

1.5. APPROPRIATE ROLE OF THE GOVERNMENT IN THE ECONOMY

The World Development Report (1988) presented a detailed analysis of the various aspects of public finance. Since then some writers on public finance chose to examine the appropriate role of government in economic development in the light of the experiences of the emerging East Asian governments of the 1980s. In this context, an important contribution has been made by Joseph E. Stiglitz³⁶ in his key note address at the annual World Bank Conference on Development Economies in 1996. He refuted the prevailing fashionable notion that whatever the government did, the private sector could do better. He pointed out that the successes of East Asian economies simply demonstrated the effectiveness of a more market-based development strategy. These governments abandoned the rigid planning model of the early development period, but did not commit the mistake of going to the other extreme. "Their governments helped to guide and create markets, rather than completely supplanting or surrendering to them."³⁷

Stiglitz also referred to the grand socialist experiment and its dramatic failure. For the extremists of the opposite thinking, it meant almost no economic role for the government. "But", as Stiglitz maintained "the rejection of one extreme is not the affirmation of the other. The real issue that both the success of East Asia and the failure of the socialist experiment raise is; What is the appropriate role of government in economic development?"³⁸.

While discussing the appropriate role of government in economic development, that is, "the fiscal tasks of the state in a developing economy", in the words of Amresh Bagchi, Stiglitz mentions a number of areas where selective interventions in the market place are needed. One such area is externalities. State intervention is required in developing countries where information and competition are imperfect and the markets are deficient. Drawing on the experience of the USA, the rapidly growing economies of East Asia and advances in economic theory, Stiglitz is of the opinion that the government can assist economic development better by establishing infrastructure in its broadest sense, namely, educational, technological, financial, physical, environmental and social. In both the USA and the rapidly growing economies of East Asia, Stiglitz maintains, government played six important roles that have encouraged development.

These six roles are, in short, (i) promoting education (ii) producing technology, (iii) supporting the financial sector, sometimes, depicted as the brain of the economy, (iv) investing in physical infrastructure, such as roads and communication system, (v) preventing environmental degradation and (vi) creating and maintaining a social safety net including access to basic health services. Then the pressure of urbanisation also calls for greater role of the government.

Stiglitz's portrayal of the appropriate role of the government is based on two assumptions, namely, (i) incentives are important and (ii) the government plays a dynamic role: as the economy changes, so does the government. Societies that adapt better to these changes, do better in terms of raising living standards.

Stiglitz presents a pragmatic framework which entails a balancing of strength and limitation of markets and government and determines how they can best complement each other. This framework does not put economic activities in two distinct categories and label them as "activities to be carried out by the government "and" activities to be carried out by the private sector". His careful balancing puts great emphasis on how the government does what it does and how it interacts with the Private Sector.³⁹ It is in this context that he outlined a few general principles, such as incentives and change (referred to above). Amresh Bagchi comments that Stiglitz's essay sets out in a clear perspective what the government can or cannot do in promoting economic development and clears many of the doubts raised in the recent controversies about the role of the public vs the Private Sector."⁴⁰

NOTES

1. James Buchanan quoted in Alan S. Blinder, *et al.* (ed), *The Economics of Public Finance*, The Brookings Institution, 1964, p. 237.
2. J.A. Schumpeter writes, "Public Finance in our sense, and especially modern taxation, first developed in the course of the fifteenth century in the Italian city-republics, Florence in particular, and in the German free towns". *History of Economic Analysis*, George Allen and Unwin, 1955, p.200.
Further, in our sense "Public Finance is a field of inquiry that treats of the income and outgo of governments (federal, state and local). In modern times, this includes four major divisions: Public revenue, public expenditure, public debt, and certain problems of the fiscal system as a whole, such as fiscal administration and fiscal policy." Harold M. Groves, *Financing Government*, Henry Holt and Company, New York, Fifth Edition, 1958, p. 1.
"The complex of problems that centers around the revenue-expenditure process of government is referred to traditionally as Public Finance." R.A. Musgrave, *The Theory of Public Finance*, International Student Edition, p.3.
3. Amresh Bagchi (Ed), *Readings in Public Finance*, Oxford 2005, P.I.
4. Hindriks, Jean and Gareth D. Myles, *Intermediate Public Finance*, Prentice-Hall of India 2007, P.3.
5. Bagchi, Amresh *op. cit.*, P. 5.
6. R.A. Musgrave, *Public Finance in a Democratic Society*, Vol. II, Wheat-sheaf (UK), 1986, p.338.
7. *Ibid*, p.339.
8. Antonio de Viti de Macro, *First Principles of Public Finance*, Jonathan Cape, 1950, p.52, note 1.
9. R.A. Musgrave, *op. cit.*, p.343.
10. *Ibid*, p.344.
11. Knut Wicksell, "A New Principle of Just Taxation," in Musgrave and Peacock (Ed), *Classics in the Theory of Public Finance*, Macmillan, 1962, p. 72.
12. Musgrave, *op. cit.*, p. 345.
13. *Ibid*, p. 347.
14. *Ibid*, p. 348.
15. *Ibid*, p. 349.
16. *Ibid*, p. 363.
17. J.D. Sethi, "Fiscal Policy and Economic Development—A Perspective", *Indian Economic Journal*, October, 1960, p. 127.
18. *Ibid*, p. 128.
19. A.G. Buehler, "Government Finance in a Stable Economy," *The Annals*, 1949, p. 32.
20. H.M. Groves, *Financing Government*, Henry Holt and Company, New York, Fifth Edition, 1958, p. 514.
21. Raja J. Chelliah, *Fiscal Policy in Underdeveloped Countries*, George Allen and Unwin, Second Edition, 1976, p. 18.
22. *Ibid*, p. 19.
23. Walter W. Heller, "Fiscal Policies for Underdeveloped Countries", in Bird and Oldman (Ed), *Readings on Taxation in Developing Countries*, Third Edition, 1975, pp. 5-6.
24. Raja J. Chelleah, *op. cit.*, p. 20.
25. B. Higgins, *Economic Development*, p. 479.
26. *Second Five Year Plan (India)*, 1956, p. 38.
27. Raja Chelliah, *op. cit.*, p. 21.

28. Ragnar Nurkse, *Problems of Capital Formation in Underdeveloped Countries*, Oxford University Press, 1953, p. 143.
29. Quoted in S. Please, "Saving Through Taxation—Reality or Mirage?", *Finance and Development*, March 1967.
30. *Ibid*, p. 46.
31. Jean Hindriks and G.D. Myles, *op. cit.*, Chapter 3.
32. *Ibid*, p. 49.
33. *Ibid*.
34. *Ibid*.
35. *Ibid*, p. 52.
36. Joseph E. Stiglitz, The role of State in Economic Development; reprinted in Amaresh Bagchi (Ed), *Readings in Public finance*, Oxford University Press, 2005, Reading 9. All references to this paper refer to this Reading.
37. *Ibid*, p. 156.
38. *Ibid*, p. 157.
39. *Ibid*, p. 165.
40. A. Bagchi (Ed), *op.cit.*, P. 23.

QUESTIONS

1. Examine the Keynesian Theory of Public Finance and its relevance for developing countries.
2. Discuss the impact of Keynesian Revolution on public finance.
3. Examine the statement that "Public Finance shapes economic development."
4. Examine the appropriate role of public finance in economic development.
5. Briefly explain the main themes of public finance in the modern period.
6. Critically examine the modern concept of public finance. How does it differ from the classical concept ?
7. Write notes on :
 - (a) Growth of the public sector; and
 - (b) Justification for the public sector.
8. Comment on the evolving views on the public sector.
9. Discuss what should be the appropriate role of government in the economy in the light of the development of the last three decades.
10. Discuss the optimal mix of state and the market.