



CHAPTER - II

: THEORY OF PUBLIC EXPENDITURE :

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CHAPTER - II: THEORY OF PUBLIC EXPENDITURE :2.1 INTRODUCTION:

Public expenditure is an important element of study in public finance. It is important because all other elements of study in public finance depend on the public expenditure. It is the public expenditure which makes us to study all other elements. Government performs various functions to achieve socio-economic objectives by rendering services and supplying public goods. Government requires expenditure to perform various functions. In absence of incurring expenditure, government cannot perform functions and achieve predetermined socio-economic objectives. Therefore, the study of public expenditure is inevitable in Public Finance.

2.2 MEANING OF PUBLIC EXPENDITURE:

Public expenditure refers to the expenditure made by the public authorities i.e. Central, State and local governments. Hence, an expenditure which is made by the government at all levels is called public expenditure. Public expenditure is a compound word, which is made of 'Public' and 'Expenditure'. The term 'Public' implies here government. The government may be Central, State or local. The term 'Expenditure' implies spending of money. Thus in simple words, public expenditure means expenditure made by State or government.

Basically a government undertakes public expenditure to satisfy collective wants which the people privately are unable to satisfy efficiently. A government, by satisfying collective wants of the citizens, tries to achieve pre-determined socio-economic objectives. Thus, the main object of public expenditure is to satisfy the collective wants of the people.

The careful study of the public expenditure helps us to draw an important conclusion, that is, public expenditure has been increasing rapidly and continuously. It is true in case of India also. The public expenditure of India has been increasing rapidly and continuously. The reasons of rapidly growing public expenditure are increased governmental activities, development of concept of welfare state, increasing defence expenditure, rapidly growing population, urbanisation, increasing demand for infra-structural facilities and civic amenities. As the public expenditure has been increasing, the other elements like revenue, public borrowing, taxation, deficit financing are also rising. Public revenue from taxation has been rising but not at to the required extent. Therefore, government has to depend upon public borrowing and deficit financing as an important source of public revenue.

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2.3 CANONS OF PUBLIC EXPENDITURE:

Prof. Findly Shirras in his famous book entitled " The Science of Public Finance " has given four canons of public expenditure¹.

1) Canon of Benefit:

This canon implies that the government expenditure should be beneficial to the maximum number of people of the society. The state spendings should confer benefits to the entire community at large rather than to an individual, group or sections. The government should spend funds in such directions which will be beneficial to the entire community. In brief, government spendings should derive maximum benefits.

2) Canon of Economy:

The economy canon of public expenditure suggests that, the government should use public expenditure carefully and economically on essential items of common benefits. It means public expenditure must be productive. The canon of economy implies that the government should avoid extravagance. It also suggests that the government should avoid avoidable public expenditure and should incur unavoidable expenditure to fulfil determined objectives.

1 Shirras F., The Science of Public Finance, p.42.

3) Canon of Sanction:

The canon of sanction is that no public expenditure should be incurred without the sanction of proper authority². The canon of sanction suggests that, public expenditure should not be undertaken without sanction by proper authority. The canon of sanction prevents misuse of funds and enforces canon of economy. The canon of economy diverts public expenditure from socially undesirable to socially desirable expenditure. It provides guide lines regarding how it is possible to fulfil maximum public wants with limited public revenue. This canon of public expenditure also prohibits extravagance and wastage of public revenue.

4) Canon of Surplus:

The canon of surplus of public expenditure suggests that, the government should avoid more spending than its revenue. It means the government should avoid deficit spending. The government should try to maintain surplus in the budget. The maintenance of surplus budget will help in reducing inflationary pressure in the economy.

But in the modern times the canon of surplus of public expenditure has lost its importance. The functions of government are increasing day by day, therefore, it is not possible to maintain surplus budget. The modern age is the age of deficit budget. Therefore, today, this canon has become useless and outdated.

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Ibid., p. 44.

Besides Prof. Shirras canons of public expenditure a few more canons are suggested by some economists. They are:

i) Canon of Elasticity:

The elasticity canon of public expenditure suggests that, government expenditure should be elastic. It should be fluctuating. It should change according to the changed circumstances of the country. The expansion and contraction in public expenditure should take place according to the requirements of the country. Elasticity of public expenditure is useful to the government to adjust public expenditure according to the changed conditions in the economy.

ii) Canon of Equitable Distribution:

The canon of equitable distribution suggests, public expenditure should be incurred by the government to reduce inequalities of income and wealth and should ensure equity in the distribution of wealth and income. To maintain equality in distribution, the government should give more benefits to the poor sections of the community. Maintenance of equality helps solving some socio-economic problems.

iii) Canon of Productivity:

The productivity canon of public expenditure suggests, public expenditure should encourage production of the country.

Public Expenditure should be directed towards only productive and developmental purposes. It implies that, the government should use public expenditure to increase national income, to generate employment opportunities and maximise the output of the goods and services in the economy. This canon is useful to raise the standard of living of the people.

2.4 HEADS OF PUBLIC EXPENDITURE:

The study of public expenditure enables us to study what the different heads of public expenditure are available. The study of heads of public expenditure enables us to trace the properties of public expenditure incurred on different heads of public expenditure.

Prof.H.Dalton has told different heads of public expenditure in his famous book " Principles of Public Finance"³.

1) Defence Expenditure:

It refers to the expenditure incurred by the government for the defence of the country. It implies the government's expenditure to protect country from war, foreign aggression and also to maintain external as well as internal peace. It includes expenditure to be incurred by the government on armed forces, production of weapons and armaments. It also

3 Dalton,H., Principles of Public Finance, p.143.

includes expenditure on maintaining internal peace. It includes expenditure on police force, home guards, semi-military force etc. It is essential expenditure because in absence of external and internal peace, it is not possible to start productive activities to increase employment, output and national income.

2) Administrative Expenditure:

It refers to the expenditure which is to be incurred by the government for the administration of the country. It implies expenditure of the government on the administrative agencies. Administration is also an important aspect of the activities of the government. Administration observes discipline in the country. Administrative expenditure includes expenditure on administrative officers, clerical staff and peons and others.

3) Expenditure on Machinery of Civil Government:

It refers to the expenditure to be incurred by the government on the members of the government. It includes expenditure on Ministers, Members of Lok Sabha, Members of Rajya Sabha, Members of Legislative Assemblies and Members of Legislative Councils. In brief, it can be said that, expenditure to be incurred by the government on the representatives of the government is called expenditure on machinery of civil government.

4) Ceremonial Expenditure:

It refers to public expenditure on various national and governmental ceremonies held in a country and also abroad. It includes expenditure on foreign guests, representatives, diplomates, Royal family members etc. It also includes expenditure on national festivals and ceremonies. The ceremonial expenditure is incurred by the government to maintain good international relations and also to celebrate and arrange national festivals and ceremonies.

5) Expenditure on Industrial Development:

Industrial development is the master key of economic development. The development of industrial sector develops other sectors of the economy. Therefore, it becomes the government's responsibility to develop industrial sector of the economy. At the same time, development of industrial sector also requires a huge amount of investment which cannot be made sufficiently by the people only. This expenditure includes investment in the basic and heavy industries, to provide basic or infrastructural facilities to establish industrial estates, to make provision of sale of industrial products etc. It is necessary expenditure because economic development of the country depends on this expenditure. This expenditure increases employment, output and national income.

6) Expenditure on Social Welfare Schemes:

Because of the origin of the concept of welfare state, the government requires to incur state expenditure. This expenditure is necessary to promote the social welfare of the country. It includes expenditure on various social welfare schemes. It also includes expenditure on providing social goods and services like health and medical facilities, education, pensions, unemployment doles, bonus, and other allowances. It also includes expenditure on schemes for specifically weaker sections of the population. This type of expenditure increases standard of living and promotes social welfare.

7) Expenditure on Public Debt:

The expenditure of the government has been increasing rapidly. But to that extent the revenue of the government has not been rising. Therefore, the government is using public debt as a source of public revenue. Expenditure on public debt includes expenditure on repayment of loans and advances, payment of interest and also the cost of management of public debt. Now-a-days, public expenditure on public debt has been rising rapidly and continuously.

2.5 SIGNIFICANCE OF PUBLIC EXPENDITURE:

Public Expenditure refers to expenditure of government at all levels. It is with the help of public expenditure the government is enabled to perform functions. Public Expenditure plays very vital role in the economy.

It provides public goods to the citizens and satisfies their public wants.

It has enabled the government to perform various different functions to achieve pre-determined socio-economic objectives.

It has enabled the government to protect the country and also to maintain internal as well as external peace.

It is because of public expenditure, the government has become able to develop industrial sector and there by promotion of the rate of economic development.

The Government has become able to introduce and implement new social welfare schemes to promote the social welfare of the community.

It has become possible for the government to reduce inequality of income and wealth and ensure equality because of public expenditure.

It has become possible for the government to eliminate the extent of poverty because of public expenditure.

It has become possible for government to cut-down expenditure of rich section of population on the luxurious goods. The government, to meet public expenditure, imposes more taxes on rich people and reduces their luxurious consumption.

It has enabled the government to undertake public enterprises to provide public goods.

It has enabled the government to provide civic amenities like health and medical facilities, water supply, street lighting, drainage, education facilities etc.

Thus, public expenditure has achieved unique position. It has helped the government to perform various functions and achieve pre-determined socio-economic objectives. It has been playing a vital role in the economy.

2.6 THEORY OF PUBLIC EXPENDITURE AS BASED ON THE CONCEPT OF PUBLIC WANTS:

Public Expenditure is the most important aspect of the study in public finance. Because the working of all other aspects depends on it. It has achieved a central position in the study of public finance. It is the public expenditure which makes us study all other elements. It will be useless and meaningless to study all other elements in absence of public expenditure. It is the public expenditure for which revenue

is collected and public debt is raised. The government can perform functions only with the help of public expenditure. It incurs public expenditure to provide public goods and services as to satisfy the social wants of the people. The main objective of public expenditure is to satisfy the public wants which cannot be satisfied by the people in their own capacity.

Public expenditure is an important fiscal instrument of the government to achieve pre-determined socio-economic objectives. In other words, it is only the public expenditure, an instrument of fiscal policy, can achieve the objectives of the government. Therefore, public expenditure should be so determined and allocated to increase the level of employment, output and national income. The government can create socio-economic overheads which are essential to increase the level of employment, output and national income by spending its funds on developmental activities. The developmental activities of the government can create and increase the extent of socio-economic overheads. The government undertakes public expenditure to satisfy social wants of the people. Therefore, modern economists like J.M.Keynes, R.A.Musgrave, A.P.Lerner have developed a scientific, precise and more comprehensive theory of public expenditure, which is based on the concept of public or collective wants.

Any government undertakes public expenditure to satisfy those wants which cannot be satisfied by people in their individual capacity. It is necessary to define the terms 'want' and 'public want'. 'Want' is defined as an experience of lack of satisfaction. Wants are divided into two types (1) private wants and (2) public or collective wants. The wants which are felt by an individual independently and also to be satisfied by him by consuming private goods are called as private wants. For e.g. food, cloths, entertainment, smoking etc. The peculiarities of private goods are product divisibility, principle of exclusion, private costs and benefits, payment and benefit simultaneously, payee and beneficiary identical, independent consumptions etc. They are satisfied through market mechanism by immediate paying prices of goods. In case of private wants, principle of exclusion is applicable.

There are some common wants which are to be satisfied collectively by the people are called collective or 'public wants'. The wants which are felt by the people collectively and also to be satisfied them collectively are called collective wants. In simple words, the wants which are satisfied by consuming public goods are called public wants. For e.g. need of defence, flood control, roads and transport etc.

The peculiarities of public goods are indivisibility of product, principle of exclusion is not applicable, joint consumption etc. Public wants are satisfied collectively and no one can be excluded from consumption. In case of public wants, price mechanism fails to work. These wants are felt by every one, but no one is ready to pay for these wants. Therefore, these wants are called as public wants and also they ^{need} government budget to satisfy them. The government satisfies these wants by making provision in the budget.

Public wants are divided into two categories e.g. (1) Social wants and (2) Merit wants. It is essential to explain these two concepts neatly and in detail. Social wants may be defined as the public wants which are satisfied by goods and services which should be consumed by all the society members in equal amount. The market mechanism cannot satisfy these wants because price mechanism fails to work. Social wants break down the working of market and price mechanism. These wants are satisfied by an individual independent of his own contributions. In case of social wants an individual is one among the other contributors. He can cover only a small part of the total cost of production of social goods. But, at the same time, these goods help in promoting social welfare as a whole. For e.g. defence,

flood control projects, sanitary campaign, judiciary system etc.

It becomes a problem how to satisfy social wants. Therefore, it becomes necessary to make provision for the government regarding the satisfaction of these wants. Tax collector by collecting tax bills cannot solve this problem. The responsibility of solving this problem ultimately falls on the economist. In other words, an economist can only solve this problem. An economist must take decision regarding what expenditure should be made, what taxes should be levied and how should the revenue be collected. For this it is necessary to take into account people's true preferences in social wants. The preference pattern will show the rate of satisfying social wants and private wants. On the basis of their preferences the government can make provision to satisfy social wants.

'Merit wants' is the second category of the public wants. Merit wants are different from social wants because these wants are partly satisfied through price mechanism in the market. These wants are basically private wants, but are so meritorious, therefore, they are called merit wants. In case of these wants resources should be allocated in response to the effective demand for these goods by the consumers. So they are so meritorious that their satisfaction

is made by the government through its budget. For e.g. milk is a common want of the people. But every person cannot buy milk which is available through market mechanism. Therefore, if large number of people live without milk it will affect adversely in the future. So the government supplies milk at lower price by taking its supply in its own hand. The milk can be supplied through price mechanism in the market, but it is not possible to buy it at existing market price to all the people. Therefore, the government has to enter into market to meet effective demand for it. And it becomes necessary to make provision for it in the budget. Thus, though the want for milk is a private want, it is so meritorious that it is satisfied through government budget only. Construction of employees' quarters or construction of houses for industrial labours also is an example of merit want. The government provides staying facility in these quarters at concessional rates or low cost. Thus in case of merit wants, the government supplies the goods and services at lower cost than their actual cost of production. In such cases the government bears some cost by providing them goods at low or subsidized prices.

The government takes decision regarding the allocation of resources to produce different types of goods. While taking such decisions, the government discourages production of such goods which satisfy the wants which are harmful to the health of man. e.g. liquor, charas, opium, brown sugar etc.

The government tries to use existing resources of the country to produce those goods which are necessary and have greater demand in the market. On the basis of consumers demand the government tries to supply goods and services. Sometimes, more consumption of a particular commodity also creates problems in the economy. e.g. increasing use of motor cars leads to air pollution. In such air pollution it also becomes necessary for government to interfere and take measures to prevent air pollution in the country.

The government has limited resources but has to satisfy innumerable wants of the citizens. It is true that all wants are important to satisfy from the point of view of an individual, but it creates a problem before the government how to allocate expenditure to provide different wants of the people. The first attempt regarding the allocation of expenditure and provision of such goods was made by a Swedish Economist Erik Lindahl. According to him the government should provide such public goods which are preferred by the consumers showing desire to contribute cost of production. For this he took two persons and two goods and explained the process of allocating public expenditure to produce public goods. The theory of Lindahl is based on two persons and two goods. It is very difficult to apply this theory in practice , because the theory of

two consumers and two goods cannot be applied to all consumers in the society. Therefore, it has less practical value.

Prof.P.A.Samuelson tried to improve Lindahl's analysis regarding the allocation of public expenditure to provide public goods. He took into account a mixed economy of both the private and the public sectors on the basis of general equilibrium analysis. In the mixed economic system, both the private and the public sector exist and simultaneously the production of both the public goods and the private goods takes place. But consumers do not reveal preference for public goods because it is an invitation to tax liability. In a democratic country the elected members have to take decisions regarding the supply of public goods by formulating budget. Therefore, it requires to incur expenditure to provide these goods to satisfy the public wants. The government incurs expenditure mainly to provide public goods.

An expenditure incurred by the public authorities to satisfy those common wants which the people are unable to satisfy in their individual capacity is called the public expenditure. The government incurs public expenditure to satisfy the public wants of people. A Municipality undertakes an expenditure to satisfy those wants which people cannot satisfy efficiently in their individual

capacity within a limited area or within a particular locality. It incurs expenditure for useful developmental schemes like local transport, and communication, drainage, water supply and sanitation, public health and medical arrangements, primary education etc. Thus, expenditure policy of the local governments should sufficiently and effectively promote economic growth by expanding infra-structural investment which has been called as Foundation Investment⁴.

Want is defined as an experience of lack of satisfaction. Wants are divided into two types private wants and public wants. Private wants are felt by an individual independently and are also to be satisfied by the same individual. Public wants are those wants which are felt collectively by the people and are to be satisfied by them collectively. Public wants are further divided into two categories social wants and merit wants. Social wants are felt collectively by the people and are satisfied by joint consumption of goods of equal amount. Municipalities meet social wants by erecting and maintaining a slaughter house, garbage, gutter cleaning, anti-malaria measures and public health facilities. The wants which Municipalities satisfy like fire brigade also come under social wants.

4 Singer, H.W., International Development, Growth and Change, p.48.

The local government of a Municipalities need to come forward to satisfy social wants by making provision in its budget because people do not come forward to satisfy social wants on themselves.

Merit wants are those private wants which are so meritorious on social and economic grounds that, those are to be satisfied by the government through budget in the market. The examples of merit wants are milk supply, transport and communication services, water supply, development of parks and gardens, development of markets, primary and higher educations etc. Municipalities spend a major portion of their revenue on medical and health services and education. Municipalities have neglected other services due to their insufficient funds. They have to depend on the State government for grants and other assistance, even to provide health and education facilities.

In the case of India, local bodies have to depend on the State government to meet expenditure due to insufficient finance sources available to them than their expenditure due to increasing activities. State governments have allocated maximum functions and minimum financial resources. Therefore, it is an urgent need to assign some new sources of revenue to local bodies which will help them to perform their functions by reducing undue dependence on State governments financial assistance and grants. ..

2.7 BRIEF REVIEW OF SOME RECENT STUDIES IN THE
FIELD OF PUBLIC EXPENDITURE:

In the field of empirical analysis of Public Expenditure two main questions are important in recent writings on Public Expenditure.

- i) The question of time pattern of Public Expenditure, and;
- ii) The question of divergence between nominal and real growth.

Empirical studies have shown that the concept of continuity (Wagner's law) and discontinutinitics or displacement effects (introduced by Peacock and Wiseman) are not mutually exclusive but overlap. Studies of Henning and Taussig,⁵ Ganti and Kolluri⁶ indicate that all modifications in the trends of Public Expenditure growth are discontinuous and they reflect changes in the causal relationship govering the process of growth.

As regards the question of divergence between nominal and real growth, the reasons for it were well put forth by Baumol⁷. Baumol argued that productivity growth had been

5 Henning, J.A. and Taussig, D.A. "Income Elasticity of the demand for Public Expenditure in the U.K.", 1974, Public Finance, Volume 29, No.3-4, pp.325-41.

6 Ganti, S. and Kolluri, B.R., "Wagner's Law of Public Expenditure: Some Efficient Results for the United States", 1976, Public Finance, Volume 34, No.2, pp.225-33.

7 Baumol, W.J. "Macro-economics of Unbalanced Growth: The autonomy of Urban Crisis", 1967, American Economic Review, Volume 57, pp.415-426.

slower in the Public sector than the private sector because of labour intensive nature of public utility services, tendency of public sector to be inefficient and wasteful. In addition labour costs also have gone up in both the sectors and this has caused the costs of public services to go up faster than the costs and prices of goods and services produced in the private sector. Following Baumol Beck⁸ made attempts by using the price deflator to empirical study the divergence between real and nominal growth of public expenditure by using official data.

In some of the more recent studies of the local bodies public expenditure growth, economists were mainly concerned with the impact of interest groups on the relative size of government. Economists tried to measure the strength of interest group and its impact on decision making of expenditure. The most frequently used public choice model in the studies of local government expenditure is the 'Median-Voter Model' which is developed by Bergstrom and Goodman⁹, Borcharding and Deacon¹⁰, Deacon¹¹ and Pommerchne¹².

8 Beck, M. 'Public Sector Growth: A Real Perspective', 1979, Public Finance, Vol. 34, No. 3, pp. 313-356.

Beck, M. 'Towards a Theory of Public Sector Growth', 1982, Public Finance, Vol. 37, No. 2, pp. 163-177.

9 Bergstrom, T.C. and Goodman, R.P., 1973 'Private Demands for Public Goods', American Economic Review, Volume 63, pp. 280-296.

10 Borcharding, T.E. and Deacon, R.F. 'Non-Federal Governments' 1972, American Economic Review, Vol. 62, pp. 891-901.

11 Deacon, R.T. 1978, 'A Demand Model for the Local Public Sector' 1978, Review of Economics & Statistics, Volume 60, pp. 184-192.

12 Pommerchene, W.W. "Institutional Approaches to Public Expenditure", Empirical Evidence of Swiss Municipalities", 1978, Journal of Public Economics, Vol. 9, pp. 163-201.

The median voter studies use the income of the median voter and adds the median voter's tax price which measures the cost to the median voter for one unit of the public good. The studies take into account the estimate of the progressivity of the tax structure and is used on the assumption that ceteris paribus, the more progressive the tax structure, the lower the relative tax price of the median voter and higher the expected size of the government expenditure.

Two more research studies developed which used the above median voter theorem and then seeked to explain the size or growth of local government. Both the studies assumed that all governmental activity involved only redistribution and the amount of redistribution is related to the skewness of the distribution of income. Meltzer and Richard¹³ argued that more redistribution takes place (and thus more governmental activity) the lower the income of the median voter, relative to average income. Further empirical studies by Verba and Nie¹⁴ have shown that in the total voting

 13 Meltzer, A.H. and Richard, S.F. 1981 ' A Rational Theory of the Size of Government ', 1981, Journal of Political Economy, Volume 89, No.5, pp.914-927.

14 Verba, S. and Nie, W.H. " Participation in America - Political Democracy and Social Equality " 1972, New York; Harper and Row.

population lower income groups tend to be disproportionately excluded for voting defacto is not dejure. Thus higher percentages of voters in the population means higher percentages of low income voters relative to high income voters and this leads to greater redistribution and therefore, larger government expenditure size.

Many economists following the work of Niskanen¹⁵ also argue that the strength of the bureaucracy is an important determining variable in the size of the government. The public bureaucracies have the ability to increase expenditure in one direction in which they are interested because of the strategic position they occupy in the operation of government activity.

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15 Niskanen, W.A. "Bureaucracy and Representative Government", 1971, Chicago, Aldine Atherton.