# Chapter 34 Public expenditure

## Key terms

1. Capital government expenditure: spending by government on investment goods, such as new roads, new hospitals or new street lighting.
2. Crowding in: in the context of public sector spending, crowding in occurs when extra government spending leads to higher private sector spending.
3. Crowding out: in the context of public sector spending, crowding out occurs when extra government spending leads to lower private sector spending.
4. Current government expenditure: spending by government on goods and derives which will be consumed in the short term such as teachers' salaries or heating for government buildings; it also includes transfer payments and debt interest.

1. **<u>The distinction between capital expenditure, Current expenditure and transfer payments</u>**

- **3 types of government spending**
    1. **Current spending;** spending on running costs of the public sectors e.g. gov employees' salary.
    2. **Capital spending;** spending on infrastructure e.g. road, hospitals
    3. **Transfer spending;** payment without exchange of goods and services e.g. spending on welfare, unemployed benefits, state pension, and child benefit

**<u>2. Reasons for the changing size and pattern of public expenditure</u>**

The size of government spending is normally measured as a percentage of an economy's GDP or government spending per capita. Government spending includes

- **Social protection** : this cover transfer payments such as unemployed benefits, benefits to those on low incomes etc.
- **Health spending** : this includes services provided by state health clinic and hospitals.
- **Education** : this includes government spending on primary, secondary and further education
- **Public order and safety**
- **Defence** : Spending on the army, air force
- **Debt interest** : this is the interest that the government has to pay on money it has borrowed in the past.

**<u>2.1 Changing incomes</u>**

- During recession, government has to increase spending relative to GDP.

**<u>2.2 Changing age distributions</u>**

- An increase in number of population will increase government spending on public services.
- If working age rises, GDP will have risen too, so government spending as a proportion of GDP might remain the same.

**<u>2.3 Changing expectations</u>**

- The higher income in the country will increase demand for high quality of goods and services including education and health care.

## 2.4 Other factors

- **Resource efficiency** : If the inefficiency of government is greater than the benefits from correcting market failure, then government should be as small as possible. Governments around the world and over time will have different views on whether the public sector is more or less efficient than the private sector. This partly explains why the size of the state may differ significantly over time or between countries.
- **The austerity debate :** The country with high debt as a percentage of GDP will limit government spending.
- **Disincentive effects of taxation and welfare benefits :** Imposing high tax may discourage people to work. Then government should reduce spending in order to reduce tax rate.

## 3. The significance of differing levels of public expenditure as a proportion of GDP

Differing levels of public expenditure can have an impact on a large number of economic variables, such as productivity and growth, crowding out and levels of taxation. These will now be considered.

### 3.1 Productivity and growth

- Free market economists argue that government can never be as efficient as the private sector. They argue that public sector spending is often wasteful and inefficient, because a government lacks the profit motive.
- On the other hand, it can be argued that, with the right controls and incentives in place, government can be a cost-effective and efficient provider. It can also be argued that the public sector provides goods and services vital to productivity and growth which the private sector would otherwise not do.

### 3.2 Crowding out

- If the economy is at full employment and on its production possibility frontier, it would seem logical to suggest that increasing government spending by \$1 must lead to \$1 less of private sector spending.
- However, there are a number of reasons why public sector spending need not crowd out private sector spending