

BASUDEV GODABARI DEGREE COLLEGE, KESAIBAHAL



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CHAPTER

5

THEORY OF PUBLIC EXPENDITURE

INTRODUCTION

The concept of public expenditure plays a very prominent role in public finance. In the nineteenth century, the economists paid very little attention to public expenditure as there was no sound classification of the expenditure by Central Government, State Government and Local government. There were no principles for these public expenditures. Basically, the functions of the government were restricted to justice, police and arms. They were also of the confirmed belief that government expenditures are totally wasteful and money can be best utilised by the private persons rather than government in the ancient times. With the passage of time, the situation has altogether changed and economic activities have become complex which have forced the economists to pay a great attention to public expenditure. Thus, in modern times, the subject of public expenditure has earned great significance.

Public expenditure is the expenditure incurred by public authorities *i.e.* Central Government, State Government and Local bodies for the satisfaction of collective needs of the citizens or for promotion of economic and social welfare. The development functions include education, public health, social securities, irrigation, canal, drainage, roads, buildings etc. These functions of social welfare have increased public expenditure to a greater extent. In short, it has gained a significant place in the study of public finance just like the place of consumption in economics due to two major reasons :

- (i) The economic activities of the state has increased manifold ;
- (ii) Nature and volume of public expenditure has greatly affected the economic life of the country in a different manner *i.e.* it has affected production and distribution and general level of economic activities.

MEANING AND SCOPE

In simple words, public expenditure refers to the expenses incurred by the government for the maintenance of the government and to preserve the welfare of society as a whole. In other words, it refers to the expenses made by the public authorities *i.e.* State Government,

Q2 Central Government and other Local bodies to satisfy the community wants of the people which they cannot satisfy individually. It is for protecting the citizens and/or for the promotion of their economic and social welfare.

Public expenditure shows the decisions of the Parliament and other independent executive bodies for the scope of public expenses. It is measured with respect to the financial interval in the previous year or last financial interval. The public expenses made by the government in two parts as current expenditure and capital expenditure. Most governments classify it into two main reasons. The first was the belief of Adam Smith and his followers. They were of the opinion that the function of the state should be restricted to 'Justice, Police and Arms'. They thought that the government expenditure is wasteful and that money can be used much better by private persons than by government.

"Every article of expense that is incurred beyond what necessity absolutely requires for the preservation of social order and for protection against foreign attack, is a waste and an unjust and oppressive imposition upon the public." Prof. Parry

Accordingly, they advocated the policy of 'Laissez-faire'. However, Adam Smith in his famous book 'Wealth of Nations' observed that the sovereign has three main duties to perform as (a) to protect the society from violence and invasion of other independent societies, (b) to protect against injustice, (c) erecting and maintaining certain public works.

These arguments do not hold good in the present era. As we have already seen an increase in the activities of the state it is inevitable and is indeed essential in the interest of justice and efficiency. It is not universally true that the private person can use money in a better way. The state spends money in a much better way than the private persons in the performance of certain types of functions. So, public expenditure has emerged great importance in modern times for two reasons. Firstly, the economic activities of the state have increased manifold. Secondly, the nature and volume of public expenditure have important effects on production, distribution and the general level of economic activity. Therefore, it is the need of the hour that state should participate in almost every field and the government is responsible even for small matters. Prof. Musgrave advocated that public expenditure should be forced to deal with many day-to-day activities like re-allocation of resources, redistribution activities, stabilising activities and commercial activities.

SIMILARITIES BETWEEN PUBLIC AND PRIVATE EXPENDITURES

Both public authorities and the private individuals do not like to waste expenditure without expecting anything in return. It means each will try to attain maximum possible returns with the minimum possible expenditure. Any shortfall in these returns will tantamount to inefficiency, uncertainty and lack of foresight on their part. Another point of similarity between the two is that there is an element of flexibility in both types of expenditure though it is slightly more in case of public authorities. In both cases there can be more than one authorities. Public authorities though it can be more conveniently done by the public and can force the public to act according to its decision but the private individual can raise additional income through additional taxation or borrowing from the market.

THEORY OF PUBLIC EXPENDITURE

After studying the similarities between public and private expenditure that both are the part of the same coin. Rather, there are points or dis-similarities in the two which distinguish each other.

1. Public expenditure is more elastic than private expenditure. In other words, public expenditure determines the amount of income whereas private expenditure is determined by the individual's income.
2. "Private finance whether of firms or individuals, start with a given income plan contrary starts with a given expenditure must be planned; public finance on the contrary starts with a given expenditure plan and the authorities adjust their income by means of taxes and resources to match the expenditure." Mrs. Hicks

3. Public expenditure is not based on profit motive whereas private expenditure is strictly based on the motto of maximum profit.
4. State is the guardian of the social welfare, thus, public expenditure is made for social benefits like education, relief to the poor, public health etc. while private expenditure is limited to personal level.
5. State does not practise for economising during the course of spending public revenue, with an individual. Ordinarily, individual thinks many times—before incurring expenditure.
6. Public expenditure is influenced by various politically motivated and social aspects while there is no such consideration or influence on private expenditure.

AIMS OF PUBLIC EXPENDITURE

Public expenditure is not merely a financial mechanism but it also aims at securing social objectives. Traditional economists held the rigid viewpoint that the government should make least interference in the general activity. The government is the only agent to keep political organisation intact. But after the world depression of the thirties, J.M. Keynes revolutionised the economic thoughts. Keynes and onward economists have expressed that the public expenditure plays a pioneer role to achieve the definite ends.

In the present era, a democratic government has to perform many functions within its territory for the betterment of its citizens which might not otherwise be provided by the private sector.

- Prof. Dalton classified the aims and objectives of public expenditure into two parts as:
- (a) Security of human life against the external aggression and Internal disorder and Injustice;
 - (b) Promoting maximum social welfare of the community.

Therefore, its goal is maximising social and economic welfare on one side and controlling the depressionary tendency in the market economy on the other side. Public spending is also designed to optimise the level of investment to maintain full employment with growth. It also tends to accelerate the tempo of economic development by making infrastructures

REVIEW QUESTIONS

1. Give the meaning and scope of Public Expenditure. How is Public Finance different from Private Finance ?
2. Public Expenditure has a tendency to grow very fast in modern times. Briefly discuss the factors responsible for the rapid growth of Public Expenditure.
3. Describe the various canons of Public Expenditure like India ?
4. Describe the various canons of Public Expenditure like India ?
5. Explain briefly the various canons of Public Expenditure. Is Public Expenditure in India enormous increased during last hundred years in almost all countries. Give reasons for its expansion.
6. Briefly explain Wagner's Hypothesis and Peacock-Wiseman Hypothesis of Public Expenditure.
7. Explain briefly various theories of Public Expenditure.

OR
Discuss fully the various canons of Public Expenditure. Which of these do you prefer based on the canons?

8. Write a note on the aims of Public Expenditure.
9. Describe control and accountability of Public Expenditure.
10. Make a detailed case for Accountability of Public Expenditure in India.

OR
Discuss Pure and General theories of Public Expenditure.

CHAPTER**CLASSIFICATION OF PUBLIC EXPENDITURE****INTRODUCTION**

In simple words, classification of public expenditure refers to the systematic arrangement of different items of state's expenditure on some scientific and economic basis from which one is enabled to distinguish between the nature and effects of different kinds of public expenditure. From time to time, some functions are performed by the spending authority which involve expenditure and when public expenditure is classified, the functions of the state are also classified automatically.

This classification is necessary for a clear understanding of the nature and effects of various branches of public expenditure. However, in order to make it more useful and effective, the classification should not be formal. It must always have some meaningful and realistic public expenditure to reveal the effects and incidence of various kinds of expenditure and also focus on the relative importance which has been given to each head of expenditure.

Prof. Shirras emphasised that classification of public expenditure is not the aggregate expenditure, but it is the relative amount which is assigned to the several heads. Thus, the classification of public expenditure plays a pioneer role in order to know the relative importance of each head of expenditure at different times. In this reference, Lurs has rightly observed that the aim of proper method of classification should be to establish a proper relationship and balance between such different activities and the interests for the fulfilment of which the financial responsibility has been assumed by the government.

The main characteristic of any modern democratic government is that the people are kept informed of the extent and the pattern of disposal of the revenue which goes to the public exchequer. Whether this money was properly spent or misappropriated or not or it was spent on items beneficial to them; whether these funds were allocated for the good of the entire society or for the benefit of any particular section of the society—in all matters about which the public wants—the appraisal of the government from time to time. In other words, public wants to know whether the revenue is properly utilised for the common welfare of the society. Therefore, its classification must be scientific and not ambiguous.

4. U.K. Hicks, 'Public Finance'

"A good classification ... that data can be ... mutually exclusive so that the basis of classification should be a necessary attribute of the object classified. This will make it scientific and sensible."

Dr. R.H. Bhargava

The chief aim of the study of the public expenditure is to examine and evaluate the effects and efficiency of the various items and matters for which the funds have been allocated. In order to meet this aim, a proper classification and explanation of different items of public expenditure is imperative and prerequisite.

Test of a Good Classification. Real test of every good classification lies in its removal of ambiguities and making the system more understandable and scientific. It should be exact and without any overlap. In a good classification of the public expenditure there should not be any doubt or ambiguity as to which class a public expenditure is to be placed on what basis it has been placed in a particular head or class. For instance, the money spent on eradication of Dengue or polio must not be placed in "Education" but instead be placed in the Head "Health".

BASIS OF CLASSIFICATION

Different economists like C.C. Plehn, Nicholson, Adam Smith, J.S. Mill, Rosher Dalton and Findlay Shirras have given their own style of classification of public expenditure. But these classifications do not investigate the changed nature of public expenditure, instead they represent the same thing in different ways.

Following are the basis on which public expenditure can be classified

- 1. Basis of Benefit (C.C. Plehm).** On the basis of benefit, the public expenditure is classified by Cohn and Plehm into four parts as stated below:

(a) **Public Expenditure which confers special benefit to certain people.** Public expenditure is incurred to provide the benefit of police protection and justice which strengthens the security and safety to the entire community. Even then, the particular advantage of these services is given to the weaker sections of the society who actually need protection of police and justice more than others. In this way, these services affect the entire community in general and certain groups or persons in particular.

(b) **Public Expenditure which benefits equally to all.** All types of public expenditure incurred on general administration, legislatures, defence, education, transport medical etc. benefit equally to all. It does not provide any benefit to any particular person/group.

(c) **Public Expenditure which benefits people and entire community as well.** Public expenditure confers a benefit to the certain people and the entire community as a whole. For example, social security, public welfare, unemployment relief, old age pension etc. are such benefits which aim at directly helping the particular section of the society. However the indirect effect is experienced by the entire society as a whole. In other words, public expenditure incurred on these services directly benefits certain people while it indirectly benefits the whole society.

The Theory and Working of Union Finance in India

public expenditure according to the functions of government. Charles F. Bastable also supported this classification.

The classification on the basis of functions is given as under :

- (a) **Protective Expenditure.** It includes the expenditure incurred by the government on the purchase of arms and ammunitions, defence, police, administration of justice and jails etc.
- (b) **Commercial Expenditure.** It consists expenditure incurred on the commercial activities like rail, roads, highways etc., which are taken by the government in the public interest.

(c) Development Expenditure Development expenditure includes:

This classification has the merit of distinguishing one class of public expenditure from another on the basis of its effect on the welfare of the people. This theory has also the shortcoming that it is not possible to say that a certain expenditure is protective but no development, another commercial and not developmental.

3. Classification on the basis of Revenue (Nicholson). This classification of public expenditure has been developed by Prof. Nicholson. He has divided public expenditure into following three heads :
(i) Expenditure without direct return of revenue e.g. poor relief on some cases even with indirect as well as direct loss.

(ii) Expenditure without direct return, but with indirect benefit to revenue. Usually, it is assumed that educated people are better tax-payers or less expensive to the state than those of criminals.

(ii) Expenditure with full return or even profit like the post office, gas service and generally public enterprises.

Classification of Public Expenditure
There may be considerable doubt regarding the particular items to be placed in a group.

This classification is, however, one sided. The main purpose of this expenditure is to yield revenue but to confer benefits on the general public is only interested in the interest of the politicians and policy makers but the government sells a particular service or product at a price less than its cost, it becomes grants to the buyers.

4. **Mill's Classification.** J.S. Mill classified public expenditure into two classes i.e. obligatory and optional. Obligatory expenditures, according to Mill, are those expenditures which the state must incur, such as expenditure on defence and other contractual payments while optional expenditure is that which state may or not spend. They are education, agriculture and industries etc.

The term obligatory and optional can denote a distinction which a few would recognise in these days of growing sphere of state activity e.g. expenditure which once was regarded as optional may now be obligatory and necessary for the state. Even then, one can not draw a line between obligatory and optional expenditure.

This classification is not free from limitations. Thus, it is neither scientific nor does serve any practical purpose.

5. **Classification on the basis of Importance (F. Shirras).** This classification was made by Prof. Findlay Shirras who divided the public expenditure into :

- (a) Primary Expenditure ; and
- (b) Secondary Expenditure.

It is a simple classification based on the duties of the state. In the words of Prof. Shirras, "Primary expenditure includes all expenditures of government, worthy of the name of governments, are obliged above everything else to undertake viz., defence, law and order and the payment of debts. This expenditure is imperative for the existence of any state as it involves important functions of the state. All other expenditure after achieving this level would be secondary. But in modern times, there are some other functions which are equally important such as expenditure incurred on providing education and health facilities. The government worthy of that name cannot neglect the duty of educating the people. Therefore, primary and secondary are the relative terms and water-tight classification is not possible between the both."

"We agree with Prof. Shirras that a government, worthy of that name must undertake such expenditure i.e. expenditure on defence etc. But perhaps in these days education is regarded as an equally important function, we do no think that a government, worthy of that name, can neglect the duty of educating the citizens."
Prof. J.K. Mehta

However, this classification was severely criticised because the terms primary and secondary have no scientifically fixed meaning.

6. **Dalton's Classification.** Hugh Dalton has classified public expenditure on the basis of whether or not the government gets any service in return of the expenditure. He classified into two categories "grants and purchase price." Therefore, Dalton's classification, however, distinguishes from revenue return but based upon classifications given by Nicholson. He mentions two types of cases. For example, when the state spends money and gets in return some services or commodities. It is called a purchase price i.e. salaries of government

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employees and price paid for purchasing furniture etc. When the government spends money and does not get any commodity of service in return, the expenditure is known as grants i.e., relief to the poor. In this case, a purchase price includes the elements of grant if the public authority is buying at higher the price than prevailing in the market. Similarly, if the government sells a particular service or product at a price less than its cost, it becomes grants to the buyers.

Moreover, according to Prof. Dalton, interests on public debt and pensions are grants if looked at from the point of view of the past. In the same manner, pensions are deferred payment for the services rendered in the past. But Prof. Dalton considers it grants though it would be more accurate to treat them as purchase price. Dalton also distinguishes between direct and indirect grants. According to him, direct grants are those the whole benefit of which accrues to the persons to whom the grants are made (old age pension) while indirect grants are those where the whole or part of its benefit is passed on to the other persons.

The classification appears to be sound logically. The distinction is clear enough though it may not always be possible to determine how much part of any given public expenditure is in the nature of grant and how much part is in the nature of purchase price. In fact, the distinction between grants and purchase power is thin and sometimes it is even vague. As a result, it cannot be called as a sound and perfect classification of public expenditure. But still this classification is considered as the most satisfactory and in order.

7. **Rosher's Classification.** Rosher classified public expenditure into (i) necessary, (ii) useful, and (iii) superfluous. Necessary expenditure is that which the state has to incur and which cannot be postponed. Useful expenditure is that which is desirable but can be postponed. Superfluous expenditure is that which the state may or may not incur.

This division of expenditure into these general categories does not really solve the fundamental problem of public expenditure. The merits and demerits of this public expenditure are changing with the change in activities and responsibility of the state. The expenditure which once was regarded as superfluous may now be regarded as necessary and useful for the state. It is wrong to assume that the state has incurred superfluous expenditure, as by incurring such expenditure, the state cannot maximise economic welfare or achieve maximum social advantage. In fact, there is no place for superfluous public expenditure these days and specially in democratic countries. The expenditure which is necessary is also useful and the expenditure which is not useful is also necessary. In short, this classification cannot be accepted.

8. **Pigou's Classification.**

Pigou has classified public expenditure into two parts as :

- (a) Non-transferable expenditure,
- (b) Transferable expenditure.

According to Pigou, transferable public expenditure implied to purchase current national resource service. The expenditure made on the payment of interest on government debt pensions, sickness benefit etc. Likewise, an expenditure is said to be non-transferable when public expenditure takes the form of money payment made to people either gratuitous or for the purchase of existing property rights. For example, expenditure incurred on maintenance and building of the army, naval and air forces, civil services, education services, judiciary, post office etc. is included in the non-transferable public expenditure

In the second accounting sense, non-transfer expenditure always implies the actual use of commodities and services while transfer expenditure does not give rise to an income output. For example, when the state recruits a soldier in an army and pays for his services and his services cannot be utilised for any alternative purposes. However, transi-

PUBLIC ECONOMIC expenditure implies only a transfer of command over commodities and service from government to the recipients. Non-transfer expenditure, on the other hand, leads to the actual using of the current services and resources of the nation.

"Real government expenditure differs from transfer expenditure, not in that the one does, while the other does not, involve the using up of real resources but that the one using up which takes place in both cases is with real expenditure on the basis of the recipients of the transfer."³?

Similarly, Dalton also observed, "Real expenditure determines, as far as it goes, the amount and character of production. Transfer expenditure does not directly influence either, though it has direct effects upon distribution and indirect effects upon production." Although, Pigou's classification is logically sound as it is associated with essential characteristic of public expenditure. However, it suffers from vagueness as there is no clear cut distinction between transferable and non-transferable public expenditure.

9. Mehta's Classification. Prof. J.K. Mehta has given new classification of public expenditure and divided into two categories :

(a) Constant expenditure, (b) Variable expenditure.

"Constant expenditure is that the amount of which does not depend upon the extent of the use by the people in whose interest it is incurred, make of the services that the financed by it."⁴

For example, defence expenditure as these expenditures are incurred irrespective of the number of people using the services. In other words, people have no influence upon the amount that the government decides to spend. Again

"Variable expenditure is that which increases with every increase in the use of public services by the people for whose benefit it is incurred." J.K. Mehta

Postal service is the example of such expenditures.

The basis of Prof. J.K. Mehta's classification is that either the expenditure points for groups or for individuals. Public expenditure is either of the first type which can be controlled by the public or of that cannot be controlled by them. Prof. Mehta himself recognised that every item of public expenditure cannot be placed wholly under one class or another. So a clear cut distinction cannot be found in practice. In Prof. Mehta's classification, the basis of classification is cost and not benefit like other classification modes.

The superiority of this classification is that the public expenditure from point of view of the government is cost, as in the case of public revenue, it is income. Like all costs, it must lend itself to the division between primary and supplementary costs. It must be remembered that our constant expenditure is the same as supplementary costs. It must be expenditure is similar to prime costs. So this classification is satisfactory costs and variable time, some economists criticise by saying it defective as it assumes that state can incur unproductive expenditures also.

10. Economic Classification. After second world war, the technique of social accounting has been adopted in advanced countries as well as developing countries in order to classify the budgetary transactions of the government which may be useful to interpret the fiscal activities of the state. Thus, United Nations prepared 'A Manual for Economic and Functional

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Classification of Government Transactions' in 1958 for functional and economic classification of their budgets. In this way, public expenditure of each head is classified into two heads i.e., Revenue Account and Capital Account. In other words, it means that government income is divided into two heads Revenue and Capital. Revenue and Capital Account and government disbursement as Revenue and Capital accounts.

In India also, such classification of the government's budgetary transaction to the Central budget is being followed since 1957-58. In our country, revenue expenditure includes all current expenditure on administration, defence and public commercial undertakings like railways, post and telegraphs, grants-in-aid while capital expenditure consists of all capital transactions including defence and capital transactions of public commercial undertakings. Capital expenditure is further sub-divided into two heads as Gross Fixed Capital and Increase in Inventories and Capital Transfers. Gross Fixed Capital includes expenditures on buildings, construction, machinery, equipment etc. while increase in inventories consists of stores and stocks of foodgrains etc. and capital transfers includes grants for capital formation to the states and union territories etc.

11. Functional Classification. When Revenue Expenditure and Capital Expenditure are further classified on the basis of heads mentioned and specified into Revenue Account and Capital Account of the Budget, such classification is termed as the functional classification. This type of classification points out the description of revenue and capital disbursements on different heads of expenditure. It is just a detailed break up of revenue and capital expenditure. It is a classification of government transactions based on the purposes for which expenditure is incurred with an aim as to spend public money in the most judicious manner. Economic and Functional classifications are usually combined to form an economic-functional classification.

This classification provides useful information on purposes served by the governmental expenditure irrespective of the organisation making that expenditure. It is done by grouping programmes and activities of the organisations according to the services provided.

12. Plan and Non Plan Expenditure. The Govt. of India Expenditure is also classified as plan and Non Plan expenditure. Plan Expenditure comprises current development and investment outlays while non plan expenditure is the one which the government is committed or obliged to do. It includes both development and Non development. Part of this expenditure is obligatory like Defence, Police and interest payment. Expenditure on maintenance of assets of the previous plan is called non plan expenditure in current plan. Expenditure of all continuing services in a plan period when shifted to next plan is added to non plan expenditure.

To sum up discussion, revenue expenditure and capital expenditure can be classified

on the basis of heads of the budget. This classification is also popularly known as functional classification. Actually functional classification is nothing but a description of revenue and capital disbursement of various heads of expenditure in a detailed manner.

REVIEW QUESTIONS

- Critically examine the various classifications of Public Expenditure.
- Which of the classification do you prefer ? Give arguments.
- Briefly discuss the different classifications of Public Expenditure. Which of the classification is most suitable to developing countries ?
- Why is the classification of Public Expenditure considered desirable ?



To achieve these aims, ^{the} further augmenting of public expenditure in a matured economy, and increasing capital formation for further augmenting of public expenditure in the matured economy.

They are :

- (a) to secure a re-allocation of resources and for re-allocation of resources.
- (b) to make measures to reduce inequalities and to maintain economic stability.
- (c) to avoid business fluctuations and for the benefit of the community.
- (d) to maintain commercial activities for the benefit of the community.

THEORIES OF PUBLIC EXPENDITURE

THEORIES OF PUBLIC EXPENDITURE did not pay much attention to frame any theory in ancient times, classical theorist did not pay much attention to frame any theory regarding the increase of public expenditure. They simply regarded it as an administrative institution which only concerned with performing certain protective functions. The state has to do very little with the provision of public services, but in 20th century concept of government has changed altogether. The modern state is termed as welfare state in which the Government has enormous functions to perform. For the first time, Adolph Wagner, a fiscal theorist propounded an empirical theory to effect that Govt. inequitably grows larger.

Therefore, the various theories regarding increasing public expenditure can be classified into two parts as :

(a) Pure theories of public expenditure (b) General theories of public expenditure

A. PURE THEORIES OF PUBLIC EXPENDITURE

The pure theories regarding increasing public expenditure can be further classified into four parts

- (1) Pigou's Ability to Pay
- (2) Benefit Analysis
- (3) Sammonson Theory
- (4) Johansen Theory

1. PIGOU'S ABILITY TO PAY THEORY
Prof. Pigou gave the most comprehensive treatment to ability to pay theory in the determination of optimum level of public expenditure.

"Goods and services which are provided by government departments and can be sold for fees so arranged as to cover cost of production pose no problem. The amount of resources which should be devoted to these purposes is determined automatically by public demand. But fees can cover neither bulk of non-transfer expenditure of government such as defence, civil administration and so forth nor transfer expenditure. So, there is no automatic machinery to determine how far expenditure shall be carried; and some other method has to be employed."

He further opined that bulk of current transfer expenditure—debt services, as pensions old age pensions—is regulated by practically irrevocable contracts. But large parts of non-transfer expenditure are optional. The optional parts of public outlay—transfer as well as funds to finance them. And he propounds the principle of balance based on the concept of margin. The optimum amount of Govt. expenditure is determined at the point at which the satisfaction obtained from the last rupee spent is equal to the satisfaction lost in respect

Pigou states the conditions when Govt. expenditure could be larger as under :

1. The greater is the aggregate income of the community, the larger will be the optimum amount of the Govt. expenditure.
2. Suppose new opportunities for expenditure by Govt. are opened up but there is no corresponding opportunities for private expenditure. In this case the balance between marginal benefit of expenditure and marginal disutility of revenue will be struck at a higher point.
3. Given aggregate income and population greater the concentration of income in the hands of a few rich persons, the higher the optimum level of public expenditure.

It is for the simple reason that the tax scheme can be framed as to raise a given revenue with lower marginal sacrifice.

2. BENEFIT PRINCIPLE

The optimal determination of public expenditure on the basis of benefit principle finds its clear statement in the voluntary exchange theory of Erik Lindahl. It was further developed and refined by Johansen and Bowen. The most recent analysis based on this principle is presented by Samuelson and Musgrave.

VOLUNTARY EXCHANGE THEORY OF LINDAHL

Microeconomic theory analyses that price mechanism under certain conditions lead to the realisation of Pareto optimality. Such a price mechanism does not exist for the provision of public goods and services because they are jointly consumed. Therefore, they cannot be split up and sold to individual group. Moreover, once these goods and services are supplied, all members of the society consume them, those who pay for them as well as those who does not. In spite of these difficulties attempts have been made to construct a theory of public expenditure based on price mechanism. The clear cut statement of this theory was provided by Lindhal in 1919. The relevant portion of the theory is printed in English book 'Classics in the Theory & Public Finance' edited by R.A. Musgrave and Allan T. Peacock.

"The determination of public expenditure in connection with the distribution of the corresponding tax burden among the groups within the community. The distribution ratio for this burden will then play a role similar to that of prices in the adjustment between supply and demand in any ordinary market." *Lindahl*

In this theory, the revenue-expenditure process, as a phenomenon of economic value and price, is arrived at in a threefold decision. (1) Before determining the relative distribution of tax shares between various taxpayers, a choice must be made between the satisfaction of alternative wants by private households. Let us suppose a given sum is to be raised from the taxpayers A and B jointly. Now if B pays a larger share of the total tax, A's curtailment of his own private outlays will be smaller (that is, A pays less tax) and vice versa. (2) A second choice is now required. It is between the satisfaction of alternative wants in the public sector. If more is spent on defence, less can be spent on education. (3) In order to determine the total revenue to be collected and spent, a third choice is to be made between the satisfaction of public wants and private wants. If public expenditures are lower, taxes will be required in smaller quantity and private wants. If public expenditures are higher, this third decision cannot be rendered without a knowledge of the relative distribution of tax shares and the expenditure allocation corresponding to varying revenue expenditure totals. The three decisions, therefore, are mutually interdependent and must be rendered jointly.

into the design complex of public expenditure. Hence, Auditor Generals all over the world into the design complex of public expenditure reviews which take into account the now-a-days conduct efficiency-cum-effectiveness of expenditure. The absence of such detailed aspects of economy, efficiency and effectiveness behind mounting rise in wastage, misuse and fraud in our country is the main reason behind audit leaves remarks on red tapism in our recurrence of such public funds. Curiously, while the government audit leaves remarks on red tapism or arrest recurrence of such avoidable costs, no comprehensive analysis to identify reasons or arrest recurrence of such wastage is ever made.

Apart from this, many lines of government expenditure are related to goods and services. It is crucial to note that the general practice has been to appoint a senior civil servant from this, many lines of government expenditure analysis cannot be done of high scientific and technological complexity. Their cost-benefit analysis cannot be done by other than the suitable expertise. To ensure this, the adult organisation in India has to be equipped with proper man-power of diverse technical nature with multi-sided expertise needless to say, financial independence of the CAG is the most important pre-requisite for this purpose.

It is crucial to note that the general practice has been to appoint a senior civil servant on verge of retirement to the Post of CAG. It may, therefore, be difficult for him to suddenly get rid of all his leanings and obligations of the past career and free himself completely of executive or political pressure to do proper justice to this high office. There is, thus a serious case for revision of the present practice of appointment in this regard. Moreover, in view of the federal nature of our country, it would perhaps be more in fitness of things to provide for a say of the state governments, too, in the matter of appointment of CAG.

Since the decisions of PAC are required to be unanimous and since the majority of membership belongs to the ruling party in most of cases, it is difficult for the PAC's to take stern action against misuse of funds by government departments. The composition of PAC, therefore, needs to undergo a change to provide for at least half the membership from opposition parties in the legislature.

To conclude our discussion, we can say, India is, perhaps, the only democratic country in the world where the state of audit work—the methods, the extent of audit arrears, remedial measures against financial irregularities and frauds, etc.—are not disclosed to the public or the legislature. One can not, thus, discuss the functioning of the audit organisation. That the audit institution itself has its own accountability is, thus, denied. A more positive public relations approach will not only be a check to the erosion of public accountability but will also emerge as a motive force to safeguard the independence of the audit institution itself.

CANONS OF PUBLIC EXPENDITURE

The canons or principles of public expenditure are the fundamental rules which should govern the expenditure policy of the state authority. Some economists like Prof. A.G. Bucher attempted to lay down certain guidelines for public expenditure to be followed by the concerned government.

"As far as the theory of taxation is concerned as the theory of taxation, but there are certain objectives and fundamental principles which may serve as guide to legislators and the public until more standards have been devised". Prof. A.G. Bucher

Therefore, such rules have to help insight into the problem. In case of any pit-fall it must easily be checked at the early stage.

In this regard, under-mentioned guidelines should be followed :

- (a) It should promote the welfare of the society.
- (b) It should stimulate the social welfare.
- (c) An eye should be kept whether the funds are properly utilised for conducting social welfares.

In fact, the principles of public expenditure determine the efficiency and propriety of the expenditure itself. Prof. Shirras has made the unique contribution in suggesting the canons of public expenditure. These canons are broadly described below :

1. Canon of Benefit.

"Other things being equal, expenditure should bring with it important social advantages such as increased production, the preservation of social whole against external attack and internal disorder and as far as possible a reduction in the inequalities of income. In short, public funds must be spent in those directions most conducive to the public interest i.e. maximum utility is to be attained in public expenditure."⁶

Therefore, this law states that the public expenditure should be planned in such a way that it results in achievement of maximum social advantage. Public money should not be utilised for the benefit of an individual or particular group rather it should equitably confer benefits on the entire society. Thus, this canon is synonymous with the principle of maximum aggregate benefit.

"Public Expenditure in every direction must be carried just so far that the advantage to the community of a further small increase in any direction is just balanced by the disadvantage of a corresponding small increase in taxation and in receipts from any other source of public income. This gives the ideal of public expenditure and public income."⁷

This principle of social benefit in the theory of public finance is similar to the equilibrium utility in the theory of consumer behaviour. Thus, public authorities should distribute its resources in such a manner that marginal utility from all uses should be equal. The canon of benefit has no substitute or alternative. However, it is difficult to measure the benefit from some items of public expenditure. In short, the canon of benefit aims at the improvement of production and distribution system in the country.

2. Canon of Economy. The canon of economy means the state should be economical in spending money. In other words, the wasteful and extravagant expenditure should be avoided. Public expenditure must be productive and efficient. So the state should not spend more than the necessary amount on the items of expenditure. It should also develop the productive powers of the community as much as possible. This is a positive aspect of the economy. However, state should give first consideration for the present and take proper care of the future.

6. Dalton, 'Public Finance'.
7. Findley Shirras, 'Public Finance'.

CHAPTER

07

EFFECTS OF PUBLIC EXPENDITURE

INTRODUCTION

The effects of public expenditure vary over time. Under the impact of *laissez faire*, functions of the state were only of regulatory nature such as the maintenance of law and order, defending against external aggression and running of public utility service normally as a waste. He further asserted that "Money would fruitfully more in the hands of the people than in those of the state, every particle of expense that is incurred beyond what is absolutely required for the preservation of social order and for protection against foreign attack is waste and an unnecessary imposition upon the public". In fact, the study of public expenditure remained neglected during the eighteenth and nineteenth centuries.

But, today, new concept of public expenditure has been developed by the most economists. Say's law of market was falsified by the onslaught of the 'Great Depression'. Keynes with his penetrating analysis showed that economic system could not function automatically and the state must take upon the responsibility for its smooth functioning. Moreover, Wagner's law of increasing public expenditure both extensively and intensively has been considered universally true. Consequently, it urges paramount significance to consider the impact of public expenditure on the level of employment, production, income, achieving the optimum allocation of resources, stability of prices, erecting in a free economy and equitable distribution of income in a country. For instance, in a socialist economy and during peace time, government expenditure is quite low while in the period of war, the contribution of government expenditure is more significant in influencing the level of economic activity and employment.

Significance of Public Expenditure. It arises from the fact that those services provided by the government which otherwise might not be provided or which could not be provided by the private sector. In fact the amount of public expenditure is so huge that the various individuals or the private sector perhaps in creation of goods and services from private firm

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individuals for the purpose of carrying out various activities in the administration and other development areas. Due to the public expenditure in creating employment and increasing national income, the government is able to utilise those resources which otherwise would have remained idle and this will help in purchasing power of one section of transferring income by way of transference of income tends to rise. In view of this great impact on the creation of employment, increasing production, generation and distribution of income in the country, the study of public expenditure becomes significant.

In accordance with Dalton's view point, effects of public expenditure can be described as under :

1. Effects of Public Expenditure on Production
2. Effects on Public Expenditure on Distribution
3. Effects of Public Expenditure on Economic Stability
4. Effects of Public Expenditure on Economic Growth.

1. EFFECTS OF PUBLIC EXPENDITURE ON PRODUCTION

The character and the volume of public expenditure is bound to have some effect on the pattern and amount of production in a country. Hence, the public expenditure policy is so devised that other things remaining the same, production is increased and encouraged. Public expenditure influences the productive activity in a number of ways, its volume and the character has an effect on efficiency : physical and mental. It affects incentive to production efforts, the provision of certain basic services and facilities make possible increased production in the public as well as in private sector. Particular firms may be assisted individually according to their needs and it can be used as an instrument to bring about the changes in the pattern of production in the country.

However, effects of public expenditure, according to Dalton depend on three factors as follows :

1. Ability to work, save and invest ;
2. Willingness of people to work, save and invest ;
3. Effects on diversion of economic resources as between different uses and localities

1. Ability to work, save and invest

Ability to work, save and invest is greatly affected with the increase in public expenditure. Increase in public expenditure on education, medical services, cheap housing facilities, means of transport and communication and recreational facilities will increase the efficiency of persons to work. This will, in turn, promote production and national income. At the same time, public expenditure can push up the saving and the efficiency of the workers. The purchasing power of the people will also be increased by such type of public expenditure on free education facilities, unemployment benefit, sickness benefit, cheap housing facilities etc. This will be helpful to promote their ability to work and save. It is true in the case of those people whose standard of living is very low. In addition to this, expenditure for maintaining law and order creates confidence and faith in the minds of the common people which helps to encourage the investment into productive channels. Obviously, this will increase their income and saving hence ability to work and save. It must be noted here that

The increase of purchasing power of the poor people, tends to go waste on drinking, gambling which results in the harmful effects on health and efficiency of work. Such extravagance can be avoided by increasing income of the poor. It can be avoided if the increase in income is not given in cash rather they should be provided free or concessional facilities, subsidised food and cheap housing etc.

In the second place, public expenditure also improves the mental standard of people resulting in better utilisation of ability of the people such as cinema, film studio or bars should not be weighed in favour of luxury goods such as work and it will lead to harmful effect because it will decrease the ability of the people to work and it will incur on public utility services such as production. But public expenditure should be incurred in other industries of all kinds. This type of public expenditure will be useful to the entire community instead of any individuals.

2. Willingness to work, save and invest

Public expenditure deeply affects the willingness to work, save and invest. It not only affects the present but also the future. Therefore, the public expenditure should be planned in such a way so that it must be more fruitful to the worker while working than when he is out of job. In other words, pension, provident fund benefits, sickness, insurance etc. should be provided when the individual is working. Regarding this type of facilities, a great fear has been expressed that under certain circumstances the public expenditure has an adverse effect on the willingness of workers to work, save and invest. The question is, why should a person would put hard work and save when he finds his future safe and secure. If there is a security of job then the workers will be lethargic resulting in the decrease in the efficiency. Because if a person knows that he is not bound to be expelled from job, he is no more interested in working hard to the full of his capacity, he is more interested in wages, salary etc. Also if the worker is insured to be looked after even after retirement by government, his tendency to save will be diminished. On the other hand, a worker's willingness to work and save will be reduced if his future is not secured.

The desire to work and save will increase if the common masses are sure that their present savings and investment are secured and will yield good dividends to them in the years to come. Similarly, the desire to work can be increased by making the benefits conditional e.g., people may be required to contribute something in order to avail the benefits of sickness or unemployment. In short, public expenditure should be incurred systematically and in a planned manner in order to provide social security to the maximum extent. It should offer greater opportunities and help so as to bridge the gap between the rich and the poor.

3. Diversion of Economic Resources

Public expenditure through the diversion of economic resources between different areas and uses can significantly influence the pattern of production. It exerts its effects on which regions or industries are to be provided with abundant productive resources. Therefore, government has to select the particular region or industry for incurring the public expenditure so that the maximum national production and maximum social advantage be attained.

However, the diversion of economic resources can easily be carried out by provisioning of basic services and facilities :

EFFECTS OF PUBLIC EXPENDITURE

Provision of Basic Services and Facilities. The provision of certain basic services and facilities by the government makes it possible for extensive productive activity to be undertaken. Thus, the development of roads, railways, irrigation etc., expenditure on infrastructures all enlarge opportunity and make it possible for people to carry on and extend productive activity. The construction of a railway system in an isolated region increases the productive power of the region, by providing marketing and other facilities. Similarly, with the development of hydroelectric system, expansion of industries took place. In under developed countries, particularly the provision of such an economic infrastructure is of great importance. Public expenditure on transport, communication, on basic and key industries like steel, coal, oil, heavy machinery, heavy chemicals, fertilizers etc., stimulates investment in other industries of all kinds. Public expenditure on such developmental projects leads to an increase in the permanent capital of the country. From the point of view of Prof. Dalton, public expenditures are socially desirable which would go a long way to push the production and raise the level of employment if the funds required were left in private hands. It includes :

- (a) debt redemption where most of the money repaid will generally be reinvested ;
- (b) many projects of transport development, irrigation, afforestation etc., which may be expected to yield large returns in the long run but not in the immediate future and which do not attract the private investor ;
- (c) increase of knowledge by the encouragement of research and invention and to create opportunities of employment by the maintenance of employment exchanges;
- (d) education and training ;
- (e) public health ;
- (f) expenditure in aid of social security schemes in order to promote efficiency and increase production.

In the second place, the government expenditure may induce people to put their resources to more productive channel. Road and railway development makes it possible for people in the affected areas to increase their production as they are brought in touch with the rest of the world and are provided with the better opportunities. In the same manner, the development of the power resources enables the development of the industries. Conditional grants and loans may bring about desired diversion of resources e.g. from promoting the manufacture of luxury goods to the manufacturer of necessary commodities. To conclude the effect of public expenditure on production it is again better to quote the views of Prof. Dalton as given below :

"Whereas taxation, taken alone, may check production, public expenditure, taken alone, should almost certainly increase it. Expenditure on police, and armed forces, if not overdone and on the other apparatus of order and security, creates the conditions under which alone organised production can take place at all."¹
Prof. Dalton

2. EFFECTS OF PUBLIC EXPENDITURE ON DISTRIBUTION

Public expenditure has an effect not only on the composition of national production and employment but at the same time, it is a powerful tool in the hands of the government

1. Dalton, 'Principles of Public Finance'.

Ques 2) We know that inequality in the distribution of income and wealth. We know that inequality in the distribution of wealth is common feature in most of the backward countries. Planned expenditure policy of the government can bring the desired results. Any state authority tries to achieve this object partly by means of taxation and partly by the way of public expenditure. Therefore, taxation and public expenditure are complementary and supplementary to each other. During the course of formulating its expenditure policy, the government considers seriously as to which of the socio-economic section/group should be specially benefited in the country. To this end, if most of the public expenditure is incurred for the welfare of the poor section, it will result to bring about a more equitable distribution of wealth and vice-versa.

Proportional and Regressive Progressives

In the opinion of Prof. Dalton, just like taxes, public expenditure is a tax on the people.

"A grant is regressive, if the smaller the recipient's income, the smaller the proportionate addition may be made by the grant; progressive if, the smaller the recipient's income, the larger the proportionate addition is the same."¹²

the size of the recipient income

Therefore, public expenditure benefiting the people in higher income group is regressive in nature as this type of expenditure least benefits to the people of poor group of the society. Public expenditure is progressive if it is incurred on the activities which adds to the real income of the poor lots in the country. It is proportional if the public expenditure is more benefiting on different groups of the community in proportion

Keeping all functions into account, it is said that the main aim of public expenditure is to reduce the disparities of income and maximising the social welfare of the society. To quote Prof. Dalton, other things being equal, that system of public expenditure is the best, which has the strongest tendency to reduce the inequality of income. Furthermore, progressive public expenditure tends to reduce greatly inequalities as the lower income groups would be benefited more than the upper income groups.

"The principle of minimum sacrifice in the distribution of taxation runs parallel to the principle of maximum benefit in the distribution of grants a rough approximation to the latter principle would be a grant system which brought all incomes below a certain level up to that level and added nothing to any income above that level."¹³

Therefore, there are various forms of progressive expenditure such as cash grants, free or cheap goods and services. Cash grants cover old age pension, unemployment benefit, sickness benefit, industrial injury benefits, maternity benefit and accident benefits. Thus, progressive in nature, these grants provide help to the people at the times when they actually need such expenditure undoubtedly reduces inequalities in wealth and income. So, expenditure according to ability to receive, the co-relative of taxation according to ability to pay, is achieved, when corresponding to a given expenditure, the maximum addition is made to economic welfare.

2. *Ibid.*
3. Dalton, 'Principles of Public Finance'

2. *Ibid.*
3. Dalton, 'Principles of Public Finance'

2. *Ibid.*
3. Dalton, 'Principles of Public Finance'

3. EFFECTS OF PUBLIC ENTREPRENEURSHIP ON ECONOMIC STABILITY

In a capitalistic economy, economic instability has been recognised the common characteristic resulting in various kinds of business fluctuations. Generally, two kinds of aggregate economic instability is found as of instability of output and instability of price. However, after the havoc created by the great world depression of 1930, some cyclical measures have been adopted to meet the adverse situation.

PERSPECTIVE: THE CHANGING FACE OF THE U.S. MARKET

According to Lord J.M. Keynes, economic instability impinges upon the aggregate effective demand at stable price levels. It is the deficiency of the aggregate effective demand caused by a low marginal propensity to consume coupled with low marginal efficiency of investment in advanced economies of the world.

Unemployment

Unemployment is the main characteristic of economic disorder. But an unemployment is not the result of the same cause. It occurs only when there is maladjustment between different factors of production. Therefore, unemployment is of different kinds as : (i) Cyclical unemployment which occurs during a period of depression, (ii) Frictional unemployment which is the result of the labour market i.e. the absence of complete interchangability and mobility among workers. (iii) Seasonal unemployment which is caused by seasonal variation. The unemployment of any kind brings misery and suffering. It gives birth to moral degradation. So it becomes the utmost responsibility of the state to bring about the situation of full employment in the economy.

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on total income of the community i.e. the propensity to consume. The amount invested depends on the expectation of profits. Actually, there is no automatic co-ordination between decisions to save and decisions to invest. An excess of intended saving over investment causes a reduction in total spending and reduction in demand for goods and services results in the reduction of employment.

Keynes and his followers have recommended many types of fiscal and monetary measures alongwith public expenditure to compensate for the deficiency or excess of the aggregate private demand. During the period of depression, when the aggregate demand is deficient, the government is expected to raise its spending which is only possible with the help of public expenditure or adopting the scheme of compensatory finance. This can also be done through deficit financing. Conversely, in the period of boom, the problem of excessive aggregate demand should be curbed by curtailing government outlay. Generally, it is made through reducing public expenditure and maintaining the same amount of taxation and borrowings.

Publi c Expenditure during Inflation

Public spending can also help in curbing inflationary conditions prevailing in the country. Prices tend to rise under inflation and one important factor responsible for this phenomenon is the volume of goods and services falling short of demand.

Under such circumstances the public expenditure should be incurred on those projects which raise sufficiently the volume of production within a short time. For instance, financial resources invested on minor irrigation projects, provision of fertilizers, seeds, manures etc. to agriculturists, providing facilities to industrialists for expansion or establishment of industrial units etc. can help in increasing the production. It helps to check the rising trend of prices. However, if the economy has already reached the level of full employment, there is every likelihood that public expenditure instead of arresting inflation, will strengthen it. It is quite obvious that different sectors of economy are working to their full capacities, any public expenditure will give additional purchasing power in the hands of the people without bringing any addition to the total production. In other words, public expenditure during inflation is desirable so long as full employment is not reached, otherwise surplus budgets are necessary to reduce the pressure on prices.

Public Expenditure During Depression

Generally, depression is a condition when saving exceeds investment which results in lowering of aggregate effective demand. Falling prices cause losses among businessmen and manufacturers and reduce their confidence in the future. This leads to curtail production shape of money than in the shape of goods as they are likely to fall. This results in falling off in employment not only in their own firms but in those firms also from where they have been making purchases. Thus, a large number of men lose their employments. They are further compelled by the circumstances to reduce their consumption expenditure. In this way, total demand in the community falls still further, leading to further curtailment in production, which again leads to fall in employment, reduction in total consumption and intervention of public expenditure. During such a period, the government spends money in public works projects. It not only creates employment among these labourers but starts a chain reaction of employment in the economy. These employed workers received wages

from the government and, thus, increase the total demand for various commodities. When the demand is increased, then the volume of production will automatically increase. As a result, more workers will get employment and this increase in employment will again increase in aggregate effective demand of the workers and this process will start and go on. The Investment multiplier was introduced by Keynes to explain investment and expenditure. He refers to it as the ratio between a given increase in gross investment and the resulting increase in national income. The total sum invested in industry is called gross investment. If the gross investment is increased, the national income will rise not only to the extent of the increase in investment but to a much greater extent. In short, public expenditure with multiplier effect can help to affect the decreased demand, and investment in public works, dams and other amenities leads to the maintaining of stability in a country.

Compensatory Expenditure

Public expenditure as a compensatory during depression period has been designated the method of financing deficits through taxation, borrowing and creation of new money. In the words of Keynes, government expenditure becomes a balancing factor in order to maintain national income at a given level. Such expenditure may be progressively increased in the depression period which in turn helps progressively to bring the recovery of the economy i.e. to off-set the effect of an increasing propensity to hoard on the part of the private individuals. For example, expenditure of this type was incurred in the USA during the thirties and made considerable success and the economy was turned around.

But at the same time, it has three types of drawbacks as :

- (a) Sometimes, governments do not have specific programmes of public works ;
- (b) Government may not prove to run public and commercial undertakings efficiently;
- (c) Public expenditure financed out of deficit financing is generally called inflationary.

Pump Priming

Some modern economists have argued that government expenditure should be devised in such a manner that a decline in business may be prevented not temporarily but permanently. Hence, sufficient large public expenditure is set in motion that may continue for an indefinite period at its momentum. Such expenditure has been designated as pump priming expenditure. Public spending in the USA in 1933-38 did not have very successful pump priming effects though it showed some success as a compensatory device. But the supporters are of the view that failure was only due to its half-hearted manner of adoption which failed to create the confidence in the minds of the public. This failure cannot be attributed to the fact that pump priming is defective.

However, its success depends on the following considerations :

1. There must be deficit spending ;
2. Borrowing for such expenditures must be from banks rather than individuals.
3. Public expenditure must boost up the employment opportunities.

4. EFFECT OF PUBLIC EXPENDITURE ON ECONOMIC GROWTH

Public expenditure has to play an active role in reducing regional disparities, developing social overheads, creation of infrastructure, education and training, growth of capital goods

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In industries, research and development etc. in developing economies. On the other hand, in well advanced economy, public expenditure maintains a smooth rate of economic activities. Thus, public expenditure in the form of stimulating saving and capital accumulation has a great role to play in the stabilisation and employment to expand.

Public expenditure in the shape of subsidies can prove helpful for getting economic growth. It can be used to raise the agricultural production and reducing regional disparities. In this way, loans, grants, tax concessions, subsidies stimulate private initiative to a greater extent. So far as savings are concerned, public expenditure should be designed in such a manner as to increase the overall savings in the country. At this time, public expenditure in the form of investment on education and various social services leads to an increase in a consumption rather than savings. Besides, for steady and balanced growth of the country, main objectives and priorities between the various development projects are to be determined in a careful manner.

"In the development programmes, all sectors of the economy should grow simultaneously so as to keep a proper balance between industry and agriculture and between production for home consumption and production for export."⁴

Prof. W.A. Lewis

Above all, public expenditure must be recognised as an economic policy along with taxation, licensing and other economic measures which can go a long way to achieve the desired economic goals. Therefore, it should be pursued and adopted under proper supervision.

PUBLIC EXPENDITURE AS COMPENSATORY MECHANISM AND PROMOTER OF GROWTH

We are already familiar with the relation of public expenditure with different aspects of development and economic stabilisation. Due to uncertain forces of free market, there arise fluctuations occasionally in economic activity. Since market mechanism of the developed countries is mostly free, their economy is subjected to periodic trade cycles which bring into existence different phases of instability such as recession, depression, recovery and boom period intervals. The two most important phenomena of economic fluctuations from which these countries suffer are deflation and inflation.

Deflation, i.e. a falling trend of price level arises from depression when the economic activities slow down—effective demand declines, prices and incomes fall, producers cut down production plans due to low marginal efficiency of capital and the economy exhibits a general fall in the marginal propensity to consume and a large increase in unemployment purchasing power. Functioning in the economy is much in excess of what is necessary to maintain the normal price level. Since all resources are fully utilised, increase in effective compensatory mechanism refers to that device by which such fluctuations and economic instability can be checked. There are a number of fiscal instruments to achieve this economic stabilisation and public expenditure is one of it. Though public expenditure alone cannot

4. W.A. Lewis, *The Theory of Economic Growth*.

During depression, the whole problem crops up from deficiency of effective demand. The economy is operated with much less purchasing power than what is necessary to maintain production, employment and price level. The solution therefore, requires pumping of additional purchasing power into the economy. Public expenditure can help the situation to a considerable extent. If construction programmes and other public investment projects are taken up together with larger provisions of transfer payments like old age pensions, unemployment allowances, additional amenities to raise real incomes of workers and a wide network of social security benefits, then additional purchasing power will be distributed in the hands of people whose propensity to consume is high and, as a result, effective demand will rise. This will generate economic activity and will help price level to rise and production and employment to expand.

From the foregoing discussion, it follows that the sooner expenditures enter into the income stream, the more effective they will be in preventing depression. To fill the gap left by deficiency of private demand, public expenditure will be most helpful if it is directed to those areas of the economy where there are idle resources and to those segments of people whose propensity to re-spend is comparatively high.

Public expenditure has also its role as a compensatory even during inflation. During inflation, aggregate expenditure in the economy is much in excess of that level at which the available output can be purchased at stable prices. Since the economy suffers from excess purchasing power and, hence, a rising trend of prices, the remedy lies in freeing the economy of excessive demand. To do this, the excess purchasing power has to be pumped out of the economy. This can be done by reducing the spendable incomes of people and public expenditure schemes. Thus, public investment has to be curtailed and transfer payments and government subsidy programmes reduced.

However, public expenditure alone can do a little job. There are some public expenditures which cannot be curtailed easily. If government investment outlays have not been expanded during depression, it will be difficult to stop or reduce government purchase of goods and services. Thus, we see that the programmes of public expenditure when judiciously planned are able to influence economic development through increase in people's ability to work, save and invest, willingness to work, reallocation of economic resources as between localities and sectors, reallocation of resources as between present consumption and future consumption and income generation through multiplier process.

Here we must remember that the efficacy of public expenditure in its role as compensatory mechanism and promoter of growth is limited by a number of factors. During inflation, as we have already seen, public expenditure cannot be curtailed on a number of accounts. As Taylor observed "The major expenditures of governments have rather rapidly responded to increased needs; although some of them have shown remarkable increase, they are still regarded as barely adequate. State and local expenditures for education, highways, and the extension of water and sanitary facilities in growing suburban areas, and federal expenditures for defence, interest on public debt, and agricultural price supports now compose the major share of governmental outlays. Increase in these categories have occurred against rather strong budgetary resistance that has kept the programmes relatively free". Curtailment of public expenditure on these programmes to a significant

27 But, the empirical evidence clearly demonstrates that 25 per cent as a critical limit during recent past due to its inflationary trends. Furthermore, budgetary activities would lead to inflation which also depends upon the manner in which public expenditure is incurred.

REASONS FOR THE GROWTH OF PUBLIC EXPENDITURE

Public expenditure has increased manifold in the recent past and it continues to do so. Public expenditure trend in almost all countries of the world. The end of the 'Laissez faire' policy has contributed much to his fact in the recent period.

"Public expenditure grows because, and as, public activities increase. The increase is both extensive and intensive. Government in every branch central intermediate and local are constantly assuming new work or duties and are constantly performing the older functions and in turn, newer ones also, on an ever larger scale".²

Therefore, statistics of public expenditure by modern welfare governments demonstrate such persistent increase, so that Adolph Wagner's law of increasing expansion of state activities proved empirically.

Let us examine the reasons responsible for inducing increased volume of expenditure as under :

1. Welfare States. In the modern times, states are the welfare states. They have the aim of promoting the economic, political and social life of the people. It is the moral duty of the state to improve the living standard of the general public. To achieve this aim, the state has to undertake so many welfare functions like education, public health etc. This is true in all types of governments either capitalistic or communist government. State intervention and increasing through legislative and administrative measures to enhance production and improving distribution system. The state satisfies many wants of the society collectively which were earlier satisfied individually. Keynes and others are of the opinion that state must intervene in the economic system of the country to secure stabilisation in advanced countries and acceleration of rate of growth in underdeveloped countries. The new functions are social insurance, unemployment reliefs, cheap medical facilities, old age pensions, housing facilities etc. The state has come to reduce the social inequalities in the society. Especially in underdeveloped countries such as India, the state expenditure is rising very fast.

The welfare aspect of government activity is described as the pressure for social progress by Wagner. According to Wagner's hypothesis, the pressure of social reform may be regarded as the root cause of the relative growth of the public expenditure today. In short, these functions have necessitated the adoption of the strategy of planned economic development which involves huge amount of expenditure.

2. To meet the Defence Needs. Due to rapid growth of the science and technology in the sphere of nuclear weapons, there is a grave threat of foreign attacks. The political situation all over the world is uncertain and insecure. If one country strengthens its defence forces, the other countries are forced to take similar steps in their self-defence in anticipation. The manufacture of modern nuclear weapons, training and planning of army is a very costly affair. The technique of war is a changing phenomenon and with the change of techniques

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of war, new weapons have to be purchased for army. It increases the burden of public expenditure.

In India, the defence expenditure has been increased manifold since Chinese aggression in 1962 and wars with Pakistan in 1965 and 1971 respectively. Furthermore, the defence expenditure also includes the maintenance of army, air force, navy, development of military art and practice. Obviously, this has led to a huge increase in public expenditure.

3. Development of Agriculture. In developing countries like India, the development of agriculture is the key factor of the progress of the economy. The government has come to know the effect of agriculture or the industry sector. The inter-relationship between agriculture and non-agriculture sector causes the development of both the sectors.

The expansion of agricultural sector provides a stimulus to industrialisation. On the other hand, industrial sector also helps to supply modern tools and implements to it which in turn are responsible for the rise in agriculture productivity. The governments are spending huge amounts for the development of agriculture sector. So the loans, subsidised fertilizers and pesticides on minimum prices are given for its betterment. They also spend a lot of money on agricultural research and conservation programmes.

4. Urbanisation. The spread of the urbanisation is another factor for the relative growth of public expenditure in the modern times. There has been increased tendency of expenditure on civil administration with the rise of population in these areas. Expenses on water supply, electricity, transport, maintenance of roads, educational institutions, traffic controls, public health have increased tremendously in these days. Hence, increase in expenditure on civic amenities has led to an upward increase in public expenditure.

5. Democratic and Socialistic Structure of the Government. The growth of democracy and socialism everywhere in the world has been responsible for the increase of public expenditure to a greater extent. A democratic form of government is more expensive than the other forms of government. For instance, democracy in India has become a costly affair. Expenditure on election, bye-election and administrative set up is increasing. The ruling party has to persuade the public opinion in their favour by making excessive expenditures on new policies. Furthermore, they have to fulfill their promises made in the manifesto at the time of election. Similarly, there is gradual shift of thinking from capitalism to socialism with the result that state governments have to shoulder larger responsibilities to perform social activities. Public sector and nationalisation are equally responsible to push the public expenses to a larger extent.

6. Rural Development Schemes. The government has to spend huge amount for the development of rural folk in the developing countries like India where majority of population lives in villages. It has to undertake schemes like community development projects and other social measures. In India, many such schemes have been introduced to eradicate the poverty. They are IDP, DPAP, NREP, TRYSEM, CSRE, DDP, SFDA/MFALA etc. Undoubtedly, they have raised the expenditure of the government manifold.

7. Industrial Development. After world depression, government took active participation to promote an industrial development. Actually, it brought a happier life, higher standard of living, increased the efficiency and raised the production of all commodities to a sufficient level. In addition to it, government also took measures to control monopolies and to provide consumer goods and services at reduced cost. This led naturally to a greater share for public expenditures.

8. Rising Population. The growth of population is also responsible for increase in the public expenditure as the government needs money to perform various functions efficiently.

2. C.C. Pehm, 'Introduction to Public Finance'.

21 | examine Pareto efficiency rule for private goods first. There are two consumers A & B and two private goods X and Y.

Optimum state of consumption and production is attained when the following three conditions are fulfilled :

- With given technology, largest possible amount of Y should be produced with a given amount of X. It is known as production optimum, the best mix of X and Y.
- The marginal rate of substitution (MRS) in consumption between products X and Y must be same for consumers A and B. It is known as exchange optimum.
- The marginal rate of transformation (MRT) of X and Y in production.

(iii) The marginal rate of transformation of X and Y in production.

In Fig. 5.3 the optimum allocation of output mix Z between two consumers A and B is decided. Of Y is divided between A and B in the ratio of OF_1 and F_1F , while OE and B in the ratio of OE_1 and E_1E . Still one of X in the ratio of OE_1 and E_1E . Still one problem is remained unresolved. All points on the production possibility curve C and D are equally preferred points. Choosing Z implies in terms of relative welfare, Ia_3 utility level for A and Ib_2 utility level for B. Whether this point Z will be chosen or not, cannot be answered in terms of Pareto optimum rules. In fact, it is a matter of judgement on distribution.

4. JOHANSEN THEORY

Samuelson's pure theory of public expenditure solves two problems under the assumptions of given preferences and distribution of income. These are divisions of total output between public good and private good and division of the total supply of private goods between two consumers A and B. All these solutions are Pareto optimal because any departure from them involves a loss either to A and B. The optimum of all such optima is then decided on the basis of a social utility function maximization.

"This formulation meets the test of theoretical rigour and sweeping elegance and ranks among the great contribution to the theory of welfare economics as applied to public finance." **Musgrave**

Even then, Samuelson's theory does not satisfy those who intend to apply fiscal theory to partial problems and specific issues. From the implementation point of view, it is far from

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satisfactory. Moreover, Johansen has tried to remove some of these difficulties. This fact is illustrated with the help of Fig. 5.4.

Thus, Johansen assumes a fraction of the total cost of producing public good G which is borne by the taxpayer A. Therefore, the share borne by B is $1-h$. In Fig. 5.4 he considers the case of A and examines his preferences with regard to a private good X and a public good G. Two budget lines are drawn correspondingly to two different values of G, steeper the budget line higher is the value of G. Given the distribution ratio G, the point of tangency between the budget line and the indifference curve showing combinations of private good X and public good G represents best preference for A. The two points P and Q as in Fig. 5.4, are points of this kind and a curve AA' obtained by pairs all such points is a curve showing most preferred values for various cost shares. This curve is redrawn in Fig.

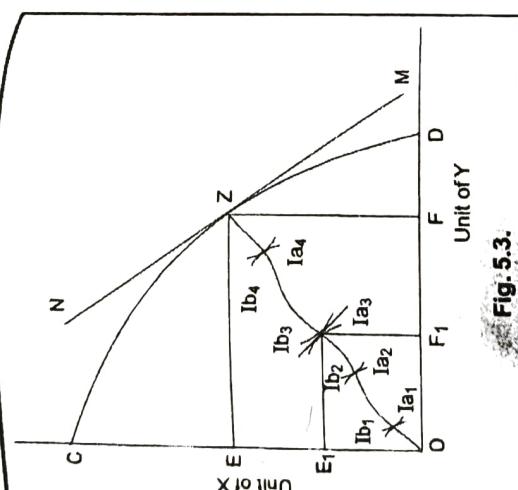


Fig. 5.3.

There are three important theories of increasing public expenditure given by (i) Adolph Wagner, (ii) Wiseman, (iii) Peacock and Colin Clark. We shall now explain these theories in detail.

B. GENERAL THEORIES OF PUBLIC EXPENDITURE

There are three important theories of increasing public expenditure given by (i) Adolph Wagner, (ii) Wiseman, (iii) Peacock and Colin Clark. We shall now explain these theories in detail.

1. ADOLPH WAGNER HYPOTHESIS

Adolph Wagner, a famous German fiscal theorist believed that there is a functional cause and effect relationship between the growth of an economy and the relative growth of public sector. Presenting his famous 'Law of the increase of state activities' Adolph Wagner opines ;

"Comprehensive comparisons of different countries and different times show that among progressive people, with which alone we are concerned, an increase regularly takes place in the activity of both the central and local governments. This increase is both extensive and intensive; the central and local governments constantly undertake new functions, while they perform both old and new functions more efficiently and completely."

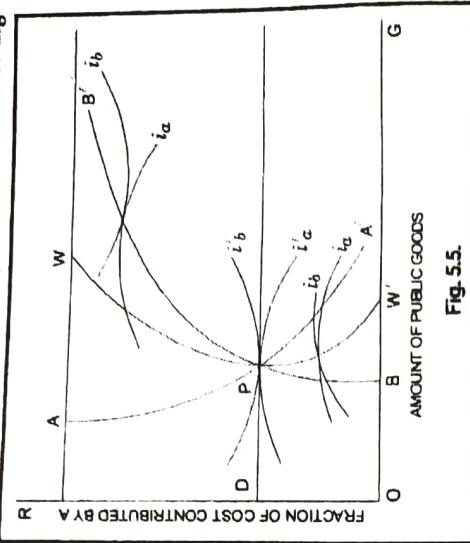


Fig. 5.5.

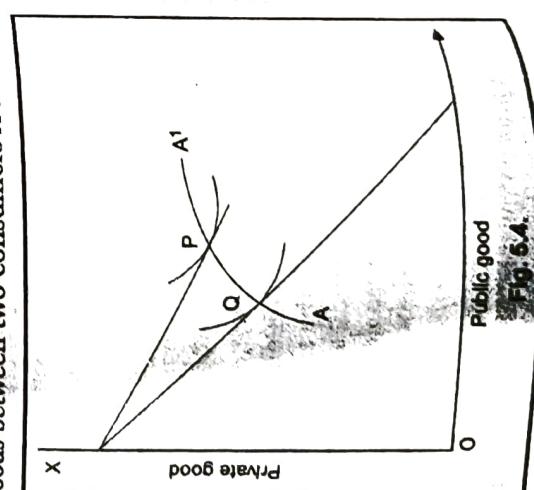


Fig. 5.4.

Role of Diagram

Wagner's Hypothesis which the real per capita income has been shown on the X-axis and the real per capita output of public goods as been shown on the Y-axis.

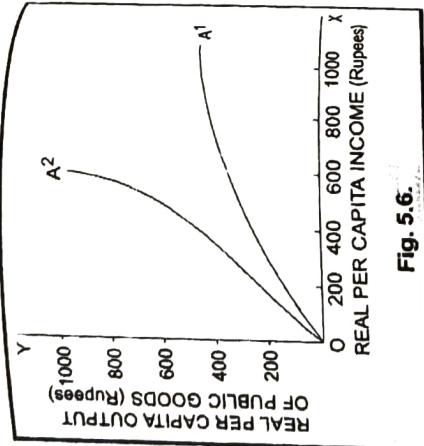


Fig. 5.6.

Factors Responsible for Persistence increase in Public Expenditure

Persistence increase in Public Expenditure

Wagner's hypothesis was supported by the famous economist F.S. Nitti. He concluded that the subject of empirical evidence that this law was applicable not only to Germany but to various governments which differed widely from one another. All kinds of governments irrespective of their type of governments, size had shown the same tendency of increasing public expenditure. According to Wagner hypothesis, there are many factors which are responsible for persistent increase in public expenditure.

They are as unique as the increase in public expenditure.

- 1. Continuous Extension of Social Activity.** Wagner admitted that continuous extension of social activities was the basic reason of the relative growth of public expenditures. In the past, governments restricted themselves to the problems of external defence and maintenance of law and order within the country. But in the modern and dynamic world, old-fashioned concept has changed altogether and new governments are assigned with the objective of promoting economic, political and social well being of its citizens. Besides, they perform

In a country, most growth of these government functions lead to absolute and relative growth of economic activity.

2. War and Preparation for War. In the present century, the most important single factor in pushing public expenditure upward is war. Expenditure for national defence accounts for half of the total expenditure. Wars and rumours of war between countries forced them to remain ready for it all the times. Therefore, progress in the art of military goods has been so rapid that the war goods have been extremely costly affair in recent times.

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Another factor responsible for the rise of public expenditure, in turn, governmental activities. Thus, the process of urbanisation seeks an expansion in such expenditures as those of protection of life and property. This imposes additional responsibilities upon the government. The functions, they perform are inspection of food, distribution of essential commodities, promotion of public health, construction and maintenance of hospitals, education and other amenities of life. Furthermore, modern societies are becoming more

4. World Depression. The great world depression of 1929-33 is another major factor responsible for the extension of public expenditure. This depression demonstrated the need for government intervention which is responsible for the growth of government activities in various fields. So investment activities of modern governments constitute another factor in increasing public expenditure.

5. Rise in Prices. The sky rocketing rise in prices has equally contributed to the rise in the public expenditure since independence. The rise in prices has two effects. One, the government has to pay higher price for all goods and services which it has to buy. Two, it has to find larger financial resources to meet its growing expenditure. In this way, the increased government expenditure is itself one of the contributory factors responsible for increased public expenditures.

6. Democratic Institutions. Democratic institution is not the direct factor responsible for pushing public expenditures. But it makes indirect influence upon it. A modern democratic state has to maintain the ceremonial head of the state and it incurs expenditure on legislature at the central, state and even local levels. Above all, they have to maintain diplomatic and consular relations with rest of the world. It will not be out of place to note the increasing concern for underdeveloped nations felt by the advanced countries which have started a retarding part of their resources for economic development of these backward nations. It is, therefore, whatsoever the real cause, these activities constitute very important factor for the increased public expenditure in the 20th century.

7. Role of Economic Planning. In almost all countries, the state government adopted planning in any form to accelerate the pace of economic growth. This has substantially increased the expenditures.

8. Modern Complexities of Life. The fast growing complexities of modern life compelled government to take in hand qualitative and quantitative functions for the betterment of common lots. These welfare schemes of the government, naturally involve massive public expenditure.

25 "Increased efficiency of public sector is also the factor to stimulate public expenditure relatively to that of private organisation. It is well known public expenditure looks for maximum profit whereas individual private organisation for the social advantage of the country." Prof. Dalton

Criticism of the Theory

Wagner's hypothesis was widely criticised by noted economists such as Allan Peacock and Jack Wiseman on the following grounds :

1. **It lacks Inter-disciplinary Relationship.** No doubt, it deals with inter-disciplinary phenomenon but basically it lacks essentially inter-disciplinary relationship in its analytical framework. Other sciences like political science, economics and sociology must be evolved in any theory of public expenditure. Such type of theories must consider cultural characteristics of a society. Therefore, it deals with the causal conditions described by Wagner which constitutes all the primary determinants of a relatively expanding public sector during the course of industrialisation and economic growth.

2. **Not Comprehensive Analysis.** Although Wagner's hypothesis possesses the accumulating and explaining the crucial historical facts, it lacks a comprehensive analytical framework.

3. **Not Acceptable to Western Countries.** Wagner's version is based on an organic self-determining theory of the state which is not, however, at least accepted in most western countries.

4. **It ignores the Influences of War.** Wagner's hypothesis ignores the influence of war on government's spending activities which play a vital role in the public expenditure in modern times.

2. PEACOCK-WISEMAN HYPOTHESIS

This hypothesis of the growth of public expenditure was advanced by Peacock and Wiseman in the study of public expenditure in Great Britain during the period 1890-1955. It stresses the time pattern of public spending trends and highlights the fact that the increase in public expenditure does not follow any smooth and continuous trend but the increase in public expenditure occurred in step-like manner or in jerks. During this phase, some social or other disturbance takes place which shows the need of increased expenditure. However, the approach of the hypothesis is made of three separate concepts :

1. Displacement effect
2. Inspection effect
3. Concentration effect

Peacock and Wiseman observed that the relative growth of the public sector in Great Britain followed a discrete step-like pattern rather than a continuous growth pattern during the span of seven decades. Most of the upward steps in taxing and spending have taken place during period of major social disturbances. This has created a 'displacement effect' by which the previous lower tax and expenditure are replaced by new and higher budgetary levels. After the social disturbance has ended, the newly emerged level of

1. A.T. Peacock and Jack Wiseman, *The Growth of Public Expenditure in United Kingdom*.

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tolerance makes the society willing to support a higher level of public expenditure since the society realises that they are capable of carrying a heavier tax burden than it previously was. In this way, the public expenditure and revenue get stabilised at a new level and still another strong motivation exists which may compel the society to return to the old lower level of taxation. The higher government revenues are used, instead, to support a permanently higher level of public sector allocation.

This displacement effect does not require the new higher growth of expenditure should continue with the same expenditure pattern that was created by the social disturbance. In this way, the increased expenditures are partly direct result of disturbance while other expenditures frequently involve the expansion of government into new areas of economic activity. For instance, war and other social disturbances frequently force people and their government to find out the solution of problems which previously had been neglected. This is known as 'inspection effect'.

Thirdly, Peacock and Wiseman also described a concentration effect which refers to the apparent tendency for central government economic activity to grow faster than that of the state and local governments when a society is experiencing economic growth. Actually, concentration effect is closely related with the political set up of the country. In short, Peacock-Wiseman thesis of government spending trend is more convincing than Wagner's hypothesis. It does not claim to be an immutable economic law or principle but tries to point out some pivotal characteristics of the growth pattern in the industrial set up. Here, it must be remembered that there is natural course of advancement and structural changes in the economy which in turn leads to constant and systematic expansion in the public expenditure. Similarly, urbanisation, population expansion and awareness of the civil rights coupled with an awareness of state government towards duties lead to an upward movement of public expenditure. In this manner, this hypothesis is still description of a particular tendency and does not isolate all the relevant causes at work.

3. COLIN CLARK HYPOTHESIS OR CRITICAL-LIMIT HYPOTHESIS

Another hypothesis of the growth of public expenditure was put forward by Colin Clark in his *'Public Finance and Changes in the Value of Money'*. He called it as 'the Critical-Limit hypothesis regarding tax tolerance'. Colin Clark concluded his version on the inter-war empirical data of several western countries. According to his opinion, when the share of the government sector exceeds 25 percent of the total economic activity in the economy, inflation occurs even in balanced budget.

In this connection, Colin Clark opines :

- (a) When the government's share of the aggregate economic activity reaches the critical limit of 25 per cent, the community behaviour pattern changes and people produce less since incentives are harmed by the fact that increasing proportions of additional income must be paid in taxes under a progressive tax system.
- (b) People become less resistance to various inflationary means of financing government expenditure which in turn reduces the 'aggregate supply'. On the other hand, increased purchasing power tends to expand aggregate effective demand. Inflation results from maladjustment between demand and supply under conditions of high employment of resources.

In a nutshell, Colin Clark's hypothesis was welcomed in the business community while it failed to get any recommendations in academic circles. Its basic drawback is of choice of

Questions

- No 1 Distinguish between public Expenditure and private Expenditure.
- No 2 what do you mean by public Expenditure? Name the types of public expenditure.
- No 3 what do you mean by Public Expenditure? Discuss the types of public expenditure.
- No 4 what do you mean by public Expenditure? Discuss the causes of public expenditure.
- No 5 what do you mean by public Expenditure? Discuss the effects of public expenditure.
- No 6 what do you mean by public expenditure? Discuss the causes or growth of public expenditure. In regard to state activities.
a - wages law of increasing
b - Peacock-Wesern hypothesis.