
UNIT 10 PUBLIC EXPENDITURE: THEORIES AND GROWTH

Structure

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10.0 OBJECTIVES

After studying this unit you should be able to:

- evaluate the various theories and approaches by different schools of thought regarding the determination of public expenditure;
- explain how public expenditure policies and measures affect different aspects of the economy;
- trace the growth of public expenditure in India and analyse it with the help of theories discussed; and
- highlight the recent trends in public expenditure policies in India.

10.1 INTRODUCTION

Consistent with the earlier concept of state as a police state, minimum expenditure by it was considered to be the best level of expenditure. The analysis of public expenditure was not, therefore, recognised as a worthwhile field of economic research. Public finance concentrated on the study of public revenue and issues relating to taxation rather than the expenditure therefrom. In the post Second World War period, there has been a phenomenal increase in the level of government or public expenditure both in absolute terms and also in relation to the national income. There has, therefore, been a great amount of scholarly interest in understanding the causes of public expenditure, and its incidence, that is, who benefits from the various components of public expenditure. The major area of concern has been to channelise public expenditure into those areas of the economy where its effects will be optional in terms of growth, consumption and distribution. More recently, however, serious concern has been voiced regarding the effective utilisation of government funds and the paramount need to avoid wasteful expenditure. A correct perspective on Central Government expenditure, reasons for its massive growth, pattern and direction of its increase, effects on the economy, recent trends and the need to control it, are issues which are central to the understanding of financial administration. These are precisely the issues which will be examined in this unit.

10.2 DETERMINANTS OF PUBLIC EXPENDITURE

Various theories have been formulated during the last three decades to explain different aspects of public expenditure. As said in Section 10.1 the analysis of trends in public expenditure and its determinants caught the attention of researchers for the past few years. In spite of all these attempts, no comprehensive theory of public expenditure has been developed.

Let us now discuss some of the important theories which seek to explain the factors that determine increasing public expenditure.

Marginal Utility Approach

This is one of the important theories developed in the 1920s which suggested an economic approach to determine the composition of expenditure and budgeting. According to this theory, the government spends its limited income on alternative services in such a way that the marginal benefit is the same on all items. Just as an individual, in order to satisfy his/her wants, spends in a manner to achieve a certain balance among different types of expenditure which would ensure, some marginal return of satisfaction from all of these. According to Pigou, "Expenditure should be so distributed between battleships and poor relief in such wise that the last shilling devoted to each of them yields the same real return." The same principle has been restated by Dalton thus "Public expenditure should be carried just so far that the marginal social advantages of expenditure in all directions are equal and just balance the marginal social disadvantages of all methods of raising additional public income".

Though the principle of maximum social advantage is quite attractive in theory, there are practical problems in making it operational. Firstly, it is not easy to quantitatively measure the benefits flowing from diverse items of public expenditure for instance, expenditure incurred on defence and social security.

Secondly, this theory cannot be subjected to a test. Evaluation of activities of the government is difficult due to the vast array of services and goals of the government and absence of an acceptable measure.

Thirdly, it is not only the level of present satisfactions of the 'Community' that a government will be concerned with. The future interests of the community are also important.

Fourthly, what the community can afford also depends on how the money is raised and how it is spent. Expenditure on unnecessary wars or departments of the government may result in social disadvantages. Expenditure on sustaining loss-making public enterprises with a social service content may, on the other hand, be easily justified.

This principle is thus, at best, applicable to the use or distribution of a fixed sum rather than as a standard for determining the total size of public expenditure.

Public Goods Approach

Public goods are those for which no private mechanism exists for providing them and which are consumed in equal amounts by all. People who have not paid for them cannot be excluded from their enjoyment, e.g. public parks or security. Public goods usually correspond to all goods and services provided by government and include a wide variety of goods and services. The demand for such public goods becomes an important element in the determination of public expenditure.

Public Choice

The recognition of the importance of the political processes in revealing public preferences has, in due course, contributed to the growth of "public choice" theories. Anthony Downs offered useful analysis of these political processes. Downs' theory, which was based primarily on the US systems, provided a general framework for explanation of public expenditure. In democratic societies, it is held, governments determine revenues and expenditure to maximise their chances for winning the election. The budgeted expenditure is determined not with reference to overall spending and taxation but through a series of separate policy decisions based on estimates of gains and losses of votes. According to Downs, government will provide what voters want and not necessarily what is beneficial. Thus the central reality for governments is the citizen's vote and not his welfare. In order to fulfil voters' demands, promises made at election time, their aspirations for projects or services, the expenditure has to expand making for larger government, larger bureaucracies, bigger budgets and more problems in trying to find resources for financing the budgeted expenditure.

Positive Approaches

The positive approaches are concerned with the actual growth of public expenditure over a period of time and deal with the formulation and verification of hypothesis. These include:

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Wagner's Law

The earliest theory advanced is that of Adolph Wagner in 1876 which came to be known as "Wagner's law". He propounded the "Law of increasing expansion of public and particularly state activities" which is referred to as the "law of increasing expansion of fiscal requirements". The law suggests that the share of the public sector in the economy will rise as economic growth proceeds, owing to the intensification of existing activities and extension of new activities. According to Wagner, social progress has led to increasing state activity with resultant increase in public expenditure. He predicted an increase in the ratio of government expenditure to national income as per capita income rises. It is the result of growing administrative and protective actions of government in response to more complex legal and economic relations, increased urbanisation, and rising cultural and welfare expenditures. Another reason is the decentralisation of administration and the increase in the expenditure of local bodies.

According to Musgrave, however, it is not fruitful to seek an explanation for the total expenditure. Tests carried out by various researchers have shown that the increase in expenditures is far more complex than is evident from the tests carried out on empirical data. Therefore, according to Musgrave, it may be far more rewarding to adopt a desegregated approach (an approach which divides the study of expenditures of government) through a study of expenditures of government on capital formation, consumption and transfer payments.

Displacement Effect Hypothesis of Peacock and Wiseman

Peacock and Wiseman based on a study entitled "The Growth of Public Expenditure in the UK, 1961", provided an explanation to fluctuations in public expenditure over time. The hypothesis put forward is that public expenditure grows due to growth in revenue. During settled times, people can be expected to develop notions of acceptable rates of taxation. This can be known as the tolerable level of taxation and this level cannot be high. With real economic growth, the more or less stable level of taxation will produce increasing amounts of revenues as well as expenditure. This, however, does not explain the relative increasing growth in public expenditure.

Large scale social disturbances, like wars, influx of refugees change the tolerance limit of people to the burden of taxation which arises as a result of increased spending. The result is called a "displacement effect" which shifts expenditures and revenues to new higher levels. So a displacement effect is created when the earlier lower tax and expenditure levels are displaced by new and higher budgetary levels. Even after the event is over, new levels of tax tolerance change and the society feels capable of carrying a heavier tax burden. The level of public expenditure does not return to the low level it was before the event.

According to Buchanan "the single best explanation for tremendous growth in the public sector of the economy and also for the increased concentration of expenditure in the federal government is provided by the predominant importance of expenditures, direct or indirect made necessary by wars and threats of war". While war and military expenditures are the most important factors responsible for an increase in public expenditure, other "social upheavals" and natural calamities like droughts, famine and earthquakes cause a substantial upward shift in public expenditure. These events create new emergency demands on government — new social welfare schemes, war pensions, etc., which were not affordable previously all leading to maintaining the level of expenditure after social upheavals.

Distribution

usually has the important policy objective of securing better distribution of income for the less fortunate citizens. A reduction in inequalities of income can be achieved through a progressive tax structure, public distribution system, social security programme, large scale transfer payments e.g., pensions, etc. Social welfare programmes aimed at reducing rural and urban poverty programmes involve large scale outlays at least till such time as a minimum standard of living is assured to all.

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outlined above do throw light on the determinants of public expenditure. It is possible to lay down a law which will explain the

behaviour of public expenditure in different environments. The factors that have so far influenced public expenditure are environmental, technological, economic, administrative and political in nature.

Check Your Progress 1

Note: i) Use the space given below for your answers.
ii) Check your answers with those given at the end of the unit.

1) What are the practical problems involved in the marginal utility approach?

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2) Explain public choice theory as a determinant of public expenditure.

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3) Discuss Peacock-Wiseman hypothesis on public expenditure.

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10.3 IMPACT OF PUBLIC EXPENDITURE

Public expenditure diverts economic resources into channels determined by the government in accordance with national objectives and public policy. As a consequence, the scale and direction of public expenditure may affect the

- pattern and levels of consumption of the community
- volume of production
- allocation of resources
- distribution of incomes
- levels of prices and employment.

These effects are discussed below:

Consumption

Public expenditure enhances the quality of life of people by providing recreational, cultural, educational and public health facilities, such as public parks, playgrounds, libraries, educational institutions, hospitals and dispensaries and scientific, cultural and commercial exhibitions. Consumption, after all, is the end objective of economic activity of individuals. By promoting the level of economic activity and a more equitable distribution of income, the state can bring about a greater sense of social and economic security in the lives of individuals. The government enables them to live a fuller and richer life.

Allocation of Resources

Public expenditure allocates resources in accordance with national priorities. The priorities may be defence, agricultural production and self-sufficiency in food, industrial development, generation of employment opportunities, an equitable distribution of income, balanced regional development, population control, a better ecological

balance etc. Public expenditure in these areas is bound to raise the community's productive power. According to Dalton "increased public expenditure in many of these directions is desirable in order to bring about that distribution of the community's resources between different uses, which will give the best results, balancing without bias the present and future".

Changes in national priorities, from time to time, will be reflected in the pattern of public expenditure. Again, resource allocation has to take into account the balance between present needs and future requirements. Apart from imparting a sense of fairness as between generations, projects with long gestation periods can be undertaken only by the state. Hence allocation has to keep in view the fact that market economy cannot always take care of social needs. These can be taken care of only by the state.

Production

The roles of private and the public sectors are complementary. The public sector provides the infrastructure, transport and communications, power, education and public health programmes. In the absence of goods and services provided by the government sector, private sector can hardly make any meaningful contribution towards production and development. According to Dalton, other things being equal, taxation should not adversely affect production and public expenditure should increase it as much as possible. Public expenditure can affect (i) the ability to work, save and invest, (ii) the desire to work, save and invest, and (iii) allocation of resources as between different uses. Public expenditure can influence these factors either favourably or unfavourably.

The economies of developing countries cannot make significant progress unless they concentrate on development of investment goods sector. This may not result in production in the immediate future, as in education and health programmes, infrastructural projects and projects with long gestation periods. This would, however, certainly build up growth potential in the economy, and help take the economy to a self-generating level.

Distribution

In Dalton's words, "other things being equal, that system of public expenditure is best, which has the strongest tendency to reduce the inequality of incomes." A system of grants and subsidies is equitable in the measure in which it is progressive. This leads to maximum social benefit. An approximation to this principle would be provided by a system of grants which would bring all incomes below a certain level to that level (say, above the poverty line), without adding anything to incomes above that level. A public distribution system which makes available essential commodities at subsidised prices to the poor, will also achieve the same result. Free provision of services to all members of the society e.g., free health service or free education, "narrows the area of inequality". Social security measures and social insurance schemes, which are helped partly or wholly from public funds, e.g. oldage pensions, sickness and maternity benefits, unemployment relief, industrial injury compensation, widows pension etc., improve distribution by reducing inequality of incomes.

Economic Stabilisation

Business activity in an economy is usually characterised by fluctuations of a cyclical nature. A boom in the economy may burst and lead to a depression. While during boom, prices rise beyond the reach of common person, spelling misery. During depression, employment and production levels fall drastically causing colossal damage. During depression, when employment, production and national income start declining, government can undertake compensatory spending. This may imply heavy public works programmes so that employment and incomes may pick up leading to economic recovery. During boom, public expenditure should be strictly curtailed, leading to surplus budgets. During depression, public expenditure policy would lead to heavy outlays on public works; expenditure would thus be in excess of revenues, leading to deficit budgets. Thus public expenditure, if properly planned and conscientiously undertaken, will have the favourable effect of raising employment, production and national income, after pulling the economy out of depression and thus bringing about greater economic stability.

10.4 GROWTH OF PUBLIC EXPENDITURE IN INDIA

The total expenditure of the Central government has grown from Rs. 529 crore in 1950-51 to Rs. 1,19,087 crore in 1992-93 (budget estimates) (225 times). Of this revenue expenditure grew even faster. It went up from 347 crore in 1950-51 to Rs. 89,570 crore in 1992-93 (B.E.) (258 times). But capital expenditure grew at a slower rate. It increased from Rs. 183 crore in 1950-51 to Rs. 29,517 crore (161 times). It is, however, clear that the total expenditure of the Central government has grown at a much faster rate than the growth rate in national income which went up from Rs. 8,938 crore in 1950-51 to Rs. 4,25,672 crore (estimated) in 1991-92 (48 times). One can say, that the total expenditure has been increasing at a rate about 5 times higher than the growth rate of national income (Gross National Product).

Table 10.1: Growth in Central Government Expenditure

(Rs. crores)

	1950-51	1992-93 (B.E.)	Growth over 1950-51
Total Expenditure	529	1,19,087	Over 225 times
Revenue Expenditure	347	89,570	Over 258 times
Capital Expenditure	183	29,517	Over 161 times
National Income (1991-92) estimated	8,398	4,25,672	About 48 times

Source: Annual Budgets and Economic Survey 1991-92.

Another way of looking at this absolute and relative increase would be to relate the expenditure to GNP, as shown in the table below.

Table 10.2: Growth of Central Government Expenditure

(Rs. crores)

Year	GNP at current prices	Expenditure of the Central Government (Capital+Revenue)	Col. (3) as per cent of (2)
(1)	(2)	(3)	(4)
1950-51	8,938	529	5.9
1960-61	15,182	1,826	12.0
1970-71	39,424	5,673	14.4
1980-81	1,22,772	24,838	20.2
1990-91 estimated	4,15,290	1,05,316	25.4

The trends of the Central government expenditure seem to support two of the most widely discussed approaches to the behaviour of public expenditure. First, there has been an increase in public expenditure that conforms to Wagner's law of increasing state activity. This is obviously the result of the planned economic development undertaken in India since 1950-51. Second, there have been several discontinuities in the trend, suggesting the pressure of Peacock-Wiseman "displacement effect". As already stated, this effect hypothesizes that government spending rises by discrete stages in response to the periodic occurrence of "social upheavals". Some of the discontinuities in Indian government spending, however, can be attributed to events that may not qualify as "social upheavals". It has been shown that the "displacement effect" was a factor responsible for increase in spending during and after the Indo-Chinese hostilities of 1962. Other factors are: rehabilitation of displaced persons from Pakistan, oil price hike in 1973 and the inflation that followed, and Indo-Pak war in 1971.

Another salient feature of the growth of government expenditure is the increase in the relative share of revenue expenditure in the total expenditure. This share was 65.5 per cent in 1950-51. When planning got underway and gathered momentum in the first two

decades, revenue expenditure always stood at less than 50 per cent of the total outlay of the Central government. The balance, over 50 per cent, was accounted for by capital expenditure. Since the seventies, however, the rate of growth of revenue expenditure has far exceeded that of capital expenditure. In the eighties, revenue expenditure has increased at twice the rate of increase in capital expenditure.

Recent Trends: During the two years (1991-92 & 1992-93) (BE) the pace and direction of expenditure have changed radically. The revenue expenditure in 1991-92 increased by 13.8 per cent over that in 1990-91 whereas capital expenditure actually declined by seven per cent. In 1992-93 (BE), while the revenue expenditure increased by only seven per cent (down from 13.8 per cent increase in 1991-92), there was a standstill in respect of the capital expenditure. There are two reasons responsible for the downward trend in the rate of increase in government expenditure. Firstly, the fiscal crisis faced by the country beginning with the year 1990-91, deepened in 1991-92. The government initiated corrective measures to restore fiscal discipline in the economy. Some of the key elements in this structural adjustment were containment of non-plan expenditure including defence expenditure and subsidies. Secondly, the economic philosophy of the government has undergone a revolutionary change. The investment programme of the government is no longer aimed at increasing investment in public sector enterprises. With the liberalisation of the economy — changes in industrial and trade policy, financial sector reforms etc., are all aimed at less government intervention rather than more. Hence, the relative decline in government expenditure. This is every reason to believe that this trend will continue in the foreseeable future.

Check Your Progress 2

- Note:** i) Use the space given below for your answers.
ii) Check your answers with those given at the end of the unit.

1) Examine the impact of public expenditure on distribution.

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2) Analyse the increase in Central government expenditure in the light of Wagner's Law & Peacock-Wiseman Hypothesis.

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3) Indicate broadly how the various components of the Central government expenditure have been registering an increase since 1950-51.

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10.5 LET US SUM UP

The study of public expenditure has become worthwhile because the role of state has been expanding. There has been a phenomenal increase in public expenditure consistent with the welfare functions assumed by governments. As we have discussed in the unit, various theories and approaches have sought to explain the factors determining the growth in public expenditure. Among them, Wagner's Law of increasing state activities and the Peacock-Wiseman Hypothesis are more important. The factors are mainly environmental, technological, economic, administrative and political in nature.

Public expenditure diverts economic resources into channels determined by the government in accordance with national objectives and priorities and public policy. As a consequence, the scale and direction of public expenditure may affect the pattern and levels of consumption of the community, volume of production, allocation of resources, distribution of incomes, levels of prices and employment.

There has been a phenomenal growth in public expenditure both in absolute terms and also in relation to growth in national income. This growth is a consequence of the state taking over the function of economic development. Other factors influencing rise in public expenditure have been wars, rehabilitation of displaced persons, oil price hike, and natural calamities. The government is now making a conscious and vigorous effort to reduce the magnitude of public expenditure.

10.6 KEY WORDS

Economic Stabilisation: Smoothing out business fluctuations of cyclical nature. These fluctuations are boom conditions and depression which affect prices, production and employment.

Maximum Social Advantage: Net social advantage of an additional unit of expenditure on all items should be equal to the net social cost of raising additional revenue.

Public Goods: Public goods are those for which no private mechanism exists for providing them and which are consumed in equal amounts by all. Individuals cannot be excluded from consuming them even if they do not pay for them. Also, consumption by one individual does not preclude others from enjoying it.

10.7 REFERENCES

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10.8 ANSWERS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

- 1) Your answer should include the following points:
 - Quantitative measurement of benefits flowing from diverse items of public expenditure becomes difficult.
 - The level of present satisfactions of the community are mainly kept in view by the government whereas the future interests of the community are equally important.
 - The principle is applicable to the use or distribution of a fixed sum rather than for determining the total size of public expenditure.
- 2) Your answer should include the following points:
 - Public choice theory as propounded by Anthony Downs based primarily on the system of USA, provided a general framework for explanation of public expenditure.
 - According to this theory, public expenditure is determined by the governments desire to maximise their chances for winning the election.
 - Budgeted expenditure is determined not with reference to overall spending and taxation but through a series of separate policy decisions based on gains and losses of votes.
 - Citizen's vote is the determining factor in public expenditure.
 - The expansion in expenditure is to fulfil voter's demands — promises made at election time.

- 3) Your answer should include the following points:
- The increase in public expenditure is due to growth in revenue.
 - During settled times, people can be expected to develop notions of acceptable rates of taxation which is known as the tolerable level of taxation.
 - Large scale social disturbances, like wars change the tolerance limit of people to bear the burden of taxation to meet the expenditure. This is called a "displacement effect".
 - This effect shifts revenues and expenditures to new higher levels, which continues after the completion of the event.
 - The new levels of tolerance which emerge make the society feel capable of carrying a heavier tax burden.

Check Your Progress 2

- 1) Your answer should include the following points:
- Introduction of a system of grants and subsidies which lead to maximum social benefit.
 - Public distribution system which makes available essential commodities at subsidised prices to the poor.
 - Social security measures and social insurance schemes like oldage pensions, unemployment relief etc. to improve distribution by reducing inequality of incomes.
- 2) Your answer should include the following points:
- The increase in expenditure of the Central government due to planned economic development undertaken since 1950-51, conforms to Wagner's law of increasing state activity.
 - Events which may not be called 'Social upheavals' like Indo-China war of 1962, rehabilitation of displaced persons from Pakistan, oil price hike in 1973, etc. resulted in "displacement effect" leading to increased spending by the government. This effect hypothesizes that government spending rises by discrete stages in response to periodic occurrence of social upheavals.
- 3) Your answer should include the following points:
- Total expenditure of the Central government from 1950-51 till 1992-93 (B.E.) has increased about 225 times.
 - Revenue expenditure has gone up 258 times during the same period.
 - Similarly, capital expenditure has risen 161 times.
 - National income, during the same period went up only about 48 times.