^{49}\) Ibid., p.154.
State and local governments usually provide a range of public services that contribute substantially to raising living standards and growth. These include basic health and education; street lighting and cleaning, water, sewerage, and power; public markets and refuse collection, major transport networks; and land development for business and residential purposes. Sub-national government must decide how much to spend for these public services and how to finance them. Ideally each sub-national government provides both the level and mix of public services and the means of financing these services that most closely meet the preferences of individuals in its jurisdiction. In this way decentralization promotes efficiency by allowing a close match between public services and the multiplicity of individual preferences, and it promotes accountability and equity by clearly linking the benefits of services with their costs. This is the rationale for establishing State and local governments that are responsive to the wishes of their citizens and not simply the instruments of Central government.  

50. Ibid., p.157.
Hicks stresses these words efficient, democratic and local, because they seem to contain the kernel of the whole matter: local because the system of government must be close to the common people and their problems; efficient because it must be capable of managing the local services in a way which will help to raise the standard of living; and democratic because it must not only find a place for the growing class of educated men, but at the same time command the respect and support of the mass of the people.

2.12 THEORY OF LOCAL FINANCE: Tiebout model

The decentralization theorem establishes a presumption in favour of a system of local choice. But do local units actually provide the goods and services was best explained by Charles Tiebout. Tiebout pointed out that, although an efficient amount of a pure national public good can be defined, we cannot count an ordinary market transactions to produce it. People will not voluntarily reveal their true preferences for such goods. Generally, therefore, we rely on a political, i.e., voting process to decide on the amount of the public good to be made available to the sharing group. All people may gain from voluntary transactions.

in the markets for private goods. Under a political process and uniform consumption, however, we always expect some people disappointed.

Tiebout's main point was to suggest that, although for national public goods we must accept the solutions of the political process, for local public goods there is a market-type mechanism working to achieve greater efficiency. The supply of local public goods, like that of national public goods, is determined by a political process. But the unsatisfied citizen voter has an option concerning local services that is not readily available for national public services. People who are not pleased with the menu of goods and services being provided by their town can improve their welfare position by moving to a locality offering a mix of goods and services more in harmony with their preferences. That is people can vote with their feet.

A central theme of this literature is the efficiency enhancing properties of the Tiebout solution. In the 'Pure' case, it is a straightforward matter to show

55. The option of moving to achieve an improved welfare position is available for national public goods as well as local public goods. However, international migration for purely fiscal purposes is not likely to take place very often.

that a system, in which mobile consumers 'shop' among a large group of local jurisdictions that offer a sufficiently diverse set of local public goods at a 'tax-price' equal to marginal cost, will generate a Pareto-efficient outcome. The result is, in fact, a close analogue to the private-market solution, for as Charles Tiebout pointed out, "spatial mobility provides the local public goods counterpart to the private markets shopping trip.... just as the consumer may be visualized as walking to a private-market place to buy his goods, the prices of which are set, we place him in the position of walking to a community services are set"57.

Not all public goods should be provided by the central government. State and local governments are needed to assure an efficient and equitable allocation and distribution of resources. They will provide a variety of public services and, as Charles Tiebout hypothesized, there will be a tendency for people to gravitate to those communities offering a preferred mix of public goods and tax structure.

However, mobility and migration can also result in crowding and congestion unlike their membership, State and local governments cannot reject or expect citizens to achieve a desirable use of public utilities.