Chapter-2

PUBLIC EXPENDITURE AND ECONOMIC DEVELOPMENT
Public Expenditure and Economic Development

An important objective of public expenditure in underdeveloped countries in the contemporary world is to promote economic development. Rapid transformation from backward agricultural state to a modern industrial power cannot be possible without a positive and large scale government intervention.

Approaches to Public Expenditure

The economy of a country is greatly influenced by the level of public expenditure. Government’s expenditure is considered as one of the significant factors by which the welfare of the people is noticed and it is also an important aspect of a government’s budget. It is regarded as an important instrument which can be used by the government for the maximization of public satisfaction and for achieving public welfare.

Some of the approaches to the public expenditure are as follows:

Classical Approach

The classical approach to public expenditure was based on the assumption that government is nothing more than an agent for the people and has to spend the people’s money discreetly and sparingly. This approach was based on the assumption of non-interference by the state. The classical economists supported the laissez-faire policy firmly. Their opinion was that the
economic role of the state must be restricted. The classical economists did not develop the theory of public expenditure in the right way. The attitude of classical economists to public expenditure was represented in the famous expression of J.B. Say, "the very best of all plans of finance is to spend little and the best of all taxes is that which is the least in amount."¹

Adam Smith assumed a limited role of the state. Smith recognized only three functions which the state can perform. The first duty of the state was to protect the society from the violence and injustice of other independent societies.² The second duty of the state was of protecting every member of the society from injustice or the duty of establishing an exact administration of justice.³ According to Adam Smith, the third duty of the sovereign, was of building and maintaining some public works and certain public institutions.⁴

Another classical economist, David Ricardo never felt it necessary to analyse and examine the public expenditure as in his opinion the public expenditures were only a waste. He supported the golden maxim of J.B. Say.

The doctrine of public expenditure reached a perfection with Mill. His principle of public expenditure was based on the system of natural liberty that public expenditure should be at the narrowest possible range. According to him, the general practice should be of laissez-faire. Mill is greatly in accord with Adam Smith, except that he gives a much broader application to the principle of interference on behalf of the consumer as such.
The ideas of classical economists on public expenditure are that it should be limited and they also favoured the principle of a balanced budget.

**Neo-classical Approach**

Professor Pigou as a welfare economist, among the neo-classicals was mainly concerned with the problem of maximising the social benefit which public expenditure conferred on the people. This social benefit can be maximised only if resources are distributed perfectly among the different uses in such a way that the marginal returns of satisfaction are the same for all. An individual can achieve the equilibrium position only when he distributes his limited resources among different uses in such a manner, that the marginal utility derived from the last unit applied in every use, tends to be equal. It is just similar to the case of the state in allocation of its resources among various uses. Dr. Dalton has more or less supported the view of Pigou.

L. Robbins has seriously objected to Pigou’s theory and has remarked that no-one can provide a firm basis for interpersonal comparisons of utility. It is totally a normative study without a positive scientific character. In the words of Robbins himself – “The postulate of equal capacity for satisfaction rests upon ethical principle rather than upon scientific demonstration; it is not a judgment of fact in scientific sense but rather a judgment of value perhaps, even in the last analysis, an act of will.”
Keynesian Approach

Lord Keynes’ theory of public expenditure is a landmark in economic thought and which made him the greatest economist of the 20th century. The significance of public expenditure as a ‘balancing factor’ in the determination and distribution of national income recognises its origin to ‘General Theory’. If there was an imbalance between investment and savings and it caused recession or depression in a country, then the government can control this type of situation only by increasing expenditure on public works or transferring income from the rich to the poor whose marginal propensity to consume is higher than that of the former. The government would have to increase its expenditure to finance relief works or to raise the level of employment for the unemployed people in the country.

Keynes’ main concern was the achievement of full employment and economic stability and therefore he explained the doctrine of public expenditure by giving details to ensure economic stability. But practically, the application of Keynesian theory of public expenditure in an underdeveloped economy looks quite doubtful. From the viewpoint of increasing speed of economic development of underdeveloped economies, it is quite necessary to use the fiscal tool for restricting the propensity to consume and thus increasing the propensity to save as against its use for reducing savings and raising propensity to consume as expressed by Keynes.
Ragnar Nurkse has remarked that “Keynes’ General Theory has a bias against saving and in favour of spending, but one that is prenicious when transplanted to conditions in which the underdeveloped countries find themselves.”

Keynesianism has increased the importance of compensatory spending as a contracyclical method to maintain economic stability and prevent secular stagnation.

**Post-Keynesian Approach**

Alvin Hansen, who is called American Keynes has criticized the classical doctrine of balanced budget and proposed to improve budgetary technique to make the budgets more useful and also flexible. He argues, “if one adopts whole heartedly the principle that government financial operations should be regarded exclusively as instrument of economic and public policy, the concept of a balanced budget however defined, can play no role in the determination of that policy.” While discussing the problem of balancing the budget, he pointed out that expenditure incurred by the state can be divided into ‘operating expenditure’ and ‘capital expenditure’.

Another strong pillar of Keynesian School, Lord Beneridge argued that the national budget should not be made on the basis of purely financial considerations but on the income and expenditure of the community as a whole. He also said that the primary objective of government’s economic and fiscal polices should be to achieve the goal of full employment of human and
material resources, so that poverty, misery, unemployment, starvation etc can be removed from the national economy. But Dr. Dalton has given a different view on the structure of the budget. He has viewed that the budget should be balanced, but in the short run, measured in terms of a year or two, in the long run, the budget need not be balanced.

A.P. Lerner, while following the Keynesian line of thought, maintains that the volume of employment depends on the rate of spending. There are five elements in the total spending of the economy: consumption and investment by the individuals, consumption and investment by the government and investment by businesses. Any policy for full employment has to work on one or more of these five elements which make up the total spending on currently produced goods and services.⁹

Components of Public Expenditure

Total public expenditure is the sum of the expenditure on current and capital account of the public sector and is by definition equal to the sum of consolidated public sector receipts.

The total public expenditure is made up of the following components:

1) Public sector consumption: i.e., current expenditure on goods and services at market prices by central government and local authorities. This also includes the wages, salaries, NHS contributions made by public sector employees, and expenditures on all the items that are required in the production of public output.
2) **Public sector investment**: i.e., expenditure on fixed assets such as land and buildings, vehicles, plant and machinery etc. by central government and local authorities, less sales of fixed assets, plus the book value of stocks and work in progress of central government and public operations.

3) **Subsidies**: Unrequited payments on current account by central government and local authorities to enterprises both in the private and public sectors.

4) **Current grants**: i.e. grants to the personal sector, principally national insurance benefits such as unemployment benefits and pensions; grants paid abroad; e.g. development aid, are also included in current grants.

5) **Capital transfers**: i.e. unrequited payments on capital account by central and local government to the private sector and abroad.

6) **Debt interest**: Total payments of interest by public sector less all identified payments to other parts of the public sector.

7) **Net lending to the private sector and overseas**

In defining government or public expenditure we have to decide which spending agencies to include and then which items of their expenditure to take into account. The spending agencies that are considered are central government and local government. We also make some adjustments after the spending agencies are decided. For avoiding the double counting, we omit transfers between public authorities when we take both the authorities together. From the public expenditure we also omit the government financial transactions on
capital account, mainly consisting of loans to private and nationalized industries.\textsuperscript{11}

In the national income accounts, public expenditure is represented by two broad categories of government activity.

a) Exhaustive public expenditures

In these expenditures there are government’s purchases of current goods and services (i.e., labour, consumables, etc.) and capital goods and services (i.e. public sector investment in roads, schools, hospitals etc.). The exhaustive public expenditures are purchases of inputs by the public sector and are calculated by multiplying the volume of inputs by the input prices. These expenditures are claims on the resources of the economy.

b) Transfer expenditures

These public expenditures include expenditures on pensions, subsidies, debt interest, unemployment benefits etc. These expenditures do not represent a claim on the society’s resources by the public sector.\textsuperscript{12}

Some important distinctions must be identified within the total of government expenditure. For some purposes we have to separate current expenditure (on services and on goods which will be soon used up) from capital expenditure (on acquiring assets like schools, hospitals and roads which we will go on using for a long period). If we assume that problems of demand management will not arise then there is stronger case for using loans to finance capital expenditure than current expenditure, because capital expenditure
benefits the citizens of the future and is also useful for the present generations
and therefore they can be called reasonably to pay extra tax to meet the future
interest and repayment charges on the loan.\textsuperscript{13}

**Growth of Public Expenditure**

The German economist Adolph Wagner, in his writing in 1883, thought
he had discovered the “Law of Ever-Increasing State Activity” upon surveying
the public expenditure records of several advanced countries in the nineteenth
century. He based his “Law” on the “pressure for social progress and resulting
changes in the relative spheres of private and public economy, especially
compulsory public economy.” History has definitely borne him out, though war
and its aftermath have cost more than social progress.\textsuperscript{14}

Peacock and Wiseman at the London School of Economics tested
Wagner’s ideas with modern statistics for Britain.\textsuperscript{15} They both found his “Law”
still working, but they presented a more complex explanation. They found that
expenditures grow because revenues grow, rather than the other way about: a
given tax system with constant tax rates yields more money as the economy
grows, and governments, like most of us, somehow spend their income. And so
forth, the cost of providing public services grows with the nation. There is
usually a considerable gap between people’s beliefs about the desired public
expenditure levels when they think of the benefits, and the amounts which they
accept as tolerable burdens of taxation. The pressures for larger budgets from
beneficiaries and bureaucracies of operating agencies are extremely large. To
the extent at which the revenues are available, the budget bureaus and treasuries of the world have little power to refuse requests.\textsuperscript{16}

It is realized now in the present century that public expenditure is more important in its implications and bearing on public welfare than public revenue. In the past, the public expenditure was neglected and it was mainly neglected because the amount of public expenditure was small due to the restriction of the governmental activity. But now the situation is different and the public expenditure is reaching astronomical figures.

In recent times, public expenditure has increased. The increase in public expenditure is due to the increase in the state functions. The state was regarded only as a police state in the past but now it is called a welfare state.\textsuperscript{17} The modern government has now the objective of promoting welfare of its people. It protects its people not only from internal disorder and external aggression but it also protects its people from disease, hunger, illiteracy etc. The welfare of the citizens is the main concern of the modern government.\textsuperscript{18} Public expenditure can also provide a communal use of many services like parks, museums, libraries etc. The sphere of the state activity has widened because of these reasons and therefore there has been a corresponding increase in public expenditure. The state has also increased its expenditure in view of its social objectives.

To reduce vast disparities in the income and welfare of the citizens it also provides many social services, particularly to the under-privileged, for the equality of opportunity to its citizens.\textsuperscript{19} Thus, because of the increasing
responsibilities which the state has to look after and also because of some other factors like rapid growth of population, there has been an enormous growth in social and development expenditure of the State Governments.

**Importance of Public Expenditure for an Underdeveloped Economy**

Underdeveloped countries are characterized by poverty, low income and productivity levels, low capacity to save, absence of social and economic infrastructure, income inequalities, all of which are responsible for low levels of development. In fact, under developed countries are poor countries, poor in the literal sense, suffering from the vicious circle of poverty, economic stagnation and income/ inequalities. Apart from expenditure on defence police and administration, which has always been considered as government’s domain, there are at least four ways in which public expenditure can play a useful role in underdeveloped countries.

1) In building up the economic infrastructure.

2) In reducing economic inequalities.

3) In removing regional imbalances.

4) In protecting and preserving the environment, thus ensuring sustainability in the development process.

The ideas relating to the need and the effects of public expenditure change from time to time. The earlier economists suggested that there should
not be any government interference in the economic lives of the people. But now in modern times the recent view which represents the principles of public expenditure is that the government should spend more to increase the economic development of a country. The role of public expenditure in an under-developed economy is to be appreciated as it transforms the backward economy to a forward economy, by increasing more money in the economy.\(^\text{21}\)

Public expenditure will introduce new ideas and new methods in the economy through the creative role of the entrepreneur. Thus, modern theory of public expenditure makes it clear that none of the economy can go ahead in the race of economic development, without accepting the importance of public expenditure in the economy. In conclusion, there is only one principle of the public expenditure which states that the state should incur its expenditure in such a way that the whole economy can achieve maximum benefit.\(^\text{22}\)

The concept of public expenditure has achieved great importance in the process of economic development and its importance is increasing day by day. Nurkse states, "I believe that public expenditure assumes a new significance in the face of the problem of capital formation in the under developed countries."\(^\text{23}\) Just as consumption is the end of all activities, so as public expenditure is the end of all fiscal affairs of the state.\(^\text{24}\)

The influence of public expenditure on the levels of economic activity and on distribution will depend upon the nature of the government and the period during which the public expenditure is made.
Effects of Public Expenditure

The nineteenth century economists could not recognize the possible favourable effects of public expenditure. As a result the study of public expenditure was totally neglected till as late as the 1920s when the importance and significance of public expenditure was fully realized. The fact was that the study of public expenditure was neglected because of the mistaken belief that all public expenditures were useless and are a waste. This belief was strengthened by the writings of the classical economists and especially that of Adam Smith, who advocated that the government should restrict its activities to 'justice, police and arms,' that is to say the protection of the citizens from foreign aggression and internal disorder.

The advocates of social services are not all inspired by the same reason. Some, very frankly consider them as means to the social end. However, others do not share the socialist view. They believe that there are certain essential services in which public expenditure proves to be superior over private expenditure. These services can very often be provided more efficiently and economically when they are regulated by public department if it has the advantage of a large scale organization as against scattered activities, with the liability to overlapping and waste.

Investments in human capital is an important instance in which public expenditure is superior to private expenditure. It increases productivity and is a great equalizer as they provide new opportunities to the low income groups and increases their standard of living.
Public expenditure has now become an important and effective fiscal weapon for attaining the goal of economic development with stability and also to reduce the existing income inequalities in the distribution of income and wealth in the economy.\(^{26}\) Public expenditure programmes directly help, to provide employment to many individuals and by the increase in the demands of people for goods and services, the employment opportunities also increase as the increase in demands leads to greater production and better distribution. Therefore, it provides employment to a greater number of people.

The private sector is also encouraged for making a steady investment and increasing production, if public expenditure is liberally incurred for the provision of social and economic overheads.

The use of positive theory of public expenditure should be the beginning and not the end point in the decision making process for the determination of the future public expenditures.\(^{27}\) Therefore, Martina and Lewis have proposed the introduction of the positive public theory for having the maximum social advantage to the people to a great extent. W.A. Lewis has remarked that the three factors-economic activity, increase in knowledge and increase in capital stock are the three important factors of economic growth. The last factor is the most important as it accelerates the tempo of economic development.\(^{28}\)

When the state spends its revenue, the benefit is acquired by the citizens of the state. These benefits are enjoyed jointly by the people or it is also enjoyed individually. In other words, some items of public expenditure confers individual benefits while on the other hand, other public expenditure confers
social benefits. That is every expenditure confers both. In some the social benefit is more prominent while in others the individual benefit appears predominant. However, the fact is that the effect of public expenditure proves beneficial in some way or the other for the citizens of the country.

Need for Public Expenditure on Social Sectors

The ultimate objective of the public expenditure is to maximize social welfare. Public expenditure on social sectors assumes significance on account of poverty and low levels of living, which is a feature of the greater section of the people. A big majority of the population is so poor that it is not able to fulfill their basic nutritional needs. The Five Year Plans gave major emphasis to human development and declared it as the ultimate goal.

Human resource is regarded as an important factor in economic development. The development of human resources acquires adequate provision of health services, water supply, education, housing, nutrition and family welfare facilities which are necessary for the good quality of life. The provision of these resources are important for the overall development of human beings.

Human beings are ends and means at one and the same time and give the meaning and also justification to the wide range of activities. In the same context, A.C. Pigou has said, “Human beings are ends in themselves and instrument of production, natural and capital resources are not an end in themselves, they are means for achieving certain ends”.

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The human capability is very important in increasing economic development and rapid growth. We cannot see rapid and increased economic development and the use of modern technology with uneducated and unskilled workers. On the other hand, educated and skilled persons show entrepreneurship and promote new economic enterprises and hence, contributes to wider economic development in the country.  

Economic growth has also been associated with improved health of the population as an increase in the expenditure per head of the population on health and medical services. The increase in this type of expenditure has resulted in a substantial increase in life expectancy and a corresponding decrease in death rates from communicable diseases which in turn have facilitated not only an increase in the size of the labour force but a greater efficiency in the effort put on the job resulting in increased national output.  

The Mahalanobia Committee in 1964 observed, "Real incomes, particularly of the low income groups are increasingly affected by the provision of various types of services provided by the state, which do not get reflected in the income data. Some of the services like low-cost housing, health, free-primary education and social welfare services improve the relative income position of the low income group and thus tend to reduce concentration in the distribution of real income."  

It is widely recognized that the provision of social services freely or at subsidized rates would raise the standard of living of the people and this is how they can reduce poverty and inequalities in income distribution. Hence, the
major role of government in providing for the social services necessitates the need to see how the benefits of public expenditure on social sector are distributed across the different groups of people.\textsuperscript{35}

Basically, public expenditure on social sectors consists of expenditures on education, health and family welfare, water supply and sanitation, housing, rural development, social welfare, nutrition and minimum basic services. Expenditures on education and health have a direct impact on productivity and are amenable to measurement and control.

The importance of the two social sectors comprising health and education has been emphasized by Professor Amartya Sen in his book, "India: Social Development and Social Opportunity." He says that they are of value to the freedom of a person in at least five ways:

1. Intrinsic Importance: Being educated and healthy are valuable achievements in themselves and are of direct importance to an individual’s effective freedom.

2. Instrumental Personal Roles: Education and health can be important in other ways, for instance, getting a job and more generally for making use of economic opportunities.

3. Instrumental Social Roles: Greater literacy and basic education can facilitate public discussion of social needs and encourage informed collective demands for e.g., for health care and social security.
4. Instrumental Process Roles: The process of schooling apart from imparting formal education is helpful for e.g. in reducing phenomenon of child labour so prevalent in India. Schooling also helps in broadcasting the horizons of children, which is specially important for young girls.

5. Empowerment and Distribution Roles: Greater literacy and education can increase their ability to resist oppression and get a fairer deal. Even within the family it is helpful as it contributes to reduction of gender based inequalities.36
References


3. Ibid. p.230.

4. Ibid. p.244.


