Unit II

Wagner’s Hypothesis:

Adolf Wagner a noted German political economist (1835-1917) propounded an empirical law to analyses and explains the trend in the growth of public expenditure. Wagner argued that a functional, cause and effect relationship exists between the growth of an industrializing economy and the relative growth of its public sector.

According to Wagner, relative growth of the government sector is an inherent characteristic of industrializing economies. He illustrates this with the examples of Great Britain, U.S.A, France, Germany and Japan. He came to the conclusion that as per capita income and output increases in industrializing nations, the public sectors of these nations necessarily grow as a proportion of total economic activity.

Wagner hypothesized a functional relationship between industrialization and the relative importance of public sector activity. He then set out to test his hypothesis by examining the industrialization process in various European countries and Japan. His observations led to what is now called as Wagner’s Law of Increasing State Activity.

Statement of the Hypothesis:

The German Economist Adolf Wagner, systematically observed the historical facts of increasing expenditure activities of public authorities particularly of Germany, He then tried to explain the cause of growth in public expenditure in terms of his famous “Law of Increasing State Activities”.

According to Wagner there are inherent tendencies for the activities of different layers of a government (such as center and state) to increase both intensively and extensively.

Wagner presented his law in the following words “Comprehensive comparisons of different countries and different times show that among progressive people, with which we alone are concerned an increase regularly takes place in the activity of both the central and the local governments. This increase is both extensive and intensive. The central and local governments constantly undertake new functions, while they perform both old and new functions more efficiently and completely.”

Wagner’s law of increasing state activities is a universal truth in recent years. It is a fact that economic growth of a country has always been accompanied by increasing state activities and hence increasing public expenditure.

Empirical evidence indicates the hypothesis of continuous upward trend in government activities. F.S. Nitty made an empirical study of the expenditure trend of public authorities of varying countries of the world, and concluded with empirical evidence that Wagner’s law was not only applicable to Germany but to various governments which differ widely from each other.

Nitty states all kinds of government, irrespective of their layers (say central, state or local) intensions (peaceful or warlike) and size etc., had shown similar tendencies towards increasing public expenditure.

Wagner’s law was based upon historical facts. His law was applicable to modern progressive governments only in which the state was interested in expanding the public sector of the economy. Wagner observed that there was a persistent tendency towards an ‘extensive’ and ‘intensive’ increase in the functions of the state.

Intensive increase means expansion of traditional functions of the state on a large scale. Extensive increase relates to coverage of new welfare functions.

According to Wagner’s law, the expenditure of public authorizes has a continuous increasing trend due to three reasons, they are:

a. Expansion of Traditional Functions:

Traditional functions mainly include defence, administration of justice, maintenance of law and order and provision of social overheads. The coverage and variety of such functions have gradually increased.

Defence expenditure has expanded rapidly because of a change in military arts and sciences. In modern times military activities has become sophisticated. From simple aggression, the modern warfare shifted to prevention of attack and use of sophisticated weapons.

Defence outlays on men, materials and maintenance have been on a rising trend in modern times. Similar is the case with expenditure on internal protection and administration. Increasing areas of administration and spread of government machinery with expertise have become more and more expensive.

b. Coverage of New Functions:

Secondly the activities of the state were increasing in their coverage. Traditionally the state activities were limited to only defence, justice, law and order, maintenance of the states over heads etc. But with the growing awareness of its responsibilities to the society, the governments started expanding its activities in the field of various welfare measures to enrich the cultural life of the society.

Along with this new welfare programmes were designed to provide social security to the people. This required increasing government expenditure on education, public health, low cost housing, subsidized provision of food, agricultural inputs, old age pension, sickness benefit etc.

c. Expanding Sphere of Public Goods:

Almost all modern democratic governments have increasingly recognized the need to provide and expand the sphere of public goods.

The need and necessity to provide social and merit goods through budgetary allocation was increasingly recognized by the modern state. The state was trying to shift the composition of national product more in favor of public goods.

As a result state activities expanded to areas like irrigation and flood control projects, construction and maintenance of public parks, provision of education and health care facilities, creation of economic overhead capital etc., Provision of these public goods and merit goods means heavy investment in public enterprises.

Apart from the above mentioned factors, Wagner also examined the forces that operate on both the demand and supply side of public sector activity and explained how they interact. Changing production and marketing arrangements of public sector activity affect and are affected by social organizations in different ways.

They are given:

i. Factors that affect both demand and supply of public expenditure activities:

(a) Per capital income and wealth exert a positive impact on the demand as well as cost of government services.

(b) Coupled with this rate of growth of population and density also affect the demand for public goods such as transport, communication, hospitals etc., in addition to the cost of supply of these services.

ii. Factors affecting the demand side of public expenditure activities. The major factors under this category are:
(a) Urbanization and industrialization.

(b) Structure and composition of the population which determine the demand for educational facilities, old age pension, old age homes etc.

c) Specialization of labour and centralization of administration in both private and public activities.

iii. Factors affecting the supply side of public expenditure activities. On the supply side, the major factors affecting public sector activities are:
(a) Changing scale of production of government activities.

(b) Quality of production.

(c) Intergovernmental grants.

Obviously the functional relationships Wagner sought to trace are complex. Adolf Wagner believed that increased public expenditure was the natural result of economic growth and the continued pressure for social progress.

Wagner held that the income elasticity of government services is greater than unity. In other words public expenditure will increase faster than the increase in per capita income of the people.

Graphic Presentation of the Wagner Hypothesis:
The modern formulation of Wagner’s law is that “as per capita income rises in industrializing nations, their public sector will grow in relative importance” (Bird, 1971, p.2). The Wagner’s hypothesis of increasing state activity is illustrated in Figure No.3.1.

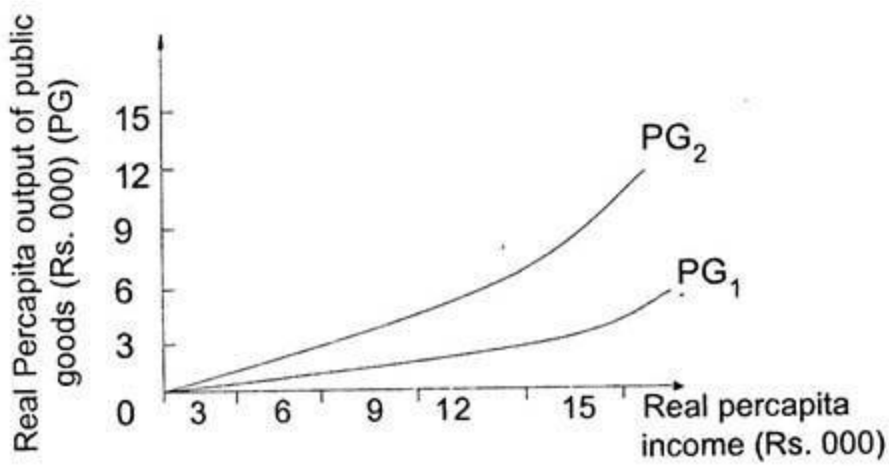

Figure: 3.1. Wagner's hypothesis: The relative expansion of public sector economic activity over time

In this graph the real per capital output of public goods (PG) is measured on the vertical axis and real per capita income (Y) is measured on the horizontal axis.

Time is an important third dimension implicit in the graph, because the growth in the real per capita output of public goods and in real per capita income is realistically assumed to take place on a historical basis over an extended period of time. Line PG^1 represents a circumstance in which the public sector maintains a constant proportion of the total economic production of the society over time.

In other words, as real per capita income increases, due to economic development of the society, the real per capita output of public goods remains at the same proportion of total economic activity. The constant proportion line, PG^1, can be used as a reference point to the graphical presentation of Wagner hypothesis as depicted by the line PG^2.

All along the PG^2 the proportion of resources devoted to the output of public goods is expanding overtime.

The implication of Wagner's law can be stated in the following equations. When the real per capita output of public goods remains at the same proportion of total economic activity, i.e. PG^1, the equation is

PGa/Ya = PGo/Yo

In other words the income elasticity of expenditure for public goods (Ye) is elastic.

Wagner's hypothesis provides the most suitable frame work for explaining economic factors, as the most important determinant of a relatively expanding public sector during industrialization and economic growth.

The functional relationships, Wagner sought to trace are complex. Wagner believed that increased public expenditure was the natural result of economic growth and the continued pressure for social progress.

Criticism of Wagner's Hypothesis:

Although the Wagner hypothesis has many attributes, it also has 'several defects. Wagner's law of increasing state activity was criticized by Allan. T. Feacock and Jack Wiseman on the following grounds:

i. Wagner's hypothesis deals with inter-disciplinary phenomenon. But it lacks interdisciplinary approach in its analytical framework.

ii. Lacks comprehensiveness in analysis Wagner's law lacks comprehensiveness. Political science, economics and sociology are among the several disciplines to be incorporated in any theory of public expenditure. The Wagner's hypothesis excludes all these characteristics.

iii. It is based on an organic self-determining theory of the state, which is not the prevailing theory of the state in most western countries.

iv. The theory ignores the influence of war on governmental spending, and

v. It stresses a long term trend of public economic activity, which tend to overlook the significant 'time pattern' or process of public expenditure growth.

Theory # 2. Peacock and Wiseman Hypothesis:

Another hypothesis regarding the growth of public expenditure was put forth by Peacock and Wiseman, in their empirical study of public expenditure in U.K. for the period 1890-1955.

Peacock and Wiseman emphasize the time pattern of public spending trends rather than striving for a genuine positive theory of public sector growth. The main thesis of the authors is that public expenditure does not increase in a smooth and continuous manner, but in jumps and jerks or step like fashion. Their analysis involves three related elements.

These are displacement, inspection and concentration effects. Using empirical data for the British economy after 1890, Wiseman and Peacock observe that the relative growth of the public sector in the United Kingdom has followed a discrete step like pattern rather than a continuous growth pattern.

During the period under study they found that, government fiscal activities, in the country have risen step by step to successive new plateaus. Moreover the absolute and relative increases (steps upward) in taxing and spending activities by the British government have generally taken place during periods of major social disturbance or crisis such as war or depression.

These kinds of changed fiscal situation cause the previous lower tax and expenditure levels to be replaced by new, higher, budgetary levels. This movement from the older level of expenditure and taxation to a new and higher level is called the displacement effect after the social disturbance has ended; the new level of tax is tolerated by the society.

The emerged new levels of tax tolerance make the society willing to support higher levels of public expenditure. In other words the lax threshold has increased. Thus there is no strong motivation to return to the lower pre-crisis level of taxation.

Over the secular period, 1890 -1955, this displacement procedure occurred several times in Great Britain. Thus when the major social disturbance ends, no strong motivation exists for the society to return to the lower pre-disturbance level.

The higher government revenues are used to support permanently higher levels of public sector allocation. Figure No. 3.2 clearly shows the displacement effect, as explained by Wiseman and Peacock.

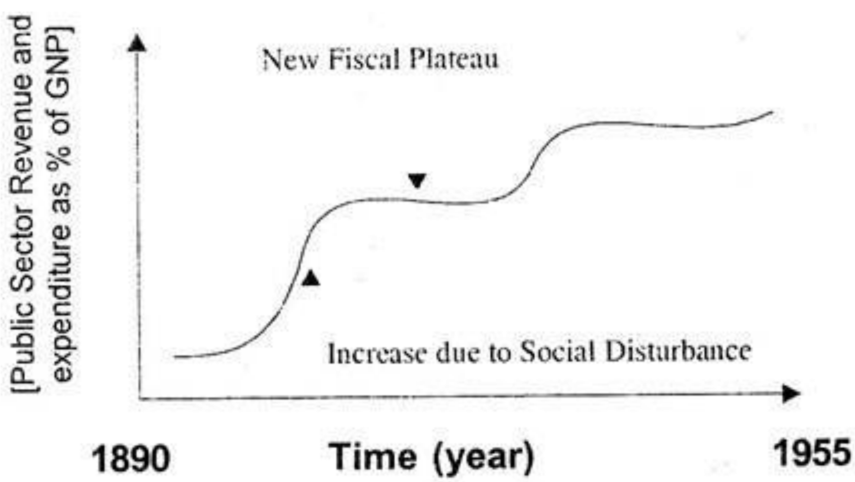

Figure No. 3.2 The displacement effect

Figure No. 3.2 demonstrates the displacement effect, tax threshold behavior. Time (years) is measured along the horizontal axis, while public sector revenues (mostly taxes) and public expenditures as a percentage of gross national product are measured along the vertical axis.

The figure reveals that as the social disturbance cause a relative expansion of the public sector, the displacement effect which occurs helps to explain the time pattern by which the government growth takes place. This displacement effect does not require that the new higher plateau of expenditure, continue the same expenditure composition that was created by the social disturbance.

Some of the increased expenditures like debt interest are the direct results of the social disturbance.

While other expenditures arose as a result of technological development and expansion of government activity into new areas. For instance, war and 'other social disturbance, frequently force the people and their government to find out a lasting solution to the long standing and pending problems, which were previously neglected.

This is known as **"inspection effect".** Inspection effect is the inadequacy of revenue in comparison with the 'required' public expenditure.

In addition to the displacement and inspection effect, Peacock and Wiseman, also give narration about a concentration (scale) effect. It refers to the apparent tendency for the central government economic activity to become an increasing proportion of total public sector economic activity, when a society is experiencing economic growth.

This occurs, because central government has to initiate a number of measures to sustain higher economic activity. Since each major disturbance leads to a situation in which, the central government assuming a larger proportion of the total national economic activity, the net result is **"the concentration effect".**

Wiseman – Peacock hypothesis appears to be quite relevant. At the outlet, the hypothesis looks quite convincing. It emphasizes jerks and jumps in public expenditure, on account of unusual and abnormal situations.

According to Prof. Aronson, for Peacock and Wiseman expenditure growth is sporadic rather than constant and revenues create their own expenditures. However, we must not forget the fact that, an account of the advance of the economy and the structural changes therein, there are constant and regular increments in public expenditure and revenue.

Public expenditure has a tendency to grow on account of a systematic expansion of government activities, both in terms of intensity and quality.

The regular and dynamic changes in state activity and public spending caused by macro variables like population growth, urbanization, awareness of civic rights on the part of citizens and political and social commitments on the part of democratic governments voted to power are major factors giving a big push to upward trend in public expenditure.

However, the influences of these factors on government spending were not systematically analyzed by Wiseman and Peacock in their hypothesis. However, Bernard. P. Herber sincerely argues that the Peacock – Wiesman hypothesis of governmental spending trends, is much more modest in what it intend to explain than in Wagner's hypothesis. The fact is that, both the Wagner's and Peacock. Wiseman narrations contribute a lot in understanding the process of public sector growth in industrialized nations.

Source: https://www.accountingnotes.net/financial-management/public-expenditure/analysis-of-public-expenditure-growth-3-theories/10016

Public Expenditure: Causes, Principles and Importance!

Meaning of Public Expenditure:

Expenses incurred by the public authorities—central, state and local self- governments—are called public expenditure. Such expenditures are made for the maintenance of the governments as well as for the benefit of the society as whole.

There was a misbelief in the academic circles in the nineteenth century that public expenditures were wasteful. Public expenditures must be kept low as far as practicable. This conservative thinking died down in the twentieth century, especially after the Second World War.

As a modern state is termed a **'welfare state'**, the horizon of activities of the government has expanded in length and breadth. Now we can point out the reasons for enormous increase in public expenditure throughout the world even in the capitalist countries where laissez-faire principle operates. These are the following.

Causes of Increase in Public Expenditure:

(a) Size of the Country and Population:

We see an expansion of geographical area of almost all countries. Even in no-man's land one finds the activities of the modern government.

Assuming a fixed size of a country, developing world has seen an enormous increase in population growth. Consequently, the expansion in administrative activities of the government (like defence, police, and judiciary) has resulted in a growth of public expenditures in these areas.

(b) Defence Expenditure:

The tremendous growth of public expenditure can be attributed to threats of war. No great war has been conducted in the second half of the twentieth century. But the threats of war have not vanished; rather it looms large. Thus, mere sovereignty, demands a larger allocation of financial sources for defence preparedness.

(c) Welfare State:

The 19th century state was a **'police state'** while, in 20th and 21st centuries modern state is a **'welfare state'**. Even in a capitalist framework, socialistic principles are not altogether discarded. Since socialistic principles are respected here, modern governments have come out openly for socio-economic uplift of the masses.

Various socio-economic programmes are undertaken to promote people's welfare. Modern governments spend huge money for the purpose of economic development. It plays an active role in the production of goods and services. Such investment is financed by the government.

Besides development activities, welfare activities have grown tremendously. It spends money for providing various social security benefits. Social sectors like health, education, etc., receive a special treatment under the government patronage. It builds up not only social infrastructure but also economic infrastructure in the form of transport, electricity, etc.

Provision of all these require huge finance. Since a hefty sum is required for financing these activities, modern governments are the only providers of money. However, various welfare activities of the government are largely shaped and influenced by the political leaders (Ministers, MPs, and MLAs to have a political mileage, as well as by the bureaucrats (MPLAD)).

(d) Economic Development:

Modern government has a great role to play in shaping an economy. Private capitalists are utterly incapable of financing economic development of a country. This incapacity of the private sector has prompted modern governments to invest in various sectors so that economic development occurs.

Economic development is largely conditioned by the availability of economic infrastructure. Only by building up economic infrastructure, road, transport, electricity, etc., the structure of an economy can be made to improve. Obviously, for financing these activities, government spends money.

(e) Price Rise:
Increase in government expenditure is often ascribed to inflationary price rise.

Types of Public Expenditure:
Public expenditure may be classified into developmental and non-developmental expenditures. Former includes the expenditure incurred on social and community services, economic services, etc. Non-developmental expenditure includes expenditures made for administrative service, defence service, debt servicing, subsidies, etc.

Public expenditure is classified into revenue expenditure and capital expenditure. Revenue expenditure includes civil expenditure (e.g., general services, social and community services and economic services), defence expenditure, etc. On the other hand, capital expenditure comprises expenditures incurred on social and community development, economic development, defence, general services, etc.

Public expenditure may also be classified as plan expenditure and non-plan expenditure.

Non-plan expenditure falls under two broad heads, viz., revenue expenditure and capital expenditure. The former comprises interest payments, defence expenditures, subsidies, pensions, other general services (like health, education), economic services (like agriculture, energy, industry, transport and communication, science, technology and environment, etc.)

Expenditures on agriculture, rural development, irrigation and flood control, energy, industry and mineral resources, etc., are included in plan expenditure.

Principles Governing Public Expenditure or Canons of Public Expenditure:
Rules or principles that govern the expenditure policy of the government are called canons of public expenditure. Fundamental principles of public spending determine the efficiency and propriety of the expenditure itself. While making its spending programme, government must follow these principles. These principles, in short, are called canons of public expenditure.

Findlay Shirras has laid down the following four canons of public expenditure:
(i) Canon of benefit

(ii) Canon of economy

(iii) Canon of sanction

(iv) Canon of surplus

(i) Canon of Benefit:

According to this canon, public spending has to be made in such a way that it confers greatest social benefits. In other words, public expenditure must not be geared in such a way that it provides benefits to a particular group of the community. Thus, public expenditure is to be made in those directions where general benefits rather than specific benefits flow in.

However, often public expenditure is incurred for the benefit of a particular group (say, dalits, tribals). This sort of public expenditure does not violate canon of benefit. Any public expenditure for the development of a backward area does promote social interest.

(ii) Canon of Economy:

Economy does not mean miserliness. It refers to the avoidance of wasteful and extravagant expenditure. Public expenditure must be made in such a way that it becomes productive and efficient. Efficiency in public expenditure requires economy of expenditures. To enjoy the maximum aggregate benefit from any public spending programme, it is necessary that the canon of economy is observed.

An uneconomic expansion in public expenditure will result in scarcity of funds, the much-needed growth of the productive sectors will be hampered. This means lower social benefit. It is thus obvious that the canon of economy is not independent of the canon of benefit.

(iii) Canon of Sanction:

The canon of section, as suggested by Shirras, requires that public spending should not be made without any concurrence or sanction of an appropriate authority. Arbitrariness in public spending can be avoided only if spending is approved. Further, economy in public spending can never be ensured if it is not sanctioned.

(iv) Canon of Surplus:

This canon suggests the avoidance of deficit in public spending. Like individuals, saving is a virtue for the government. So the government must prepare its budget in such a way that government revenue exceeds government expenditure so as to create a surplus. It must not run deficit to cover its expenditure.

However, modern economists do not like to attach any importance to Shirras' fourth canon— the canon of surplus. To them, deficit financing is the most effective means of financing economic programmes of the government.

Importance of Public Expenditure:

An old-fashioned dictum says that **"The very best of all plans of finance is to spend little, and the best of all taxes is that which is least in amount."** No one today believes this philosophy. In the 1930s, J. M. Keynes emphasized the importance of public expenditure.

The modern state is described as the **'welfare state'**. As a result, the activities of the modern government have widened enormously. Modern governments are undertaking various social and economic activities, particularly in less developed countries (LDCs).

i. Economic Development:

Without government support and backing, a poor country cannot make huge investments to bring about a favourable change in the economic base of a country. That is why massive investments are made by the government in the development of basic and key industries, agriculture, consumable goods, etc.

Public expenditure has the expansionary effect on the growth of national income, employment opportunities, etc. Economic development also requires development of economic infrastructures. A developing country like India must undertake various projects, like road-bridge-dam construction, power plants, transport and communications, etc.

These social overhead capital or economic infrastructures are of crucial importance for accelerating the pace of economic development. It is to be remembered here that private investors are incapable of making such massive investments on the various infrastructural projects. It is imperative that the government undertakes such projects. Greater the public expenditure, higher is the level of economic development.

ii. Fiscal Policy Instrument:

Public expenditure is considered as an important tool of fiscal policy. Public expenditure creates and increases the scope of employment opportunities during depression. Thus, public expenditure can prevent periodic cyclical fluctuations. During depression, it is recommended that there should be more and more governmental expenditures on the ground that it creates jobs and incomes.

On the contrary, a cut-back in government's expenditure is necessary when the economy faces the problem of inflation. That is why it is said that by manipulating public expenditure, cyclical fluctuations can be lessened greatly. In other words, variation of public expenditure is a part of the anti- cyclical fiscal policy.

It is to be kept in mind that it is not just the amount of public expenditure that is incurred which is of importance to the economy. What is equally, if not more, important is the purpose of such expenditure or the quality of expenditure. The quality of expenditure determines the adequacy and effectiveness of such expenditure. Excessive expenditures may cause inflation.

Moreover, if the government has to impose taxes at high rates there will be loss of incentives. So, it is necessary to avoid unnecessary expenditure as far as practicable, otherwise benefits of better economic development may not be reaped. As a fiscal policy instrument, it may be counter-productive.

iii. Redistribution of Income:

Public expenditure is used as a powerful fiscal instrument to bring about an equitable distribution of income and wealth. There are good much public expenditure that benefit poor income groups. By providing subsidies, free education and health care facilities to the poor people, government can improve the economic position of these people.

iv. Balanced Regional Growth:

Public expenditure can correct regional disparities. By diverting resources in backward regions, government can bring about all-round development there so as to compete with the advanced regions of the country.

This is what is required to maintain integration and unity among people of all the regions. Unbalanced regional growth encourages disintegrating forces to rise. Public expenditure is an antidote for these reactionary elements.

Thus, public expenditure has both economic and social objectives. It is necessary to ensure that the government's expenditure is made solely in the public interest and does not serve any individual's interest or that of any political party or a group of persons.

Source: https://www.economicsdiscussion.net/india/public-expenditure/public-expenditure-causes-principles-and-importance/17462

Effects of Public Expenditure:
Public expenditure is an important fiscal instrument to secure many fold social objectives in an economy. The traditional economist held the view that state should not incur more expenditure.

Adam Smith and other classical economists considered public expenditure as ‘unproductive’ and private expenditure was considered ‘productive’. This mistaken notion of the classist arose out of their false belief in the efficacy of Laissez-faire capitalism, in mitigating cyclical fluctuations and preserving full employment.

Adam Smith advocated minimum activities for the state. That is preservation of the community from aggressions and maintenance of law and order. Hence classical economists were in favour of minimum public expenditure.

However, the world wide depression of 1930’s and the two global wars, proved faulty the classical faith on Laissez-faire. With the advent of Keynes general theory, public expenditure came to be looked upon as an indispensable fiscal instrument of securing social welfare and correcting economic instability.

Moreover, there are areas of economy like provision of basic infrastructures, where market mechanism completely fails to distribute the cost of output production among expenditure beneficiaries through the pricing system.

Only the public sector can supply these welfare increasing facilities through budgetary allocation. Hence in the modern world public expenditure influence the national economy in a manifold manner. It is important therefore to examine how public expenditure affects the economy in various ways and secure social welfare.

1. Effects of Public Expenditure on Production:
According to Dalton the level of production and employment in any country depends upon three factors namely:
(a) Ability of the people to work, save and invest,

(b) Willingness to work save and invest, and

(c) Diversion of economic resources as between different uses and localities.

Public expenditure influences all these factors either positively or negatively. Production depends upon the employment of resources by human labour assisted with capital. The capital stock of a country depends upon savings or the surplus over consumption.

Thus the way in which public expenditure effects production is determined by its influence on the willingness and ability of the laborers to work, on the allocation of resources and on the amount of savings. We shall now explain these effects in detail;

(a) Ability to Work, Save and Invest:

Public expenditure can influence ability to work, save and invest either favorably or unfavorably. If public expenditure is used as an instrument to promote the efficiency of a person to work, it will promote production and national income. For example, public expenditure on education, medical services, cheap housing facilities etc. can increase the efficiency of a person to work.

At the same time, public expenditure can promote saving on the part of the lower income group by providing additional income to them, for, all the persons who has larger income can be normally expected to save lower amounts.

It improves their standard of living and efficiency and thereby their ability to work and save enhances. Finally public expenditure, particularly repayment of public debt, will place additional funds at the disposal of those who can invest.

Likewise expenditure incurred on the maintenance of law and order, will create confidence in the minds of the people, thereby creating a favorable investment climate in productive activities. In this way public expenditure can promote ability to work, save and invest and thereby production and employment.

On the other hand, if larger portion of public expenditure is channelized into wasteful social functions, on the production of intoxicants, harmful drugs etc. it will adversely affect ability to work, save and invest.

Similarly, if heavy public expenditure is made on the construction of film studios, cinema houses, hotels and bars, rather than on the construction of roads, and other means of transport and communication, public expenditure creates unfavorable effect on ability to work, save and invest.

(b) Willingness to Work, Save and Invest:

The effect of public expenditure on the willingness to work, save and invest depends considerably on the expectation of future benefits. It also depends upon the character of public expenditure and the policy of the government. For example, pension, interest on loans, provident fund, sickness benefit etc. provide security and safety to a person.

Therefore it reduces his willingness to work and save. The underlying principle is why should a person work hard and save, when he knows fully, that he will be looked after by the government when he is not in a position to earn any income.

He finds his future fully secured. In the absence of any saving, investment will notarise. Hence public expenditure should be regulated in such a way that it may not adversely affect the incentive to work of the people.

(c) Diversion of Economic Resources:
Public expenditure diverts resources from private to public use in many ways. Public expenditure has far reaching effects on the utilization of resources as between alternative uses.

In the first place, there are such diversions of resources from private to public use, about which there is some doubt. Dalton talks about government expenditure on armaments and armed forces.

To meet such expenditure, the government diverts economic resources from the general public to the government. It is thought by many that these economic resources could have contributed to economic welfare, if they have been allowed to remain with the people themselves.

But it is also true that defence expenditure is essential for the safety and security of the nation without which no country can flourish economically. Hence in this context, defence expenditure is important from the national point of view.

Alternatively, public expenditure may bring about a better allocation of economic resources between the present and the future. In a free capitalist society, very little provision is made for the future. This is because people prefer the present rather than the future.

The state on the other hand is the custodian of the interest of the future generation. It is the duty of the state to make adequate provision for the future generation. Unlike private individuals, the government can make investments in railways, irrigation projects, afforestation etc., which do not yield immediate returns, but can provide social and economic benefits to the future generation.

The government also spends money in the conservation of economic resources. Hence the diversion of resources from private to public sector for the construction of basic infrastructure and for preservation and conservation of scarce resources is very essential for economic development. These kinds of expenditure exert a positive impact on production and economic activity of a nation.

Public expenditure can result in increased production in the society through changes in pattern and composition of production. Private sector is interested in maximization of profit and is not concerned with efficient allocation of resources. Public expenditure can induce diversion of resources from less essential products to more essential products by offering subsidies and other concessions.

Hence public expenditure in the form of subsidies and grants is helpful in directing the resources of the people to establish new industries as well as to accelerate production of existing industries.

Similarly, public expenditure on social overheads like education, training, public health etc., produce favorable effect on production. It will increase social welfare and efficiency of production. Likewise government spends money for encouraging and developing research and development activities and inventions and innovations.

The diversion of economic resources here will greatly increase production and enhance productive capacity. Government expenditure on public works programmes has also favorable effect on production and employment.

Sometimes public expenditure may result in diversion of economic resources as between localities. This is done through central government grants to state governments to provide certain services more efficiently.

This will help to increase productive capacity and to reduce regional inequalities in development. For example, special expenditure in the form of grants incurred to the development of backward region help to reduce regional imbalance and to enhance production and economic development.

Prudently planned public expenditure can certainly bring about diversion of resources as between regions which will improve the economic position of backward areas, and thereby increase production and employment.

Further, public expenditure can also modify the allocation of resources and thus influence the composition of GNP. For example, an increase in public investment in highway construction may stimulate automobile and allied industries and this expansion in turn may retard railway expansion.

Similarly, subsidies given for the assistance of particular industries may develop them at the expense of others. For example, if grants are given for building houses for middle or poor income groups, resources might flow to construction industries.

On the whole, public expenditure exerts a wholesome influence on production. Dalton's conclusion on the question of the effects of public expenditure on production and employment is that **"whereas taxation taken alone, may check production, public expenditure, taken alone, should almost certainly increase it".**
It is possible that production will definitely be checked if carelessly planned, but it will stimulate production, if carefully planned.

2. Public Expenditure and Distribution:
In most communities and countries of the world, inequality in the distribution of income and wealth exists in different forms. This social problem is undesirable on many grounds ethical, economic and political, among others.

The removal of or reduction in inequality in the distribution of wealth has now universally been recognized as an important objective of state policy. India also envisages a more equitable distribution of wealth.

The tools of fiscal policy are directed towards achieving a fair distribution of income among the different classes of people in the society. The state tries to achieve this object partly by means of taxation or leveling down the wealth of the rich and partly by means of public expenditure or leveling up the wealth of the poor.

Both fiscal activities are ultimately linked with each other. They are complementary rather than competitive in character.

There are certain items of public expenditure which benefit individuals and those which benefit society as a whole, in the list of expenditure which benefits individuals, the expenditure on social services, in the form of free medical aid and free education out of state funds will benefit the poor more than the rich. Such services imply a net addition to the income of the poorer classes.

Expenditure which benefits the society as a whole is those relating to general improvement. For example, good roads, free water supply in urban areas etc.

However, any attempt to redistribute wealth by public expenditure, may reduce savings, firstly of those who are taxed and secondly of those who receive the benefits of such expenditure.

In this context Colwyn Committee remarked **“the effect of public expenditure on production seems to be in conflict with that on distribution. But up to a certain point, this is not the case. The difficulty is to know where the balance should be struck”.**

Regressive, Proportional and Progressive Public Expenditure:

Regarding the distributive impact of public expenditure much depends on the nature of public expenditure and the policy underlying it. Just as there are proportional progressive and regressive taxes, in the same manner, government grants may be proportional, progressive and regressive.

Public expenditure must be on the principle of ‘ability to receive’ (corresponding to ability to pay of taxation), if it has to secure an equitable distribution of wealth. Corresponding to the principle of minimum sacrifice in taxation, there is the principle of maximum benefit in public expenditure.

Broadly, the principle of maximum social advantage should be the underlying criteria of public spending. From this point of view, expenditure on debt services is regressive because it gives more income to those who are rich.

Old age pension and expenditure on social insurance are progressive. In this context, it should be noted that a government grant reduces the desire to work and save, it lead to reduction of income of beneficiaries. In this case inequalities of wealth distribution are reduced.

A grant or public expenditure is regressive, if the addition it makes to the income of a beneficiary is smaller in the case of people with small income and higher in the case of people with high income.

The best example is subsidy and interest offered by the government on public debt. The provision of free residence only to higher paid government employees and not to low paid employees is a typical example of regressive expenditure.

In this case benefit of public expenditure is reaped by the richer income group. This only helps to aggravate inequality of income. The public expenditure or grant will be proportional, when the proportion of additional benefit provided by the grant or public expenditure is the same, whatever the size of the recipient income.

In such case, there is no change in existing inequalities of income distribution. For example, if all categories of employees were given a house allowance at the same rate, say 10% of their salaries, it would be a case of proportional expenditure.

A grant or public expenditure would be progressive, when the additional benefit provided by the grant or public expenditure is larger in the case of low income people and lower in the case of high income people.

The expenditure on social security like free medical aid, free education, subsidized houses etc. is progressive in nature. For example, if only the lower salaried employees were given free residential quarters, it is a case of progressive expenditure.

Such expenditure helps to reduce the glaring inequality existing in the distribution of income. Dalton observes that system of public expenditure is the best, which has the strongest tendency to reduce the inequalities of income.

Hence progressive public expenditure is the best anti-dot to reduce income inequality existing in the society.

Progressive expenditure can assume different forms. It may be in the form of cash grants-old age pensions, unemployment benefit, sickness and accident benefit. This act as a sort of timely help.

Progressive redistributive expenditure may also take the shape of provision of cheap or free services and commodities. Free primary education, free medical aid, subsidies to food and housing and the provision of free meals to school children are examples of this type of progressive grant.

Such expenditure benefits the poorer among the poorest and helps to raise the living standards of the weaker sections.

Reduction of glaring inequalities in the distribution of income, provision of certain minimum basic facilities to the weaker sections of the community is now rightly regarded as the primary social functions of any modern government.

Public expenditure has therefore became an important instrument in the fiscal policies of modern governments to achieve certain social and economic objectives oriented towards the welfare of the community.

Source: https://www.accountingnotes.net/financial-management/public-expenditure/public-expenditure-meaning-classification-and-effects/10011