developed as the doctrine of excess burden and the superiority of direct taxes over indirect taxes became the accepted theory. It was left to I.M.D. Little who, in 1951, showed that no theoretical case can be built up against indirect taxation on the basis of excess burden. In 1971, the question of optimal taxation, raised initially by A.C. Pigon in 1928 and dealt with by Ramsey, was resumed and expanded by Diamond and Mirrlees. "Optimal taxation then became the centre of tax theoretical work in the 1970s."[16] Optimal taxation theory deals with normative question of designing a tax system if it is to yield efficient and fair outcomes as different from positive questions of analysing how taxes affect the distribution of income and economic efficiency.

1.2.4. Shifting and Incidence of Taxes

Economists have been aware for long that the *de jure,* that is, legal tax-payer (the point at which a tax is levied at the first instance) may not be the person who finally bears its burden (the *de facto,* that is, actual taxpayer). The process of tax shifting is being discussed since the time of the physiocrats. The development of the theory of shifting and incidence of a tax is closely related to developments in economic theory, particularly, value and distribution theories.

The heart of the incidence theory is to be found in Ricardo's works. But Ricardo was influenced by Adam Smith. Physiocrats wrote in the background of agriculture. So they analysed the distribution of national income between two factors only, namely, landlord and labour. The background of classical authors was the industrial economy. Hence they included capital as well and analysed the distribution of national income among three factors, namely, land, labour and capital.

Adam Smith first presents his maxims of taxation and then offers a detailed discussion of the major taxes, including their incidence. He begins with a tax on the rent of land. If it is imposed directly on the landlord, it will be absorbed in the rent of land. A direct tax on wages cannot be borne by the worker. Wages are set by the cost of subsistence which cannot fall below this level. A tax on wages of agricultural labourers is shifted by the farmers as their employers to the landlords through reduced rent. He then takes up the case of industrial workers. Manufacturers add the tax to price. What happens in the next round depends on whether the taxed labourers are engaged in the production of luxury goods or necessities. In the former case, the tax falls on the consumers who get subsistence wage. Hence, they (consumers) cannot absorb the tax. Wages rise and the tax is shifted backward to the landlord in the form of reduced rent. Thus, wages and necessities should not be taxed.

Smith examines the case of a tax on profit as well. He divided profits into dividend paid on risk of employing capital and interest paid as owners of capital. Entrepreneurs get subsistence wage. Hence the former cannot be taxed. Interest is like rent and so can absorb tax.

Ricardo notes at the very outset that all taxes are either paid from income or from capital. If a tax is paid by reducing private consumption, there is no adverse effect on capital formation. But if it is paid by curtailing capital, result is distress and ruin, i.e., decline in the national product. From such general propositions, he concluded that a tax on wages is shifted while one on profit is absorbed by it; it cannot be shifted.

The marginal revolution of the 1870s had profound impact on incidence analysis. It was Fleming Jenkin who, in 1871, first used the demand and supply curves in incidence analysis in partial equilibrium context. In 1874 Walras carried it in the general equilibrium setting. In 1896 Wicksell utilised the shifting and incidence analysis to examine how taxation affects income distribution among different classes. In 1890, the theme of Marshallian analysis of incidence was to examine what light it could shed on value theory.

The above discussion of incidence was done in the context of perfect competition. The theory of imperfect competition developed in the 1930s. This development influenced the incidence analysis too. There are three milestones of modern incidence analysis, namely, the development

in the field of excise tax theory by Rolph, Musgrave's theory of incidence and Harberger's analysis of a general model of the incidence of corporation tax.

1.2.5. Macroeconomic Aspect of Fiscal Policy

Before the publication of Keynes' *General Theory of Employment, Interest and Money,* writers on Public Finance generally dealt with the effects of government budgets on the allocation of resources and the distribution of income on the assumption of a full-employment economy. In other words, the situation that prevailed in the pre-General Theory period was largely the one in which government expenditure was looked upon as a means of financing government activities, while these activities were evaluated in terms of direct benefits from them. Taxes were solely a means of financing government expenditures. Budgets must be annually balanced. The main issues of traditional public finance were the welfare implications of government spending, equitable distribution of tax burden and the incidence of taxation. No regard was paid to the study of any possible effects of taxes and outlay upon the level of national income.

Impact of Keynesian Revolution

Since the Great Depression of the 1930s, it is being increasingly recognised that government expenditure and revenue programmes exert some influence upon the level of national income, in both real and monetary terms. Keynes' General Theory and Alvin Hansen's Fiscal Policy and Business Cycle had profound impact in realizing this shift. "The General Theory, in particular, made the profound contribution of reenthroning the aggregative method of analysis and struck a decisive blow at those who treated public finance in terms of disparate and independent elements."[17] The Keynesian attack also led to the destruction of one of the principles of sound finance, namely, the principle of balanced budget. Another principle of sound finance, namely, minimum government expenditure became irrelevant. Keynesian economics introduced the principle of macroeconomic effects of fiscal policy instead. It "brought into being the very change in the nomenclature through changed emphasis, that is, from Public Finance to Fiscal Policy."[18] Another impact of Keynesian economics has been its aid in bringing the field of public finance back into the mainstream of economics.

The main contribution of J.M. Keynes was his invention of a new way of looking at macroeconomics and macroeconomic policy. "Before Keynes", say Samuelson and Nordhaus, "most economists and policy makers accepted the highs and lows of business cycles as being as inevitable as the tides." (Economics, 1998, P. 374.) Because of these long-held views economists felt themselves helpless in the face of the Great Depression of the 1930s. But in his epoch-making book, *The General Theory of Employment, Interest and Money*, published in 1936, Keynes took an enormous intellectual leap. He argued that high unemployment and underutilized capacity were likely to persist in market economies which held that government should interfere as little as possible in economic affairs and economic decisions should be left to the interplay of supply and demand in the market. As against this, Keynes argued that government fiscal and monetary policies could affect output and thereby reduce unemployment and shorten the span of depression.

The recognition of the fact that government revenue and expenditure programmes have some influence upon the level of national income—net effect is likely to be expansionary—has led to the realization of the possibility of making deliberate adjustments in revenue and expenditure to forward the aims of economic policy. Fiscal Policy is a name given to such adjustments. With the Keynesian revolution, aggregate demand turns out to be a major factor which determines the level of employment. This development resulted in fiscal policy assuming a new and strategic role. It is known as the stabilisation function of fiscal policy which, in due course, moved into the centre of macroeconomics. This could be made possible because departure from full employment was seen no longer as a temporary aberration but a central tendency of the economy. Full

employment became the chief objective of fiscal policy. Thus, the older objectives of minimum interference and avoidance of deficits have given place to the objective of promoting stability. In the immediate post-Keynesian period the emphasis was placed on short-period stability and then it shifted in favour of long-period stability which was in accord with the Harrod-Domar theoretical development.

Study of fiscal policy gave birth to the multiplier analysis of fiscal policy. A host of authors have examined various fiscal multipliers such as government expenditure multiplier, tax multiplier, balanced budget multiplier and so on. Deficit Financing was seen as an essential feature of stabilisation fiscal policy. Economics of public debt is the another area of the study of the rising importance of fiscal policy because one way of financing budget deficit has been public borrowing.

The use of fiscal measures for the purpose of promoting economic growth is a much more recent development. The aims of fiscal policy today are manifold, namely, a high level of employment, a reasonable degree of price stability, balance in the foreign accounts and an acceptable rate of economic growth.

It should be clear from above that the macroeconomic aspect of fiscal policy is of rather recent origin and "by fiscal policy is meant the use of public finance or expenditure, taxes, borrowing and financial administration to further our national economic objectives."[19] In this new role "Public Finance is concerned with the operation of the fisc or public treasury. Hence, to the degree that it is a science, it is the fiscal science, its policies are fiscal policies, its problems are fiscal problems." This change in emphasis in the study of public finance has been succinctly described by Groves in the following words :

"Financing government involves three basic functions : taxing, spending and debt management. In the broad sense fiscal theory, and the fiscal policy which derives from theory, deals with all the problems relating to those functions. Prior to the great depression of the 1930s, students of public finance were mainly concerned with three issues in this area : the welfare implications of the government spending, equitable distribution of the tax burden, and the incidence of taxation; these questions still constitute a substantial part of the public finance field. During the past two decades, however, the term fiscal policy has come to mean a distinct area of thought and study concerning the problems relating to full and effective utilisation of the nations' resources and the maintenance of price-level stability."[20]

It should be noted further that the methodology of traditional public finance was microeconomics. It applied marginal analysis to welfare economics precepts. In contrast, the methodology of post-Keynesian Public Finance, that is, fiscal policy, is highly aggregative. It deals with the levels of income, output, employment, investment, consumer spending, taxation and government spending from the point of view of the economy as a whole. Thus the emphasis now shifts from the role of budget policy from matters of allocation and distribution to the macroeconomic performance of the economy.

1.3. PUBLIC FINANCE IN UNDERDEVELOPED ECONOMIES

The revolutionary changes that have occurred in the field of public finance theory and policy since the Keynesian revolution have been with reference to developed countries only. No systematic and integrated theory of public finance appropriate for an underdeveloped but developing economy could be formulated. It does not mean, however, that public finance scientists have totally neglected the problems of public finance in underdeveloped countries. Many individuals and agencies studied such problems at both theoretical and administrative levels. The Fiscal Division of the Department of Economic Affairs of the UNO has undertaken both country-by-country and thematic studies. The Technical Assistance Administration and some of the specialized agencies also have studied problems of public finance of the Third World. The U.S.A. too

had despatched several fiscal missions to many poor countries. "As a result of all this work, knowledge and understanding of the fiscal practices and problems of underdeveloped countries have significantly increased since the end of World War II."[21]

Yet, it cannot be said that much advance has been made at the theoretical level. An integrated theory of public finance suited to underdeveloped countries is still absent. Hence, it makes it difficult to evaluate the existing tax systems of these countries or to suggest modification in them. Under the impact of the Great Depression of the 1930s and World War II, macroeconomic aspect of public finance made great strides. An important role was played by the General Theory of Employment, Interest and Money in this development. "In the Asian colonies of European powers, public finances originally were conducted on more or less the same basis as in the 'metropolitan' areas. At any rate this was true of India. Apart from the use of the tariff from 1924 onwards to give protection to certain manufacturers, there was no conscious attempt to influence the economy through fiscal action."[22] In India, fiscal policy meant tariff policy. This explains why the contents of B.P. Adarkar's book entitled "*Indian Fiscal Policy*" are solely Indian tariff policy. Nationalist leaders of India were interested mainly in winning protection for domestic manufactures against British imports. Some leaders advocated and demanded many desirable forms of government expenditure.

With the revolutionization of public finance in advanced economies, economists of underdeveloped countries too began to recommend the application of Keynesian tools and prescriptions to their own economies. They argued that the objectives of fiscal policy are more or less the same in advanced and poor economies.They are economic growth, maintenance of stability, reduction of extreme inequalities in wealth and income distribution. As Heller observes, the pursuit of the aspirations of the people of poor countries involves acceptance of the following as economic objectives of tax and budgetary policy : (*i*) to make available for economic development the maximum flow of human and material resources consistent with minimum current consumption requirements; (*ii*) to maintain reasonable economic stability in the face of long-run inflationary pressure and short-run international price movements; (*iii*) to reduce, where they exist, the extreme inequalities in wealth, income and consumption standards which undermine productive efficiency, offend justice, and endanger political stability.

"These objectives are not basically different from the economic goals of allocative efficiency, economic growth, stability, and optimum income distribution which guide fiscal policy in advanced countries based on free enterprise. But similarities in goals should not, however, be permitted to conceal the vast differences in economic conditions in the cultural, legal and political environment within which economic policy must operate, and indeed, in the state of development of the art of taxation and the science of government. Failure to comprehend the nature and significance of these differences could result—in fact, in the past sometimes has resulted—in mistaken and costly transplanting of inapplicable experience to the economies of underdeveloped countries."[23]

Chelliah is of the opinion that due to these differences between developed and developing economics there is need (*i*) to pursue different policies even though the ultimate objectives may be the same, and (*ii*) the ordering of priorities among the objectives must be substantially different.[24] In advanced economics, first priority is assigned to the maintenance of stability, whereas in developing countries capital accumulation gets the topmost priority.

In most developing countries per capita income is so low that economic development cannot become cumulative without a transformation of the economy. "The task is to bring together the constellation of economic, sociological, political and technical factors that will launch a take-off."[25] Market does not provide a correct guidance for this job and traditional public finance and fiscal policy may seem useless. Still they together with the theories of economic development may provide the foundation to construct the principle of financing development. And the ordinary

public finance instruments, namely, taxation, public expenditure and public borrowing are immensely useful in most developing countries. Faster rate of growth cannot be attained without increasing participation of the government in the process of development and this, in turn, means an expansion of the public sector necessitating large public revenue. So, all developing countries were making vigorous efforts to raise the overall tax/GNP ratio.

It is to be noted further that the role of public finance increases in democratic societies where there is a dislike for direct (physical) control and regulation by the State. It is for the reason that increasing direct controls have proved to be extremely inefficient. They are also likely to pave the way to authoritarianism. "A democratic system of planning eschews direct commandeering of resources and it operates mainly through the price mechanism."[26] Thus, "in a democratic country fiscal policy is the most powerful and the least undesirable weapon of control which the state can employ to promote economic development"[27]

Yet another reason for the importance of Public Finance in underdeveloped countries was the key role assigned to capital accumulation in economic development. Capital accumulation requires raising the ratio of savings to national income. Early capitalism and modern communism could achieve this by keeping down the level of living of the people. Capitalism did it by keeping wages low and through great inequality of income. Modern communism took the path of dictatorial restriction of resources allocated to the production of consumption goods. An underdeveloped country with a democratic government could follow none of these methods. Hence, it had to depend more on public savings to raise the overall saving ratio. The best means of doing this was to raise the tax ratio. Nurkse says : "I believe that public finance assumes a new significance in the face of the problem of capital accumulation in underdeveloped countries."[28] In many underdeveloped countries individual savings were very low. Here rapid development could take place only when the state was willing and able to promote private savings as also to raise the level of public savings through taxation. Taxation played another role too besides breaking stagnation. Most developing countries suffered from inflation during the process of development. As Richard Goode says : "An underdeveloped country that is determined to avoid both stagnation and inflation will have to find ways of raising large and growing amounts of tax revenue"[29].

It will be wrong to think that developing countries are only concerned with the macroeconomic aspect of public finance. At the microeconomic level, the partial equilibrium analysis of orthodox public finance might also be of considerable importance for them. It will be rewarding to know, for instance, who bears the ultimate burden of a particular tax and what is likely to be its effect on economic behaviour. Improved expenditure of resources, as a part of the process of economic development, may be of interest to such countries.

1.4. THEORIES OF THE PUBLIC SECTOR

1.4.1. Public Sector Growth

There has been a pervasive growth of the public sector in the past half century. This growth represents a fundamental structural change which is comparable in scope with such other basic transformations as industrialisation and urbanization.

In the past hundred years, the scale of public finance has increased dramatically in advanced countries. The average share of government spending in the national income of advanced countries was about 10 per cent in 1880. In 1985 the average had reached 47 per cent. World War II is mainly responsible for this increase.

Historically the growth of public revenue has kept pace with that of government spending, but during the past two decades expenditures have tended to grow more rapidly than revenues

resulting in budget deficits. By the early 1980s, these deficits in most industrial countries had become sizable. "Many have since made efforts to cut spending. These efforts have been motivated by the inflationary pressures that fiscal deficits can generate, by the perception that private sector activity was being displaced by public intervention; and by the concern over the distortions resulting from efforts to raise more revenue."[30] Governments have not been successful in lowering the absolute level of their spending in real terms, though they have succeeded in slowing down or reversing the rising trend in relative terms.

Before 1940 the state of public finance in the developing world was similar to that of the present-day advanced countries during the 1850-1900 period. Colonial administrations and independent governments raised about 5 per cent of GNP in taxes, spent the same amount on government consumption and made only small public investments, mostly in transport (especially railways). In Table 4.2 in Chapter 4, government spending, as percentage of GDP in 1972 and 1986, has been presented for four categories of economies, namely, low income, lower middle income, upper middle income and industrial market. There is one unmistakeable trend in all countries – rise in public expenditure from 19 to 23 per cent in the case of low income countries and from 28 to 40 per cent in the case of industrial market economies.

Over the past twenty years, there has been a slowing, or even a stagnation, in the growth of government spending. Data presented for six developed economies—France, Germany , UK, USA, Japan and Australia—show that although expenditure was higher in 2002 than in 1970 for all of them, rate of increase had slowed down.[31]

41103

1.4.2. Justification for the Public Sector

In this section we discuss the justifications that have been advanced for the public sector. An attempt is also made to show how the requirements of efficiency and equity lead to the public sector. In Chapter 2 we have analysed the need for the public sector on account of the failure of the market economy to function efficiently in some areas of the economy. So public policy is needed to guide, correct and supplement it in certain respects. Here we argue that for a market economy to function in an organised fashion through exchange among producers and consumers, there must be well-defined and effectively enforced laws of contract (rules governing the conduct of trade) and rights to property (the rules defining the ownership of property). Criminal laws are also required to ensure orderly functioning of the civil society as also of the market.

Laws of contract determine the rules of exchange. These laws ensure that parties to trade receive what they expect or if they do not get, avenues are open to seek compensation through courts of law.

Property rights are required for satisfactory exchange of commodities as there may be lack of trust between the contracting parties. These rights are a first step away from anarchy prevalent in the "State of nature" where pursuit of self-interest led to a destructive "war of all against all".

In order to police and uphold these laws, there has to be a law-enforcing agency which is none but the state. There must be minimal state to provide contract law, police it and defend the economy against outsiders. In order to enforce the contract laws, rights to property and criminal laws, a source of income must be found to finance expenditure over them incurred by the state. Main source of income is tax.

These arguments provide a justification for at least a minimal state and hence the existence of a public sector.

When we move beyond the basic requirement for the public sector, we face other situations where intervention in the economy can potentially increase welfare. Since additional interventions may be required on two grounds, namely, market failure and widespread inequality of income, wealth

or opportunity. Case of market failure and need for the state are discussed in Chapter 2. Suffice it to say here that externalities and imperfect competition lead to the public sector on ground of economic efficiency where we make assessment on the basis of positive criteria.

In the case of widespread inequality in the distribution of income and wealth, government intervention is required to alleviate inequalities. This is also the reasoning for the provision of state education, social security programmes and compulsory pension schemes. These policies are supported on the basis of normative assessments of welfare, unlike the positive criterion lying behind the concept of economic efficiency.

1.4.3. Evolving Views on the Public Sector

Early writers on development of recently independent developing countries faced the challenge of accelerating the pace of economic development, while the task before the economists of Western countries was the reconstruction of the war-ravaged economy after World War II. In the face of these two important issues, these writers saw a major role for the state in the production process. It was the result of a pessimism they felt about the market's ability to create economic changes in the key sectors with the speed deemed necessary.

The growing importance of the public sector since World War II has been seen by many development economists and policy makers as a natural and even necessary ingredient of development. It is termed as the "Public Interest View" according to which governments must intervene to foster development.

Free markets either underprovide or overproduce public goods. National defence, law and order, primary education, basic health, infrastructure and research and development are underprovided because these are goods that also benefit people other than their producers or consumers. Traffic congestion, pollution, the depletion of natural resources are those goods which markets are likely to overproduce because they impose costs over and above those borne by the producers. Other factors should also be noted. Existence of monopolies, the lack of fully developed markets and gaps in the supply of information may result in inefficient resource allocation and cause savings and investment rates to be less than optimal. "Market mechanisms may thus produce insufficient growth as well as macroeconomic imbalances, such as balance of payments deficits and unemployment. According to the public interest view, these market failures need to be corrected by government—through public provision of goods and services, through public savings and investment, and through taxes, subsidies and regulations."[32]

This approach assigns to the government a special place in influencing the distribution of income and alleviating poverty. Progressive taxes and expenditure targeted to the poor are usually the means adopted to attain a more equal distribution of income. Poverty alleviation programmes are designed to provide minimum needs to the poor as also to bring them above the poverty line.

"In the developing economies the unmet backlog of physical and social infrastructure, the low levels of savings and investment, the need to foster economic growth through modernization, and the availability of concessional foreign funding for public projects explain the rapid expansion of public finance that is consistent with the public interest view. While considering the growth of government to be appropriate in general, the public interest view also recognizes that the growth in government spending is a serious problem in practice, though it is not inevitable or irreversible. Policy and administrative reforms have commonly been proposed to correct such 'government failures'."[33]

During the late 1970s and 1980s there was a growing concern about the expansion of the public sector in both advanced and developing countries. Important causes for this concern were the following :

(*i*) slow growth, (*ii*) lagging private savings and investment, (*iii*) high rates of inflation, (iv) huge balance of payments deficits, (*v*) heavy debt burden, (*vi*) continued poverty and unemployment; and so forth.

These are, in part, consequences of the excessive growth of the public sector. "The late 1970s also marked an important turning point in the centrally planned economies, where reliance on direct command by government was increasingly seen as a drag on economic growth; during the 1980s several of these countries have increased the role of markets. These concerns found an intellectual underpinning in the reemergence of what can be called the "private interest" view of the public sector."[34] This reemergence of private interest view is based on the following arguments :

(*i*) Individuals, whether in or out of government, use the resources and influence at their disposal to further their private interests, and not for any abstract notion of the public interest.

(*ii*) The pursuit of private interests leads to efficient allocation of resources in competitive markets.

(*iii*) Individuals in government such as politicians, bureaucrats and many private interest enjoy monopoly power of the government which they utilise to their own advantage.

The result is inefficient public and private provision of goods and services leading to persistent fiscal imbalances from a growing government and larger government expenditure. These imbalances have placed difficulties in implementing effective stabilization and adjustment programmes in developing countries. From this the conclusion is drawn that there is a negative correlation between economic growth and the share of government spending in GDP. This is just the opposite of public interest view that economic growth and the size of government expenditure are positively related.

According to the World Bank, a pragmatic view is one that considers the public and private interest views not as two opposing approaches but as countributing complementary perspectives to an understanding of the public sector and public finance. It stresses that the public interest view can be effectively used for providing a framework for identifying the conditions under which market failure is likely to occur and for designing appropriate policies to offset these failures. The private interest view is useful in that it shows when government intervention fails to achieve its objectives. So it cautions against an overly sanguine view of government as the impartial guardian of the public interest. The World Development Report 1988 concludes by emphasizing that pragmatic policy design can draw on the strengths of both the public interest and private interest view by :

(*i*) Considering both the benefits and costs of government involvement;

(*ii*) Asking which groups in society are likely to receive the benefits and which to bear the costs;

(*iii*) Recognizing the institutional and political constraints that are likely to be encountered in implementing a particular policy;

(*iv*) Searching for ways to ensure that the public sector operates efficiently within these constraints.

"A pragmatic approach to public analysis might begin by ranking areas of economic activity according to the extent to which government intervention is desirable. Plausible criteria for ranking would be the scope for government to promote efficiency, growth, poverty alleviation, and stabilization."[35] Accordingly, the case for government involvement is stronger in some areas than in others. And the quality of government (administrative capabilities of government) may act as an important constraint on the ability of government of a developing country to design and implement public spending and revenue programmes.