CHAPTER - 2

THEORETICAL INTRODUCTION TO PUBLIC EXPENDITURE

2.1 INTRODUCTION:

In this chapter an attempt is made to explain the theoretical background of public expenditure. The literature for theoretical base is mostly drawn from basic and widely used text books on public finance. This chapter covers meaning of public expenditure, difference between public expenditure and private expenditure, classification of public expenditure, effects of public expenditure, theories of public expenditure and significance of public expenditure.

2.2 MEANING OF PUBLIC EXPENDITURE:

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 is spending made by the public authorities i.e central government, state governments and other local bodies of a country on collective needs and wants such as education, health, infrastructure, pension etc. It is for protecting the citizens and /or for promoting their economic and social welfare. It means that public expenditure refers to all types of expenditure incurred by the government.

2.3 PUBLIC EXPENDITURE AND PRIVATE EXPENDITURE:

It is commonly admitted that there is a similarities between public expenditure and private expenditure. With regard to similarities between these two concepts, we can hypothesize that both public authorities and private units try to maximize returns per unit of expenditure. In other words, it is said neither the public nor the private individual likes to waste its expenditure without any return. It means each will try to attain maximum possible returns with the minimum possible expenditures. In case of public authorities, the aim is the social satisfaction that is maximised, and in the private individual, it is the personal satisfaction that is aimed at, though it may be harmful or wasteful to others. Any shortfall on this front will be on account of inefficiency, uncertainty, lack of foresight and similar other causes. Another point of similarity between the two is an element of flexibility in both types of expenditure. Of course, it is slightly more in case of public expenditure, since the sources of revenue are unlimited. In both the cases, there can be more than one way of raising additional income though it can be more conveniently done by the public authorities. The authorities can plan to raise the additional tax or non-tax revenue, or borrowing or even raising taxation in various forms, but the private units can raise additional income through sheer hard work or by borrowing from the market.

However, while public and private expenditures are similar in their overall and complex ramifications, the dis-similarities between them are also quite glaring. Some points of differences are given below:

1. Keeping in view the fact that the state is the guardian of the social welfare and economic and social health of the society, thus, public expenditure is made for social benefits like education, relief to the poor public health etc. Another important point is that the provision

for many public services is not decided on the basis of their cost effectiveness, while private expenditure is limited to personal level.

2. Public expenditure is more elastic than private expenditure. In case of public expenditure, it is planned first and then sources of finance are found. However, in case of individuals sources of revenue are located first, then income is estimated and then expenditure is planned. In the words of Hugh Dalton, " It is true to say that, while an individuals income determines the amount of his possible expenditure, a public authority's expenditure determines the amount of its nessesory income. In other words, while an individual adjust expenditure to income, a public authority adjusts income to expenditure." [1]
3. Objectives are different for public and private expenditure. Public expenditure is not based on profit motive whereas private expenditure is strictly based on the motto of maximum profit. The objectives of public expenditure are now far wider than imagined earlier, maximisation of social advantage is the major goal of public expenditure.
4. The benefits of public expenditure cannot be measured by any measuring rod. However, benefits from private expenditure can be measured by marginal revenue and marginal cost principle. Though Dalton attempts to apply the same principle (The principle of maximum social advantage[2]) to public finance activities, it is unrealistic to do so. It means that welfare achieved through public expenditure can not be quantified.
5. Public expenditure is influenced by various politically motivated and social aspects while there is no such consideration or influence on private expenditure. According to Mrs Ursula Hicks, " The activities of the public sector are determined primarily by political

considerations, which are a datum for the economic system, either private or public."[3]

2.4 CLASSIFICATION OF PUBLIC EXPENDITURE:

It is difficult to handle large masses of data conveniently unless they are properly clssified. A good classification is useful for comparative study and helps further analysis and research. According to R. N. Bhargava, " A good classification should satisfy at least two tests. Firstly, the classes should be mutually exclusive so that data can be allocated to one class only. This will make the classification exact. Secondly, the basis of classification should be a necessary attribute of the object classified. This will make it scientific and sensable."[4] Classification of public expenditure refers to the systematic arrangement of different items of state's expenditure on some scientific and economic basis. It helps to distinguish between the nature and effects of different kinds of public expenditure.

The classification of public expenditure plays a pioneer role in order to know the relative importance of each head of expenditure at different times. Thus, a proper classification and explanation of different items of public expenditure is imperative and prerequisite. Following are the basis on which public expenditure can be classified:

1. Benefit as the basis of classification –

Carl C. Plehn [5] classifies public expenditure on the basis of benefit into the following four categories:

(i) Confers a common benefits on all citizens – expenditure on education, health, defence, general administration, developmental expenditure, etc, which benefits all.

(ii) Confers a special benefit on certain classes – expenditure on poor relief, expenditure on justice, police protection to weaker sections, etc.

(iii) Confers both a special benefit on certain persons and a common benefit on all others -- expenditure on unemployment benefits, old-age pensions etc.

(iv) Confers only special benefit on individuals – expenditure on state industries or subsidy given to particular industries.

2. Functional classification –

Adam Smith [6] classified public expenditure accroding to the functions of government. This classification is based on a classification of various functions actually performed by public authorities. Charles F. Bastable also supported this classification. His classification is as under:

(i) Protective expenditure: expenditure on police, judiciary and defence.

(ii) Commercial expenditure: it consists expenditure incurred on the commercial activities like rail, roads, highways etc., which are taken by the government in the public interests.

(iii) Developmental expenditure: expenditure on social and economic development of the country like the expenditure made on providing education, health, public facilities to the community. This type of expenditure develops the resources of the country.

3. Classification on the basis of revenue –

J. S. Nicholson[7] classified public expenditure according to the amount of revenue the state realises in return for the services which it performs through public expenditure. He has divided public expenditure into following heads:

(i) Expenditure without direct return of revenue, i.e. on poor relief.

(ii) Expenditure without direct return, but with indirect benefit to revenue, i.e. on free education.

(iii) Expenditure with full return of revenue or even profit, i.e. on post office, railways, etc.

4. Purchase price and grants –

Dalton[8] classified public expenditure into grants and purchase price on the basis of whether or not the government gets any service in return of the expenditure. When the state incurs expenditure and gets some commodity or service in return, the expenditure is a purchase price, for example, salaries of government employees and price paid for purchasing furniture, etc. However, the state incurs expenditure and does not get any commodity or service in return, the expenditure is classified as a grant, for example, grants to educational institutions, relief to the poor, etc.

5. Transfer and non-transfer public expenditure –

A. C. Pigou[9] has classified public expenditure into two parts as- transfer expenditure and non-transfer expenditure. Transfer expenditure implies only a transfer, from the state to the recipient, of command over commodities and services. In this type of expenditure, there are no returns to the governments, for example, expenditure on grants, pensions, interest, payments, social security, etc. In this case, there is no involvement of goods or services in the public expenditure. However, expenditure involving the use of goods and services is known as non-transfer or real expenditure. For example, expenditure incurred on maintenance and building of the army, educational services, post offices, etc, is included in the non-transfer public expenditure.

6. Productive and unproductive expenditure –

This distinction emphasizes that while some expenditures are in the nature of consumption, others are in the nature of investment. Investment expenditure helps the economy in improving its productive capacity. Some expenditure of government bring income to the government. It will create some tangible assets in the economy and enable it to produce more in future. This expenditure is called productive expenditure, for example, expenditure on infrastructure. On the other hand, some expenditure do not create an asset which can bring returns or income to the government, for example, expenditure on administration, defence, justice, law and order and maintenance of the state are unproductive expenditure.

7. Economic classification –

Economic classification refers to the resources allocated by government to various economic activities. It involves the public expenditure by distinguishing current expenditure and capital outlays. Public expenditure is classified into two heads i.e. revenue and capital. The difference between revenue and capital expenditure is the difference between expenditures that result in the creation of new assets and those which do not. In India, revenue expenditure includes all current expenditure on administration, defence and public commercial undertakings like railways, post and telegraphs, grants-in-aid, etc. Broadly speaking, expenditure which does not result in creation of assets is treated as revenue expenditure. A capital expenditure may be defined as any expenditure other than operating expenditure. It is the expenditure which is intended for creating concrete assets of a material character in the economy, for example, expenditure on all capital transactions.

8. Developmental and non-developmental public expenditure –

Government expenditure can be classified into developmental and non-developmental expenditure. Developmental expenditure comprises expenditure on economic services, social services and community services and on grants to state and local bodies to perform developmental functions. Non-developmental expenditure, on the other hand, comprises expenditure on civil services, interest payments, public debt servicing, expenditure on collection of taxes, stationary and printing and other expenditure on general services.

9. Plan and non-plan expenditure –

Government expenditure can also be classified into plan and non-plan expenditure. The distinction between them is purely an administrative classification and is no way related to economic or national accounting principles. Plan expenditure refers to the expenditure incurred by the central government on programmes or projects, which are recommended by the planning commission. It comprises current development and investment outlays. On the contrary, non-plan expenditure is a generic term used to cover all expenditure of government, not included in the plan. It includes both developmental and non-developmental expenditure. There are special responsibilities of the central government like external affairs, currency and mint and the expenditure incurred in this connection are treated as non-plan expenditure.

2.5 EFFECTS OF PUBLIC EXPENDITURE:

Public expenditure is a very important fiscal weapon to achieve increase in production, equitable distribution of income and wealth, economic stability and growth. Ideas regarding the effects of public expenditure have varied over time. Under the impact of laissez-faire, the functions of the state were only of regulatory nature. Adam Smith advocated that government expenditure was normally as a waste. The study of public expenditure neglected during the eighteenth and nineteenth centuries. However, the fact that the market mechanism failed in many respect to bring about the desired results in the economy. Today, new concept of public expenditure has been developed by the modern economists. 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. There is intricate relationship between the government sector and the rest of the economy which spells out different possible effects of public expenditure. It can be described as under:

1. Effects of public expenditure on production-

The character and volume of public expenditure are bound to have some effects on the pattern and amount of production in a country. Public expenditure can help the economy in numerous ways in attaining higher level of production and growth. It helps to increase the productive capacity of a society. It may help to build up new industries through state patronage.

According to Dalton,[10] effects of public expenditure depend on three factors as follows:

(i) Ability to work, save and invest – efficiency effects;

(ii) Willing of people to work, save and invest – incentive effects;

(iii) Effects on diversion of economic resources as between different uses and localities – allocative effects.

Increase in public expenditure on social and economic services will increase the efficiency of persons to work. Expenditure on providing certain services such as education, health, social security measures to the society increases their ability to work more efficiently and thus increases production and productivity. Expenditure of the government on wages, salaries and pensions and above items will increase income of the people and that raises the ability of the people to save and invest. Public expenditure on infrastructural facilities increases the ability of entrepreneurs to invest. Conditional public expenditure, such as increase in benefits from public expenditure linked to hard work or more saving and more investment leads to favourable effects on the economy. It will increase willingness to work more, save more and invest more. Government expenditure may induce people to divert their resources to more productive uses. Conditional grants and loans to private producers, quality control schemes, etc., may bring about desirable diversions of resources. Such expenditure increases productivity with beneficial effects on total output.

2. Effects of public expenditure on distribution-

Public expenditure is a powerful tool in the hands of the government to bring about equitable distribution of income and wealth. It tends to reduce inequalities and helps to maintain income and employment of the relatively poorer sections of the community. It is helpful to increase opportunities for them through the provision of education, public health and medical services. Planned expenditure policy of the government can bring the desired results. Compensation to workers in the case of accidents and sickness, expenditure on employment exchanges, distribution of essential goods through subsidised fair price shops, provision of free education, promoting industries in the backward regions, promotions of small scale industries through various schemes are the type of public expenditure, which can secure distributive justice to the weaker section of the community. Prof. Dalton [11] advocated progressive public expenditure. Public expenditure is progressive if it is incurred on the activities which adds to the real income of poor lots in the country. Such expenditure has favourable distributional effects.

3. Effects of public expenditure on economic stability-

Economic stability refers to stability in national income, employment and general price level. During periods of depression, increase in public expenditure helps to sustain income, output and employment levels in a country. Public expenditure can create additional employment and maintain effective demand to ensure price stability. Keynes introduced the concept of the 'investment multiplier' to explain investment and employment. Public expenditure with multiplier effect can help to affect the decreased demand, and investment in public works leads to maintaining of stability in a country. Public expenditure can also help in curbing inflationary conditions prevailing in the country. Inflationary pressure can be reduced by reducing unproductive expenditure on civil services. Under such circumstances the public expenditure should be incurred on those projects which raise sufficiently the volume of production within a short time.

4. Effects of public expenditure on economic development-

In underdeveloped and developing countries the state has assumed, in accordance with the spirit of the age, responsibility for rapid economic development. Public expenditure has to play an active role in reducing regional disparities, developing economic and social overheads, growth of capital goods industries, research and development etc., in developing countries. Public expenditure on economic and social overheads assists the productive processes in the economy. In a developed economy, public expenditure maintains a smooth rate of economic growth in order to get the stabilization and stimulation of economic activities. Prof. Mrs. Ursula Hicks[12] points out that 'an increase in public expenditure will always tend to have an expansionary effect.' The construction of roads, railways and means of communication helps to increase production, trade and commerce. Public expenditure can be used to raise the agricultural production and reducing regional disparities. Subsidies can also help to promote import substitution. Expenditure on education, public health and medical services ensures that the working force is more cultured, healthier and efficient. The total effects produced by public expenditure depend upon the volume of public expenditure.

2.6 THEORIES OF PUBLIC EXPENDITURE:

Historically, public expenditure has recorded a continuous uptrend over time in almost every country. However, traditional thinking and philosophy did not pay much attention to frame and theory regarding the increase of public expenditure. It considered market mechanism as a better guide in working of the economy and allocation of its resources. However, in 20th century the modern state is termed as welfare state in which the government has enormous functions to perform.

Theories of increasing public expenditure can be classified into two parts as: (1) General theories of public expenditure, and (2) Pure theories of public expenditure.

1. General theories of public expenditure:

There are two important and well-known theories of increasing public expenditure which are as follows:

(i) Wagner's law of increasing state activities;

(ii) Wiseman-Peacock hypothesis

Wagner's law of increasing state activities-

Adolph Wagner (1835-1917) was a German economist who based his Law of increasing state activities on historical facts, primarily of Germany.

He believed that there is a functional cause and effect relationship between the growth of an economy and the relative growth of public sector. The law states that the development of an industrial economy will be accompanied by an increased share of public expenditure in GNP. In his famous 'Law of increasing 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.'[13]

According to Wagner, there are inherent tendencies for the activities of different layers of a government to increase both intensively and extensively. Wagner's hypothesis was supported by the famous economist F. S. Nitti. He concluded with empirical evidence that this 'law' was not only applicable to Germany but to various governments which differed widely from each other. All kinds of governments irrespective of their type of governments (say, the central or state governments), size had shown the same tendency of increasing public expenditure. It means that Wagner's hypothesis of increasing state activity has enlisted two major points, i.e. intensive increase in state activities; and extensive increase in state activities. Intensive increase refers to expansion of the traditional activities and extensive increase refers to the increase in the new activities of the state. According to Wagner hypothesis, there are traditional and new activities of the state which are responsible for persistent increase in public expenditure. Traditional activities are defence, maintenance of law and order in the country, construction and maintenance of roads and railways, and provision of education to the people. New functions of the state are encouragement to industry, agriculture and labour, promotion of public welfare through welfare measures, extension of control over the economy, urbanisation. Wagner admitted that continuous extension of economic and social activities was the basic reason of the relative growth of public expenditure.

Wagner's hypothesis is criticised by Allan T. Peacock and Jack Wiseman on the following grounds: it lacks inter-disciplinary relationship, it lacks comprehensive analytical framework, it is not the accepted theory in the west countries and it ignores the influences of war.

Wiseman-Peacock hypothesis-

This hypothesis of the growth of public expenditure was put forth by Wiseman and Peacock in their study of public expenditure in Great Britan for the period 1890-1955.[14] It highlights the fact that public expenditure does not increase in a smooth and continuous manner, but in jerks or steplike fashion. During this phase, some social or other disturbances takes place which shows the need of increased expenditure as the existing revenue could not meet the situation.

Wiseman and Peacock observed that the relative growth of the public sector in the United Kingdom followed a discrete step-like pattern rather than a continuous growth pattern. The step by step like spending took place in United Kingdom in a period of major social disturbances which creates a 'displacement effect'. The movement from the older level of expenditure and taxation to a new and higher level is the displacement effect. After the social disturbance is over, the new levels of 'tax tolerance' make the society to support a higher level of public expenditure. The inadequacy of the revenue as compared with the required public expenditure creates an 'inspection effect.' War and other social disturbances frequently force the government and the people to review the revenue position and the need to find out the solution of problems which previously had been neglected. Wiseman-Peacock also mentioned a 'concentration effect' which refers to the tendency for central government economic activity to grow faster than that of the state and local governments. Moreover, concentration effect is closely connected with the political set up of the country.

2. Pure theories of public expenditue-

The pure theories of increasing public expenditure can be further classified into three parts- Pigou's ability to pay, benefit analysis and Samuelson theory.

Prof. A. C. Pigou[15] in his chapter V 'Range of Government Expenditure' in *A Study in Public Finance* gave the most comprehensive treatment to ability to pay theory in the determination of optimum level of public expenditure. According to him, the optimum amount of government expenditure is determined at the point at which the satisfaction obtained from the last money spent is equal to the satisfaction lost in respect of the last money. The optimal determination of public expenditure on the basis of benefit principle finds its clear statement in the voluntary exchange theory of Swedish Economist Erik Lindahl. According to his theory, determination of public expenditure and taxation will happen on the basis of public preferences which they will reveal themselves. Samuelson's pure theory of public expenditure goes back to Italian and Australian writers who are responsible for the renaissance of the benefit approach. It solves two problems under the assumptions of given preferences and distribution of income.

2.7 SIGNIFICANCE OF PUBLIC EXPENDITURE:

The study of public expenditure plays an important role in public finance. It is because the government can not perform functions and achieve predetermined socio-economic objectives without incurring expenditure. It has assumed an important place in every country, whether developed or developing. If the state wants to perform any activity it must incur some expenditure in kind or currency and hence the need for expenditure come first. Earlier writers were generally opposed to increasing public expenditure. At that time, government was treated as an administrative institution concerned with protective and police functions and not with developmental services. In recent times public expenditure has increased enormously and the field of public activities has greatly expanded.

Thus, public expenditure has acquired great importance in modern times for two reasons i.e. increase in economic activities of the state and effects of nature and volume of public expenditure on the economic life of the country- on production, distribution and the general level of economic activity. In order to achieve rapid economic development, the public expenditure must be incurred.

The following are the most important ways in which public expenditure can achieve economic developemnt in the underdeveloped countries-

1. Social and economic overheads – The main obstacle in the way of socio-economic development of underdeveloped countries is the lack of social and economic overhead facilities. Lack of transport and communication facilities, poor education and health, electricity, irrigation etc., do not allow industries to develop. Thus, it becomes the responsibility of state to provide these socio-economic overhead facilities in the underdeveloped countries. Public expenditure directed to develop socio-economic overhead facilities will attract industries to develop and will enhance the productive capacity.
2. Public health and family planning – The development and maintenance of public health services is an important function to be perfomed by the government. Public expenditure may be directed to draw up schemes for family planning on one hand and to take care of maternity welfare and healthy development of infants.
3. Capital formation – The rate of capital formation in underdeveloped economies is highly inadequate as compared to their investment requirements. Public expenditure in a developing and under-developed economies can play an important role in increasing the rate of capital formation.
4. Optimum allocation of resources – In most of the underdeveloped countries natural resources are not only underutilized but misutilized. Public expenditure can initiate a change in allocational arrangements

through subsidies and concessions and public investment programmes can correct mal-allocation of resources and achieve better utilisation of productive factors.

5. Balanced regional development -- The development of under-developed countries is unbalanced and lop sided. Public expenditure can remove this unbalanced development if it is directed to open up avenues of industrial growth and improved agriculture in the backward regions.

6. Agricultural development -- In developing countries majority of people depend upon agriculture for their livelihood. If the agriculture remains backward, the other sectors of the economy cannot develop because agriculture is the basic industry. Public expenditure can greatly influence farming technique and productivity. If government funds are used to provide irrigation facilities, supply of improved seeds, fertilizers, etc., productivity and incomes of the people can be greatly enhanced.

7. Industrial development – Economic development cannot proceed without some basic industries like steel, cement and engineering goods etc. The development initiated by these industries opens up large employment opportunities. Government can provide cheap credit facilities, tax rebate, cheap power, water, transport facilities for industrial development.

8. Removal of inequalities – To reduce vast inequality of incomes, public expenditure can be used to implement some poverty removal programmes while building up community assets at the same time.

9. Social security measures – Public expenditure is a powerful tool in the hands of the government to provide social security measures to weaker sections. The provision of old age pension, unemployment benefit, accidental benefits, sickness and disability benefits etc., are the social security measures. It will help to bring a sense of security which is a very important factor of productivity.

10. Self reliance – Underdeveloped countries are dependent on foreign trade for their development projects. Self reliance is must for these countries. It implies creating a strong industrial base. Government has to play major role to achieve this objective for rapid economic development.

In these various ways; public expenditure can greatly influence economic development of the underdeveloped countries.

2.8 FISCAL RESPONSIBILITY AND BUDGET MANAGEMENT:

The Parliament of India has enacted the Fiscal Responsibility and Budget Management Act, 2003 (FRBMA) to institutionalise financial discipline, reduce fiscal deficit and improve overall management of the public funds by moving towards a balanced budget. The main purpose was to reduce the fiscal deficit and revenue deficit so as to eliminate revenue deficit by March 31, 2008 and thereafter build up adequate revenue surplus.

The main objective of the act was to aim for fiscal stability for India in the long run. The important feature of this act was the central government to lay in each financial year before both the Houses of Parliament three statements along with the annual budget viz., Medium Term Fiscal Policy Statement, Fiscal Policy Strategy and Macro-economic Framework Statement.

Following the enactment of FRBM Act, Government of India constituted a Task Force headed by Dr. Vijay Kelkar. The main purpose of this Task Force was to draw up the medium term framework for fiscal policies to achieve the FRBM targets. The Task Force recommended a path of fiscal adjustment that is reform efforts on revenue expenditure and capital expenditure. The Task Force estimated that under the reforms scenario recommended by it, total expenditure would come down to 14.3 per cent of GDP by 2008-09 from 15.4 per cent of GDP in 2003-04 (Revised Estimates). Fiscal deficit was estimated to come down from 4.8 per cent of GDP in 2003-

04 to 2.8 per cent of GDP in 2008-09. A revenue surplus of 0.2 per cent of GDP was estimated in 2008-09.[16]

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