CHAPTER II
REVIEW LITERATURE AND METHODOLOGY

Review of Literature

It is only in the recent years, that one finds a lot of literature on Public expenditure. As such a few decades ago it was considered that the area of Public Expenditure was a neglected and unexplored subject for research by Economists and Social Scientists. This concern has been shared by those writers who believe that "in contrast to many important empirical studies of taxation in developing countries, there are relatively few similar studies in the field of public expenditure in developing countries" Syril Enweze."
In fact, such views were expressed by many western writers including those of Samuelson and Musgrave. Even in India similar opinions were voiced. "The area of public expenditure has not, however, obtained as much emphasis as it deserves in Indian finance research. The positive aspects of Indian Public expenditure analysis remain largely an unexplored field² D.T.Lakdawala". However, in the past few decades, particularly after 1950s gradually many have evinced interest in the study of public expenditure and consequently the literature has increased. The available literature on the growth of public expenditure may be broadly categorized into (1) International Studies, (2) National Studies and (3) Regional Studies.

Adolph Wagner (1890)³ study on the "Law of Expansion of State Activity", in Germany, reveals that when government activity increases then public expenditure increases. The main thrust of Wagner's hypothesis was on the functional relationship between the growth of economy and its relative growth of public sector activity. According to this study, the Government expenditure must increase at an even faster rate than output. Similarly, the same relationship was observed between the correlation of the growth of commodity output and public expenditure in Western European countries. Wagner's Law was supported by F.S. Nitti, empirically tested and came to the conclusion that it was not only applicable to Germany but also to other countries.

**Viverka's study on the United Kingdom**

Vivekra (1963)⁴ in his study of Public expenditure in the United Kingdom presents a historical survey of the growth of public sector covering broadly two
centuries. In this study, the changes in the size and structure of public sector are linked to other historical developments such as changes in total wealth as indicated by estimates of gross national product and changes in population. Viverka also points out the irregular time pattern of growth of public sector, which is attributed to the changing structure of Government expenditure. This is supported by the statistical evidence of the income elasticity of individual categories of public expenditure differing very widely. Thus, the study points out that more realistic conclusions are derived by considering the relationship between individual components of government expenditure and economic growth than the aggregate expenditure.

National Studies on Public Expenditure

Apart from the studies relating to international aspects, there are studies which focus attention on general issues of Public Expenditure pertaining to India. Some of the important studies on public expenditure of India are as follows.

Mahalanobis Committee Report

Mahalanobis Committee (1964) found that inequality in the levels of living increased in real terms between the poorer and the richer sections of the population, but concluded that increase in the inequality of the level of living was relative to the period of low prices and did not therefore necessarily imply a deterioration in the real level of living during the period as a whole. There was very little on the contribution of public expenditure (or programmes) as such on the levels of living. Its concern was with the aggregate effect on economic activity – private and public on the levels of living and with public expenditure alone.
Mukherjee’s study

Mukherjee’s study (1965) is an exercise in the reconstruction of historical statistics and relates to the developments of the first half of the twentieth century. Moreover, he has not made any effort to go beyond his statistical results to establish a theoretical link between aggregate economic activity and the activity of public sector.

Purushothamdas Thakurdas Research wing Report

The study made by Sir Purushothamdas Thakurdas Research Wing, (1966) presented a factual picture of the finances of the Government of India from 1950-51 to 1964-65. Besides presenting the relevant data in a consolidated form for a period of 14 years, his work endeavoured to analyze the important issues and focused attention on them in such a manner that further exploration and a critical examination may be possible.

Panchamukhi’s Study

Panchamukhi (1967) presented the applied theory of public expenditure. He brings out the importance of cost-benefit analysis in the process of public expenditure. His study represents a step towards clarifying the economic aspects of the effects of expenditure on education and health, the knowledge of which is essential for making rational decisions in these fields.
Peacock and Wiseman’s Study

The empirical study of Peacock and Wiseman (1967) emphasizes the time-pattern trends of public expenditure in the United Kingdom for the period 1890-1955. Their analysis is based on three separate but related concepts, viz., displacement, and inspection and concentration effects.

According to them, during the period of study the relative growth of British public sector occurred on a step-like pattern rather than on a continues basis. That is to say, the government fiscal activities have risen step-by-step to successive new plateaus during the periods, due to the impact of major social upheavals like war and depression. These upheavals create a “displacement effect” resulting in the replacement of the previous lower expenditure and tax levels by new and higher budgeting levels. This displacement effect occurred several times during the secular period of study (1890-1955) in the United Kingdom.

Further, they also suggested that the social disturbance will force the people and the Government to inspect the efficiency and adequacy of previous measures to meet the problems, which would have been considered trivial but which assume different dimensions of urgency and importance due to social disturbance. All the factors that contribute for the increased public expenditure are grouped under what Peacock and Wiseman call it as “inspection effect” associated with displacement effect.

During the period of their study, they have also discovered one more factor viz., “Concentration effect” involving public expenditures effected at various levels
of Government, which tend to concentrate in the Central Government. This happens when a country undergoes the process of economic growth. The concentration effect is different from displacement effect, in the sense that it operates in the normal as well as disturbed times.

**Thron’s study for a sample of 52 countries**

Richard Thron’s study (1967)\(^{10}\) presents the result of the empirical analysis for a sample of 52 countries. He presented the hypothesis that social forces, which are closely related to the process of development, are the major determinants of the observed tendency of public expenditure to rise faster than national product. He emphasized the view that the forces, which shape the pattern of government expenditures and revenues, emerge from the dynamic process of growth itself. Presenting cross section studies of developing and developed, low growth and high growth countries, he stated that low growth countries have a greater social expenditure than high growth countries and developed countries have greater social expenditure elasticity than less developed countries. His propositions are substantially supported by empirical analysis. He particularly focuses attention upon the growth and changing role of the urban sector as an explanation for the growth in social expenditure.

**Gupta’s Study**

S.P.Gupta’s study (1968)\(^{11}\) tried to observe the applicability of “Displacement effect” in the case of number of countries: U.K., U.S.A., Germany, Canada, Sweden etc.,. He considered great depression a social upheaval along with the World wars. Gupta arrives at the conclusion that there was a significant
positive shift in the level of government expenditure associated with World wars in the case of countries, which participated directly in the wars. However, such a shift was associated with great depression only in the case of the U.S.A. and Canada.

**Lotz Study**

Lotz (1970)\(^1\) investigated variations in the composition and size of government expenditures among developing countries. It was found that government spending patterns are associated not only with the level of per capita income, but also with other economic and social factors viz. urbanization, monetization, literacy etc.,.

**Goffman and Mahar's study on Caribbean countries**

Goffman and Mahar (1970)\(^2\) in their empirical study relating to six Caribbean countries, stated that the growth of Public expenditure may be affected by the process of economic development itself. While the study reveals a general tendency for the public sector’s share in the community’s output \([E/Y]\) to rise, it is very doubtful about the Wagner type income-expenditure relationship because of the large variations in the income elasticity’s within and among nations. They came to the conclusion that neither Wagner’s law nor the Peacock-Wiseman’s displacement effect adequately explained the behaviour of relevant aggregates.

**Reynolds and Smolensky's study on the USA**

Reynolds and Smolensky’s study (1971)\(^3\) gives interesting results. They used the incidence assumptions to apportion expenditures among households grouped by income level. The three largest expenditure categories are general expenditure, education expenditure and cash transfers. Half of the general
expenditures are distributed on a per household basis and therefore, represent a relatively large share of a poor person’s income. Finally, cash transfers, a large component of which are public assistance, are also pro-poor. Therefore, the poor gain relatively more from public programmes than do the rich.

Reddy’s First Study

Reddy (1972) in his first study has analyzed a secular and time pattern of the growth of public expenditure in India from 1872 to 1968. His approach to the problem follows the path indicated by Peacock and Wiseman. In an effort to establish a theoretical link between the growth of public expenditure and the national income of a country, he examined the applicability of Wagner’s hypotheses to India. While examining the shorter periods (i.e. periods after the two world wars and Independence of the country), he analyzed the relevance and validity of the concept of displacement effect propounded by Peacock and Wiseman.

Zahir’s Study

Zahir (1972) examined the role of Public expenditure in the field of income distribution during the period 1951-52 to 1965-66. He concluded that the growing public expenditure in India has made a very significant contribution towards the achievement of social justice which is an avowed objective of the Indian constitution.
Mathew’s Study

T. Mathew’s study (1972) on public expenditure covered the period from 1937 to 1956. It analysed the pattern and various components of public expenditure and their impact on economic development of the country. In this study he attempted to examine whether the changes in the pattern of public expenditure were due to the deliberate Fiscal Policy of the Government or they were the outcome of several factors and circumstances that were within the purview of the Government.

Reddy’s Second Study

Reddy (1976) in his second study found total employment in the organized sector during the period in the country. He noted that expenditure per head of population varies from State to State. To a very large extent, this variance is explained by per capita federal transfers to States up to 1962. Since then the influence of the explanatory variable has declined and this pointed to the fact that federal transfers moved by and large, in favour of relatively underdeveloped States.

Gupta’s Study

Gupta (1977) estimated the distribution of benefits from the combined expenditure of the Central Government, State Governments and Union Territories by using “money flow approach”. According to Gupta, Public expenditure benefits those who receive it as their income. After all those who receive payments from Government are better off with the payments than without them. “This approach may distort the results since the objective of the Government is negatively viewed.
It forgets the fact that the objective of the Government is to serve people and not look after itself (at the expense of the people).

**Regional studies on Public expenditure**

The following are some of the important regional studies on Public expenditure.

**Thimmaiah’s (1977)** analyzed, in his study, various trends in growth of public expenditure in Karnataka state and tested the hypothesis of Wagner Law and arrived to the conclusion is that it has been proved in the case of Karnataka state. In addition, it argued that when there is rapid growth in state activities as a result public expenditure

**Christine Andre and Robert Dolorme’s study on France**

Christine Andre and Robert Dolorme (1978) in their time series analysis of the public expenditures and revenues for the period 1872-1971 in France, expressed doubt on the relevance of the two frequently proposed hypotheses viz., Wagner’s Law of increasing state activity and Peacock Wiseman’s ‘Displacement effect’. Their empirical study points to the irregular growth of public expenditure in France, marked by profound transformation by levels of administration, field of application and economic categories. They also suggested that a different approach to explanation of public expenditure is needed, which is to be based on historical dimension of the phenomenon and on the explicit theory of the State.
Ahuja study

Ahuja (1978)\textsuperscript{22}, estimated the distribution of benefits from government expenditure for three districts - Kanpur (in Uttar Pradesh), Gaya (in Bihar) and Tanjavur (in Tamil Nadu) - on the basis of a sample survey conducted for the year 1974-75. These estimates, although useful to understand the position in those districts, seem to suffer from methodological weakness. For example, he measured benefits as percentage of income by size groups. The result is overestimation of benefits to low income groups. For, in a country, with gross income inequalities, even on a pro-rate distribution of benefits of the government expenditure (that is, by using population as denominator) gives high percentage of benefits to poor since the base to which benefits are related to is already small. There is an inbuilt bias towards the poor in the measurement chosen.

The study of Singh (1979)\textsuperscript{23} analyzed the growth and pattern of the Rajasthan State Government expenditure during the period 1956-57 to 1975-76. The study examined the factors involved in determining the growth of public expenditure and it's financing.

Selowsky and Meerman studies on Colombia and Malaysia

Selowsky (1979)\textsuperscript{24} and Meerman (1979)\textsuperscript{25} investigated primarily the distribution of public subsidy in education and health care, and the distribution of public utilities (electricity, water and sewage disposal).
Some evidence was presented concerning the distribution of public expenditure in other areas, such as agriculture, garbage collection and street lighting; but it is far from comprehensive and both the authors deemphasised its importance. Most of their results are presented by annual income group and town size (or rural/urban). Meerman responding to Malaysia's ethnic diversity, also presented the results by racial group and region.

Not only their methodology but also their results are broadly similar. The distribution of primary education is pro-poor, secondary education is neutral and post-secondary education is strongly pro-rich. Public health care in both countries (although organized on quite different principles both between and within the countries) appears to be equally distributed. The better-off make more use of public utilities, partly because the demand for the services is elastic with respect to income (Meerman) or housing characteristics (Selowsky).

**International Studies on Public Expenditure**

The Following are the important international studies on growth of public expenditure.

**Wagner's hypothesis of Public Expenditure**

Adolph Wagner (1980)\(^{26}\), a German economist presented a systematic approach for explaining the theory of public expenditure and factors responsible for its growth. His approach was correlative to the growth of community output and public expenditure as was observed in a number of Western European countries.
Wagner's hypotheses emphasized on the functional relationship between the growth of economy and its relative growth of public sector activity. According to him, the Government expenditure must increase at an even faster rate than output.

J. Toye's study (1981)\textsuperscript{27} covers the period between 1955 and 1970 and it examined the major changes that took place in the structure of public expenditure of various State governments in India the period.

Misra (1982)\textsuperscript{28} worked out the distributional impact of Government expenditure for the State of Gujarat about the money spent direct to beneficiary groups. The net result of these exercises, according to Misra, was that "most of the government expenditure (on education and health) ultimately reaches those in secondary and very sectors and very little goes to producers of food crops who are the actual majority in the country. The study essentially concerns with the benefits following to different sectors and not with assessing the impact on redistribution of income.

**World Bank Study**

Sanjay Pradhan and Vinaya Swaroop (1983)\textsuperscript{29} of the World bank, carried out a review of the changes that have took place in the levels and composition of public spending in two distinct country groups. These countries have attempted to bring down fiscal deficits, often by reducing public spending, as part of their economic stabilization and structural adjustment programmes. Some critics, including UNICEF, maintain that the fiscal austerity of these policy-based lending programmes forced Governments to curtail social sector spending, particularly for health and education.
While levels of public spending have decreased, misallocation of public expenditures remains a problem. The positive developments were reductions in fiscal deficits, the squeezing out of many inefficient projects and a decline in military expenditure. At the same time, aggregate social sector spending has been protected from cuts. Little progress has been made in reducing excessive public sector employment.

During periods of fiscal austerity, Governments always find it easier to cut capital spending than to reduce current expenditures. The rapid growth in public sector employment and wages that was common in the 1960s and 1970s has been checked. But in doing so they reduced real wages, causing productivity levels to drop sharply. Budgetary share of public spending on the goods and services declined in Africa’s Sub-Saharan countries. Schools are without teaching materials, health clinics, lack of drugs and rehabilitated roads are once again becoming impassible.

Aggregate spending on health and education followed similar trends and the allocation of expenditures within the social sector remains a problem. In Pakistan and Uganda expenditures have been diverted from basic social services to defence, despite high rates of infant mortality, illiteracy and mal-nutrition. Public spending policy should be carefully tailored to individual countries, based on a detailed assessment of the need. Retrenchments of employment in surplus organizations are essential. When defence spending is crowding out necessary public spending, resources should be allocated away from military expenditures towards basic services.
**Bhattacharya's Study**

Bhattacharya (1984) made a rigorous econometric analysis of major issues relating to public expenditure, inflation and growth in the Indian economy during the planning era. It discusses the theoretical implications of Government budgetary constraints for public sector revenue and expenditure on the one hand, and for output, employment, investment and prices on the other. A special feature of the study is that it shows how various government budgetary instruments and policies are interdependent on each other and how these to inflation, growth and balance of payments. The theoretical developments in 'Government budget constraints' and their implications for stabilization policies are incorporated in both theoretical and empirical analysis in his study.

**Maitra Taresh study**

Maitra Taresh (1986) tried to estimate "Budget incidence" by using deductive reasoning and inductive reasoning. Perhaps this is the first of its kind which made systematic effort to estimate expenditure incidence. It covers expenditure on education, public distribution which account for only one-fifth of total expenditure. In his study, indirect taxes exceeded expenditure on the public services. Consequently, the general level of the distributive schedule derived from the consumption of the public services were lower than what it would have been had the excess taxes been spent and accounted for in the budget incidence analysis.

The study of Raju (1989) examined the pattern and growth of public expenditure of Andhra Pradesh on different functional categories
during the period from 1956-57 to 1981-82. This study has also made an analysis of the determinants of public expenditure and its growth.

Reddy and Sudhakar Reddy (1989) work entitled "Incident of public expenditure in India", studied the public expenditure in Andhra Pradesh. Taking allocable public expenditure as a whole per household benefits went largely to high income group during 1975-85. Per household benefits from expenditures on agriculture and allied services accrued to high income group. Within this major head, expenditure on agriculture and area development seems to have accentuated the inequalities while expenditure on schemes for small and marginal farmers and agricultural labourers, animal husbandry and dairy development reduced inequalities.

Narayana, B (1991) study on "Pattern of Public Expenditure in Andhra Pradesh", reveals that the increase in public expenditure is not homogenous and smooth, because there are fluctuations from period to period. Growth trends in public expenditure with the growth trends in population encouraging results were found. The average state income and the average growth of public expenditure positively correlated but state income is lesser than that of public expenditure.

Ravallion and Subbarao (1992) found that Kerala, West Bengal, Tamil Nadu and Andhra Pradesh were states with high social service expenditures, and the governments of these states were traditionally at odds politically with the central government. These states were politically motivated to maintain high levels of social service expenditures as well as maintained fiscal discipline in order to
finance such expenditures. However, new economic and political trends began to emerge, and from the late 1980s most state governments fell into deficit, and many of them were often ruled by a political party different from that of the central government.

Jamal Khan (1993)\textsuperscript{36} examined the growth and pattern of public expenditure and it’s financing in India from 1950-51 to 1989-90. In this study, he analyzed the growth and structural changes in plan and non-plan expenditures, developmental and non-developmental expenditures of the Government of India.

Sudhakar, S (1995)\textsuperscript{37} study on “distribution of benefits of public expenditure in India”, made an attempt to examine how the benefits of public expenditure on two important social services are distributed across different income groups in All-India as well as in the state of Andhra Pradesh. The services are Health and Public Distribution System and the reference year is 1986-1987. The study reveals that the distribution of per capita benefits of public expenditure on Health Services was unequal in favor of high income group in 1986-87. On the other hand, per capita benefits distribution of public expenditure on Public Distribution System (PDS) was in favor of low income group for both All-India and Andhra Pradesh in 1986-87.

Basu (1995)\textsuperscript{38} pointed out that the low budget for social services including education and health reflected the low priority given to these areas. Government officials generally chose to post pone “primary education for all” rather than hold back the completion of irrigation projects, and consequently when finalizing the
annual budgets, funds were often taken from educational expenditures and shifted to other government programmes.

Sham Bhat and Uma Shankar Patnaik (1996) examined the determinants of public expenditure and their variability across congress and non-congress ruled Indian States for the year 1985-86. The explanatory variables consider for the analysis are per capita income, primary sector contribution, literacy rate, density of population, percentage of urban population in total population, percentage of Scheduled Caste and Scheduled Tribe in total population and dummy variable representing '0' for non-congress ruled States and '1' for congress ruled States. Multiple Linear Regression equation has been used to identify the determinants. They arrived at a conclusion that in addition to social economic variables, changing political party in power significantly influences total expenditure, expenditure on education and expenditure on economic survives.

The studies explained above examined the growth and pattern of public expenditure of the government of India as a whole and they did not explain the growth of public expenditure of the regional Governments i.e., the state Governments in India.

Rekha Jagannath (1998), study on “India’s Public Expenditure in the 1990s”, reveals that there is a crying need to give first priority to health care, sanitation, drinking water supply and education. The study found that India's defence expenditure is higher than the outlays on education, medical and public health, sanitation and water supply, housing and family welfare. In addition
administrative expenditure and pension and other retirement benefits are higher than that of above mentioned items.

Pravakar Shao (2000) Study on “Economics of Public Expenditure in India”, and presented a brief description of the trends in public expenditure in India. It reveals that the size of the interest payment on the debt is larger the total defense expenditure of the government has increased at a lower rate in 1997-98 and 1998-99 but the expenditure on subsidies as a percentage is more or less constant leading to less fund availability for capital expenditure and infrastructure. It also indicates that the development components of both capital and revenue expenditure have been falling over time. The study concludes that for a sustainable and productive public expenditure, government should increase its efforts for tax and non-tax revenues, reduce borrowing to pull down interest rate and subsidies, increase Capital Expenditure(CE) for capital formation, cease all kinds of unnecessary non-merit subsidies and above all make sustained efforts to make CE grow faster than Revenue Expenditure.

Panchamukhi (2000) found low coefficients of correlation between government deficits and expenditures on education and health between the mid 1970s and mid 1980s. This implies that when the central government or state governments increased total expenditures, those for social service expenditures increased only a little. This implication could also be seen after economic reforms in that social service expenditures declined as governments sought to reduce fiscal deficits.
Prabhu (2001) examined social service expenditures as a proportion of total expenditures, as a proportion of GDP, and as real per capita expenditures. Using different methodologies, all of these studies analyzed the trend of social service expenditures a few years after economic reforms began, and they all in common pointed out the declining trend in these expenditures by state governments, except in a few states, such as, Kerala which were traditionally committed to social policy.

Shariff, Gosh and Mondale (2002) and Dev and Mooij (2002) analyzed social service and rural development expenditures during the whole of the 1990s, and these studies pointed to an increasing trend in expenditures by the central government in contrast to the declining trend for state government. However, it was not the intention of these latter two studies to examine whether the start of economic reforms was a turning point for social service expenditures or what the regions were for the increase in central government expenditures while those in some states decreased.

The above studies have undoubtedly contributed to the growth of general level on public expenditure. But, they did not cover various aspects of public expenditure like the determinants, factors responsible for observed trend, the effects of public expenditure on regional and Sectoral development and the like. There has been very little research analyzing the factors determining the disaggregated public expenditure in a developing State like Andhra Pradesh. It has perhaps this sort of background at the State level that prompted Prof. Lakdawala to observe “The
positive aspects of Indian Public expenditure analysis remain a large unexplored field.

It can be observed from the above brief review of Public expenditure studies, no systematic effort has been made by any study to examine the trends in the growth and pattern of public expenditure of Andhra Pradesh. It is in this context that the present study has been undertaken to bridge the gap that exists in the literature on public expenditure a State level in Andhra Pradesh.

I.M.F. Study

I.M.F.\textsuperscript{45} policy advice to its member countries has placed greater emphasis on the need for fiscal discipline through reductions in unproductive public expenditures. To shed light on this subject a recent internal study was undertaken by the I.M.F. Fiscal Affairs Department to assess the nature and depth of this advice for a sample of 17 member countries. Unproductive public expenditures are those public outlays that can be reduced without affecting the government outputs such as the provision of law and order and basic education and health services. Unproductive spending can trigger large fiscal deficits, a correspondingly lower level of public sector output, and a tax burden that is heavier than necessary. Reducing unproductive public expenditures is particularly important in countries burdened with low revenue and high spending. Reducing wasteful spending can save scarce financial resources and would yield a large increase in global financial resources.

Unproductive public spending was identified in a number of expenditure categories in both program and non-program countries, including wages and
salaries, subsidies and transfers, military expenditures and social sector outlays. In response I.M.F. policy advice has underscored the potential benefits of reducing unproductive expenditure for achieving equitable and efficient fiscal adjustment.

**METHODOLOGY**

The study is mainly based on secondary sources of data and information. The data/information required for the study has been drawn from the following published sources of various state government departments:

1. Government of India, Economic Surveys;
2. Government of India, Five Year Plans;
3. Reserve Bank of India, Annual Reviews on State Finances;
4. Government of Andhra Pradesh, Explanatory Memorandum on the Budgets;
5. Government of Andhra Pradesh, Survey of Economic Trends and State Plans;
7. Government of Andhra Pradesh, Five Year Plans; and

In addition to above, efforts have been made to collect data from other official sources to fill the gaps in time series data. All efforts have been made to collect data from the authorized sources as to ensure its reliability.

**Study Period**

The present study covers twenty years period from 1985-86 to 2004-05. Justification for the starting year of the study period is that there is a change in the
classification sectors from 1985-86 onwards. Similarly, the justification for the terminal year of the study period is the change in budgetary process towards performance budgeting by individual departments of the government.
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