

# Public Expenditure

## Causes of Increase in Public Expenditure

1. Increase in backward area and population
2. Growth of state functions
3. Higher price-level and rising cost of public services
4. Increase in national wealth
5. Increased ability to tax
6. War and prevention of war (defence)
7. Provision of public utility services
8. Expansion in social services
9. Technological changes call for larger or new production in public sector
10. Global environmental factors, including, IT, import & export requirements, international political changes, and terrorism
11. Expansion of public sector
12. Defective financial and civil administration (including corruption, red tapism, and malicious bureaucracy)
13. Political and social factors
14. Economic development (esp. for developing countries)

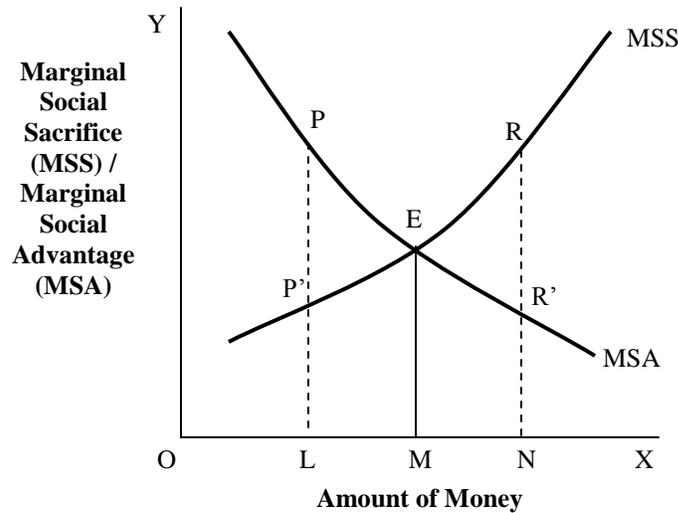
## Principles of Public Expenditure

1. Principle of maximum social benefits
2. Principle of economy, i.e., wasteful expenditure should be avoided
3. Canon of sanction, i.e., authorized expenditure
4. Principle of balanced budget
5. Canon of elasticity, i.e., fairly flexible
6. Avoidance of unhealthy effects on production and distribution

**1. Principle of Maximum Social Benefits:** According to Dalton, the best system of public finance is that which secures the maximum social advantage from the operations which it conducts.

Attainment of maximum social advantage requires that:

- (i) both public expenditure and taxation should be carried out up to certain limits and no more,
- (ii) public expenditure should be so utilized among the various uses in an optimal manner:
- (iii) the different sources of taxation should so tapped that the aggregate sacrifice entailed is minimum



In the above diagram, MSS curve represents Marginal Social Sacrifice curve and MSA curve represents Marginal Social Advantage curve. The MSS curve rises upward from left to right, and MSA slopes downward from left to right. As more and more funds are collected from the people by way of taxation, MSS increases and MSA decreases. As more and more collected funds are utilized in public welfare, MSA increases and MSS decreases. The equilibrium point is where both MSA and MSS are equal. At this point the net social welfare will be maximum.

**2. Principle of Economy:** It means that extravagance and waste of all types should be avoided. Public expenditure has great potentiality for public good but it may also prove injurious and wasteful. If the revenue collected from the taxpayer is heedlessly spent, it would be obviously uneconomical.

To satisfy the canon of economy, it will be necessary to avoid all duplication of expenditure and overlapping of authorities. Further, public expenditure should not adversely affect saving. In case government activity damaged the individual's will or power to save, it would be repugnant to the canon of economy.

**3. Canon of Sanction:** Another important principle of public expenditure is that before it is actually incurred, it should be sanctioned by a competent authority. Unauthorised spending is bound to lead to extravagance and over-spending. It also means that the amount must be spent on the purpose for which it was sanctioned. Allied to the canon of sanction, there is another, viz., auditing. A postmodern examination is equally important. That is, all the public accounts at the end of the year should be properly audited to see that the amounts have not been misappropriated or mis-spent.

**4. Principle of Balanced Budget:** Every government must try to keep its budgets well balanced. There should be neither ever-recurring surpluses nor deficits in the budgets. Ever recurring surpluses are not desired because it shows that people are unnecessarily heavily taxed. If expenditure exceeds revenue every year, then that too is not a healthy

sign because this is considered to be the sign of financial weakness of the country. The government, therefore, must try to live within its own means.

**5. Canon of Elasticity:** Another same principle of public expenditure is that it should be fairly elastic. It should be possible for public authorities to vary the expenditure according to the needs. A rigid level of expenditure may prove a source of trouble and embarrassment in bad times. Alteration in the upward direction is not difficult. But elasticity is needed most in the downward direction. It is not so easy to cut down expenditure. When the economy axe is applied, it is a very painful process. Retrenchment of a widespread character creates serious social discontent. Perfect elasticity is out of question. But a fair degree of elasticity is essential if financial breakdown is to be avoided at the time of shrinking revenue.

**6. Avoidance of Unhealthy Effects on Production or Distribution:** It is also necessary to see that public expenditure exercises a healthy influence both on production and distribution of wealth in the community. It should stimulate productive activity so that the volume of production in the country increases and it may be possible to raise the standard of living. But this object of raising of the standard of living of the masses will be served only if wealth is fairly distributed. If the newly created wealth goes to enrich the already rich, the purpose is not served. Public expenditure should aim at toning down the inequalities of wealth distribution. These two objectives may be in conflict when attempts at reducing inequalities of income and wealth distribution adversely affect production. This it can do by adversely affecting:

- (i) power to work and save, and
- (ii) will to work and save

Public expenditure can also benefit production through diversion of resources from less productive to more productive occupations.

As for (i) power to work and save, it may be pointed out that much of the socially desirable public expenditure incurred by modern governments undoubtedly increases the community's productive power and, consequently, also the power to save. Such expenditure includes provision of means of communication and transport; education, public health, scientific and industrial research; controlling of human, animal and plant diseases and expenditure on social insurance, like health insurance, unemployment insurance and old age pensions.

As for (ii) the will to work and save, much depends on the character of public expenditure and the policy governing it. By giving the people expectations of future benefits from public expenditure, it may blunt the edge of the desire to work and save. The granting of old age pensions, insurance against sickness and unemployment and provision of education of state expense must make the people indifferent towards the future and make them neglect savings. People will work less. But if such expenditure is kept within proper limits and if it helps the really helpers, the check on savings may be

mitigated. But when taxes are too heavy, the people's will to work and save may be discouraged and their power to do so reduced. That limit should not be reached.

### **Effects of Public Expenditure**

**1. Effects on Production:** Some people are of the opinion that expenditure on military warheads is unproductive. It is not true. A short and successful war may bring to the country much economic gains.

If the private consumption and investment expenditure is not sufficient in sustaining the national income at its highest level, the government comes forward and fills up the gap between actual spending and the full employment spending by arranging a series of public works programme.

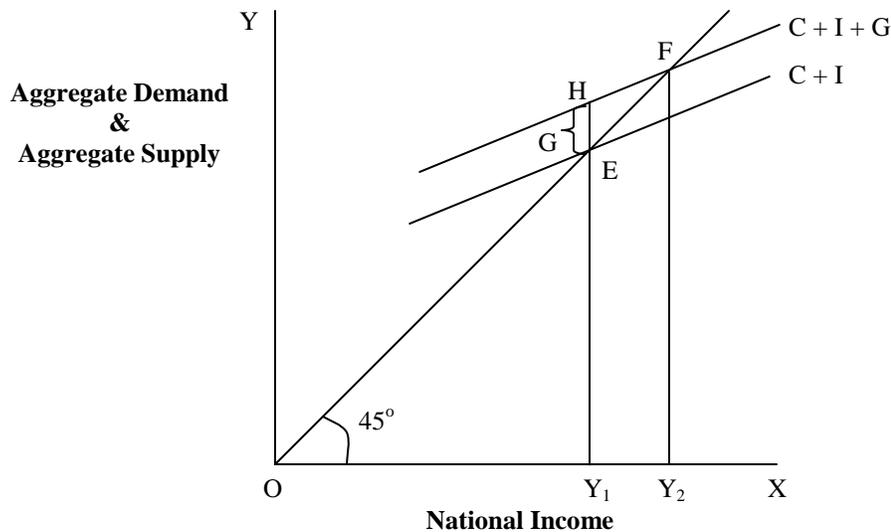
**2. Effects on Distribution:** Public expenditure can greatly help in toning down the inequalities of income and wealth distribution in the country. The government by taxing the rich people at progressive rates reduces their high incomes. The raised money is spent for the benefit of needy class of the society. State provides free education, free medical aid, free or cheap housing facilities, subsidised necessities of life, etc. When the government is trying to make distribution of national income more even and fair by public expenditure, it should be very cautious in implementing such a policy.

**3. Effects on Level of Income and Employment:** According to Keynes, the government can remove widespread unemployment during periods of depression through liberal public expenditure on public works. It can thus raise the level of income and employment in the country.

Keynes observed that when government increases its investment expenditure on public works, then the increase in level of income and employment will not be merely equal to the increase in those activities, but it will be many times more than this what he has called the 'Income Multiplier'.

The value of multiplier depends on the marginal propensity to consume. Suppose the  $mpc$  is  $5/6$  the multiplier will be 6.

$$\text{Multiplier} = \frac{1}{1 - mpc}.$$



In the diagram above, the aggregate demand curve  $C + I$  cuts the aggregate supply curve  $OZ$  at  $E$  according to which  $OY_1$  national income is determined. Now if consumption and investment remains constant and government does not increase its expenditure, then  $OY$  will remain the national income and correspondingly the level of employment. Rather, it is possible, and it happens during depression, that this level may go down owing to decrease in aggregate demand and there may be widespread unemployment in the country.

Now, according to Keynes, the government should increase its expenditure in such a situation so that the level of national income and employment in the country may increase. In the above diagram, if the government increases investment expenditure by  $EH$ , the aggregate demand curve moves upwards as shown by the curve  $C + I + G$ . Now this new aggregate demand curve  $C + I + G$  cuts the aggregate supply curve at  $F$  and accordingly the national income increases to  $OY_2$ . It will be seen that even though the government has increased its investment expenditure by  $EH$ , the national income has increased by  $Y_1Y_2$  which is many times more than the increase in investment.

### Role of Public Expenditure in A Developing Country

**1. Social and Economic Overheads:** Economic development is handicapped in under developed countries due to deficiency of capital and infrastructure. Economic overheads like roads and railways, irrigation and power projects are essential for speeding-up economic development. Social overheads like hospitals, schools, and colleges and technical institutions are essential. Capital for such overheads cannot be sufficiently come out of private sources. Public expenditure has to build up the economic and social overheads.

**2. Balanced Regional Growth:** It is considered desirable to bring about a balanced regional growth. Special attention has to be paid to the development of backward areas and under-developed regions. This requires huge amounts for which reliance has to be placed on public expenditure.

**3. Development of Agriculture and Industry:** Economic development is regarded synonymous with industrial development but agricultural development provides the base and has to be given the priority. Government has to incur lot of expenditure in the agricultural sector, e.g., on irrigation and power, seed farms, fertilisers factories, warehouses, etc., and in the industrial sector by setting up public enterprises like the steel plants, heavy electrical, heavy engineering, machine-making factories, etc. All these enterprises are calculated to promote economic development.

**4. Exploitation and Development of Mineral Resources:** Minerals provide a base for further economic development. The government has to undertake schemes of exploration and development of essential minerals, e.g., gas, petroleum, coal, etc. Public expenditure has to play its pivotal role in the exploration and development of mineral resources.

**5. Subsidies and Grants to Provinces, Local Govts, and Exporters:** The central government gives grants to State governments and the State governments to local governments to induce them to incur some desirable expenditure. Subsidies have also to be given to encourage the production of certain goods especially for export to earn much needed foreign exchange.

#### **Classification of Government Expenditure**

The older classification of expenditure is into ‘*Current Expenditure*’ and ‘*Capital Expenditure*’:

**1. Current Expenditure:** The main sources of financing current expenditure or revenue expenditure is the current revenue of the government which mainly consists of taxes and certain non-tax revenues like profits, incidental incomes, fees and some other extraordinary items.

Current revenue and current expenditure are appeared in the ‘Revenue Budget’ of the government. Such expenditure is incurred on day-to-day functioning of the government machinery including civil administration, police, judiciary and current expenses of beneficent departments like education, health, agriculture, etc. These heads are controlled by provincial governments.

The federal government is responsible for defence, foreign affairs, currency and certain supervisory and coordinating functions. Local governments have their own budgets with certain revenue sources of local nature, e.g., octroi, terminal taxes and cesses.

**2. Capital Expenditure:** The expenditure in the capital budge is incurred on building assets of a lasting character, like construction of canals, dams, water storage, roads and railway lines, public buildings of various kinds, ports, etc. such expenditure is of such a magnitude that it is not possible to meet it from current revenues. It is mostly financed by raising loans, internal or even external.

A more recent classification in developing countries is into ‘*Development Expenditure*’ and ‘*Non-Development Expenditure*’:

**1. Development Expenditure:** Following are the characteristics of development expenditure:

- (a) It should be designed to keep intact or enlarge and improve the physical resources of the country.
- (b) It should improve the knowledge, skill and productivity of the people.
- (c) It should encourage efficiency with which available resources are used.

Development expenditure is further defined as the expenditure that results in the replacement or in the creation of new capacity in the field of agriculture or industry. The expenditure on ordinary maintenance and running of existing facilities would be 'non-development expenditure'.

**2. Non-Development Expenditure:** The main heads of Government Expenditure in Pakistan are:

- (i) General Administration, i.e., expenditure on various departments of Federal Govt.
- (ii) Defence Expenditure
- (iii) Law and Order
- (iv) Community and Economic Services, e.g., expenditure on road, railways, water supply, sewerage, broadcasting, transport and communication, etc.
- (v) Subsidies on selected commodities like fertilisers, seeds, wheat, etc.
- (vi) Debt Servicing, i.e., interest paid on internal and external borrowings