UNIT-3

PUBLIC EXPENDITURE

- **Meaning of Public Expenditure:**
- Public expen-diture consists of expenditure by central government, state governments and local authorities (such as municipalities and public corporations), with central government accounting for the major portion of such expenditure.

Economic Effects of Public Expenditure

- **Effect on Production**
- In order to have a correct view of the effects of public expenditure on production, according to Dalton, it is necessary to consider (i) effects upon ability to work and save, (ii) effects on desire to work and save, and (iii) effects on diversions of economic resources as between different uses and localities.

Effect on Distribution

- The use of progressive taxes is generally advocated as a means of influencing income distribution; it renders post-tax income distribution less unequal. Hugh Dalton has stated that like the taxes, public spendings too can be made progressive.

- **Effect on Economic Development**
- There are two principal channels, through which government spending may influence economic growth and development. First, government spending, particularly investment, may provide such goods that enter directly into private sector production.

Adverse/Bad Effect of Public Expenditure

- 1. Unnecessary Assistance to Industries and Business
- 2. Excessive Expenditure on Defence
- 3. Tendency of gaining Political Influence
- 4. Advantage to a Particular Community
- 5. Rapid Increase in Taxation
- 6. Government expenditure is Misue of Scarce and Limited Resources and also Unproductive
- 7. Fear of Minority Political Parties
- 8. Dominance of Public Sector Reduced the Authority of Private Sector

The main items of government spending are the following:

- Social services such as education, health and welfare and social security; defence, that is the cost of maintaining the armed forces; environmental services, that is, spending on roads, transport services, law and order, housing and the art; national debt interest, that is, interest payments on money borrowed by the government. At present, public expenditure is about one-third of India's national income.

PRINCIPLES AND CANON OF PUBLIC EXPENDITURE

- **1. Principle of Maximum Social Benefit:**
- It is necessary that all public expenditure should satisfy one fundamental test, viz., that of Maximum Social Advantage. That is, the government should discover and maintain an optimum level of public expenditure by balancing social benefits and social costs.

- **2. Canon of Economy:**
- Although the aim of public expenditure is to maximize the social benefit, yet it does not exonerate government from exercising utmost economy in its expen-diture.

- **3. Canon of Sanction:**
- Another important principle of public expenditure is that before it is actually incurred it should be sanctioned by a competent authority. Unauthorised spending is bound to lead to extravagance and over-spending.

- **4. Canon of Elasticity:**
- Another sane principle of public expenditure is that it should be fairly elastic. It should be possible for public authority to vary the expenditure according to need or circumstances.

- **5. No Adverse Influence on Production or Distribution**:
- It is also necessary to ensure that public expenditure should exercise a healthy influence both on production and distribution of wealth in the community. It should stimulate productive activity so that income and employ-ment of the living.

- **6. Principle of Surplus:**
- It is considered a sound or orthodox principle of public expenditure that as far as possible public expenditure should be kept well within the revenue of the State so that a surplus is left at the end of the year.

What is public debt?

- Public debit or public borrowing is considered to be an important source of income to the government. If revenue collected through taxes & other sources is not adequate to cover government expenditure government may resort to borrowing. Such borrowings become necessary more in times of financial crises & emergencies like war, drought, etc.
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- Public debt may be raised internally or externally. Internal debt refers to public debt floated within the country; while external debt refers loans floated outside the country.

Types of public debt

Public debt can take various forms, but we can distinguish between two major types:

- Internal
- External

- In India, public debt refers to a part of the total borrowings by the Union Government which includes such items as **market loans, special bearer bonds, treasury bills and special loans and securities issued by the Reserve Bank. It also includes the outstanding external debt.**

- **The State generally borrows from the people to meet three kinds of expenditure:**
- (a) to meet budget deficit,
- (b) to meet the expenses of war and other extraordinary situations and
- (c) to finance development activity.

When we shift attention from external to internal debt we observe that the story is different.

- **1. Efficiency and Welfare Losses from Taxation:**
- When the government borrows money from its own citizens, it has to pay interest on such debt. Interest is paid by imposing tax on people. **If people are required to pay more taxes simply because the government has to pay interest on debt, there is likely to be adverse effects on incentives to work and to save.**

- **2. Capital Displacement (Crowding-Out) Effect:**
- Secondly, if the government borrows money from the people by selling bonds, there is diversion of society's limited capital from the productive private to unproductive public sector. **The shortage of capital in the private sector will push up the rate of interest.**
- In fact, while selling bonds, the government competes for borrowed funds in financial markets, driving up interest rates for all borro-wers.

- **3. Public Debt and Growth**:
- By diverting society's limited capital from productive private to unproductive public sector public debt acts as a growth-retarding factor. **Thus an economy grows much faster without public debt than with debt.**
- When we consider all the effects of government debt on the economy, we observe that a large public debt can be detrimental to long-run economic growth.

- To conclude with Paul Samuelson and W. D. Nordhaus: **“A large government debt tends to reduce a nation’s growth in potential output because it displaces private capital, increases the ineffi-ciency from taxation, and forces a nation to service the external portion of the debt.”**

PRINCIPLES OF PUBLIC DEBTS

- □ First principle: the allocation of credit to desired aims
- □ Second principle: priorities setting before scarcity of resource and time
- □ Third principle: debt structure on sustainability criteria
- □Fourth principle: sound legal framework
- □ Fifth principle: best management practices □Sixth principle: operational transparency
- □ Seventh principle: thorough process auditing

Methods of Debt Redemption:

- **(i) Utilization of Surplus Revenue:**
- This is an old method and badly out of tune with the modern conditions. Budget surplus is not a common phenome-non. Even when there is a surplus, it is so insignificant that it cannot be used for making any substantial reduction in the public debt.

- **(ii) Purchase of Government Bonds:**
- The government may buy its own stock in the market, thus wiping off its obligation to that extent. This may be done by the application of surplus revenues or by borrowing at low rates, if the condi-tions are favourable.

- **(iii) Terminable Annuities**:
- When it is intended completely to wipe off a permanent debt, **it may be arranged to pay the creditors a certain fixed amount for a number of years.** These annual payments are called annuities. It will appear that, during the time these annuities are being paid, there will be much greater strain on the government finances than when only interest has to be paid.

- **(iv) Conversion:**
- This is a method for reducing the burden of the debt. A government may have borrowed when the rate of interest was high. Now, if the rate of interest falls, it can convert a high-rated loan into a low-rated one.

IMPORTANCE OF SUBSIDIES

- Subsidies include all grants on current account made by the government to depress the price of any good or service below its economic cost.
- Subsidy has been defined as the "money granted by state, public body, etc., to keep down the prices of commodities, etc."

Types of subsidies

- **Direct Subsidies – Direct subsidies** are given in terms of cash grants, interest-free loans and direct benefits. For example- **Direct farm subsidies** are the kinds of subsidies in which direct cash incentives are paid to the farmers in order to make their products more competitive in the global markets.

- **Indirect subsidies** – Indirect subsidies are provided in terms of tax breaks, insurance, low-interest loans, depreciation write-offs, rent rebates. For example- **Indirect farm subsidies**: These are the farm subsidies which are provided in the form of cheaper credit facilities, farm loan waivers, reduction in irrigation and electricity bills, fertilizers, seeds and pesticides subsidy as well as the investments in agricultural research, environmental assistance, farmer training etc.

The benefits of subsidy as a policy are:

1. Inducing higher consumption/production.
2. Achievement of social policy objectives including redistribution of income, population control etc.
3. It helps in controlling the prices to maintain stability.
4. Especially in case of agriculture where food is basic right of all, you cannot leave everything to market.
5. Offsetting market imperfections including internalization of externalities.