THE INCIDENCE OF PUBLIC SPENDING ON ECONOMIC GROWTH

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Abstract:

The size of government expenditures and its effect on long-run economic growth, and vice versa, has been an issue of sustained interest for decades. Many studies have analyzed how government expenditures contribute to economic growth. However, they focused on the impact of total government expenditures and overall GDP growth. Very few studies attempted to link different types of government spending to growth, and even fewer attempted to analyze the impact of government spending at the sector level.

Key Words: government expenditure, economic growth, public sector

JEL Classification: H5, O11

Public expenditure pays to defend nations against invasion. It finances schools and universities in witch people are educated. When people are ill, it provides medical care and financial support. Public expenditure provides pensions for the old and finances the police to protect people from crime. It also provides entertainment and infrastructure. In the UK public expenditure is around 42 per cent of gross domestic product and in the US around 35 per cent [1].

It is striking how great aggregate public expenditure is in developed economies and the diversity of purposes for witch public spending is made. Many political philosophers since Hobbes and Locke have considered the hypothetical disadvantages of life without government.

The ideal size of government is not the problem of the economic theory. But, economic theory tells us to examine costs and benefits in order to determine whether resources are allocated in a manner that increases or decreases economic growth. The basic economic policy of the good society is public expenditure in step with future economic growth and well-being

The economic literature has studied the role of government size in relation to growth by estimating its impact within a simple growth models. While both government size and economic growth relationships have received considerable interest in their own right, less attention has been given to their interdependence.

We have in mind the conventional measure of government size, i.e., aggregate government consumption from the Gross Domestic Product (GDP) side of the National Accounts divided by GDP, as our measure of the government's influence on the economy and we want to consider whether this ratio has remained an appropriate index for the scale of government's activities. Most economists recognize that government has considerably more influence on society than the level of expenditure alone would suggest. In most countries, for example, governments set up and maintain (through legislation and often subsidy) operations which would otherwise be undertaken by private corporations (e.g., postal services, public utilities, hospitals). These frequently operate outside of the government's budget. In other cases, the government extends its influence by its granting (or withholding) preferential loans, import/export licenses etc. Finally, through its regulatory powers, governments can exercise a strong presence in the operation of the economy without its role ever appearing as an expenditure item.

In this sense the observation that the traditional measure of government size is levelling off or even shrinking may well mislead if the role of government has simply changed from one of direct spending to one of indirect influence through regulation.

Other forms of government spending have a less desirable impact on economic activity. If a program does not facilitate or encourage economic activity, or has only a small positive effect, then the aggregate impact on the economy will be negative because there are limited benefits – if any – to outweigh the costs. And if the program actually undermines work, saving, and investment or encourages misallocation of resources, then the overall adverse impact on economic growth will be particularly pronounced.

According to some authors, there are two macroeconomic reasons why government spending can undermine economic performance. The first reason, mentioned above, is “resource displacement.” Every time government spends money, it is using labour and/or capital and those resources no longer are available for private sector uses.

The second macroeconomic issue associated with government spending is the “financing cost.” When government taxes, it not only takes money from the productive sector, but it also raises revenue by means of a tax system that generally reduces incentives to work, save, and invest. And if it finances spending with debt, it siphons money out of private credit markets.

Leonard (1986) has argued that public budgets will understate the size of the public sector by not recording what he calls the “quiet side” of public sector activity. He points to several sources of budget under-statement: promises of retirement benefits and social insurance, tax expenditures, subsidies in sales of public activities to favoured groups but not others, and the aforementioned regulatory costs of government. He estimates that if one were to measure government at its full economic rather than budgetary cost, the U.S. federal government would be half again as big as its budget indicates!

The economic impact of government spending can be presented in graphical form by Rahn Curve ho is the equivalent for expenditure to Laffer Curve. In 1986, Richard Rahn, then the chief economist for the U.S. Chamber of Commerce, charted an inverse relationship between government spending and economic growth for the seven major industrialized countries in the form of a curve, not unlike the "Laffer Curve," which focused on the incentive effects of taxation.

The theory behind the "Rahn Curve" is that, at first, low levels of government spending on basic public services, such as law and order and a judicial system to enforce contracts, stimulate growth in the economy. But as spending rises as a share of the economy, its contribution to economic growth diminishes. Government spending eventually reaches a point where it actually retards economic growth.

There are several reasons for this. First, the growing public sector "crowds out" private sector activity, and it often uses the economy's resources far less efficiently. Second, as government grows bigger, it tends to accept broader responsibilities such as reducing poverty. This increased spending on welfare and income transfer programs, however, creates severe work disincentives. Third, an expanding government bureaucracy usually is accompanied by more complicated and burdensome regulation that stifles innovation and productivity. Fourth, the higher tax burdens necessary to finance bigger government at some point damage incentives to work, save and invest. The weakened economy fails to generate enough tax revenue to finance the ever-growing spending share, resulting in increased public sector borrowing and debt service burdens.

Discussion of the relationship between real government size and the price of government services is now an integral part of the debate over Baumol’s Cost Disease hypothesis. Baumol (1967) hypothesized that because the output of the government sector is relatively labor intensive, its rate of productivity growth would be expected to be low relative to that of private sector output. This implies that over time the real cost of public sector output will rise relative to all other goods. It then follows that if the demand curve is price inelastic, a rise in the relative price of government services will result in only a relatively small decrease in the quantity of government services demanded and hence a higher aggregate expenditure on public sector output.

Economic theory does not automatically generate strong conclusions about the impact of government outlays on economic performance, but economists will generally agree that government spending becomes a burden at some point, either

because government becomes too large or because outlays are misallocated. In such cases, the cost of government exceeds the benefit. The downward sloping portion of the curve in can exist for a number of reasons, including: the extraction cost - government spending requires costly financing choices. All of the options used to finance government spending have adverse consequences. Taxes can discourage productive behaviour and borrowing consumes capital that otherwise would be available for private investment; the displacement cost - government spending displaces private-sector activity. Every dollar that the government spends necessarily means one less dollar in the productive sector of the economy; the behavioural subsidy cost - government spending encourages destructive choices. Many government programs subsidize economically undesirable decisions. Welfare programs encourage people to choose leisure over work. Unemployment insurance programs provide an incentive to remain unemployed and flood insurance programs encourage construction in flood plains; the behavioural penalty cost – government spending can discourages productive choices because government programs often discourage economically desirable decisions; the inefficiency cost - government spending is a less effective way to deliver services but there is evidence that the private sector could provide these important services at a higher quality and lower cost; the stagnation cost - government spending inhibits innovation. Because of competition and the desire to increase income and wealth, individuals and entities in the private sector constantly search for new options and opportunities. Economic growth is greatly enhanced by this discovery process of “creative destruction.” Government programs, however, are inherently inflexible, both because of centralization and because of bureaucracy.

J. Galbraith claims that the principal objection regarding de balanced budget is that an expense would increase the deficit and this thing is clear when this expenses is made for the most necessary objective trying to solve citizen basic needs. Galbraith says that are three categories of public spending [2]: there are those which serve no visible present or future purpose; there are those which protect or enhance the current economic or other social condition; and there are those which bring or allow of an increase in future income, production and general well-being.

First, as to expenditures with no good or necessary purpose. It must be accepted that no institution is perfect, and certainly not the modern state. There is the tendency in any great organization, public or private, to an excess of personnel—to the universal desire of all in the organizational hierarchy to employ additional subordinate talent or what is so denoted. There is also expenditure that responds to political or economic interest, not to the larger public need or desire. And there is expenditure that survives the purpose for which it was originally intended and which it once served. No one, the recipients of the particular largesse always excepted, can argue that such expenditure should be covered by public borrowing.

The second and very large category of public expenditure that must be covered by tax revenue is that for the current, everyday operations of the government—for those functions which are urgent today but have no clearly recognizable time dimension. These include the vast range of government activities. There is no economic or social justification for borrowing for these tasks, thus adding interest charges to the eventual total cost.

There remain those government expenditures which are intended to improve future well-being and economic growth or which so serve. Here, borrowing is not only legitimate but socially and economically desirable. Similar borrowing in the private sector of the economy is both accepted and wholly approved even by the most eloquent, frequently vehement, opponents of the public deficit. Here, borrowing should be accepted, normal. Interest and amortization costs should be charged against revenues; capital expenditure should not.

Where public expenditure promotes or, indeed, is essential for the future growth of the economy—increased production, employment and income from which to sustain future public revenues—borrowing is fully acceptable. This cannot be considered loading costs on future generations, for they will be the beneficiaries and it is appropriate that they pay. Assuming that tax rates remain generally the same and the economy is otherwise stable, such payment will come out of the expanding future

revenues. These expanding revenues are, in greater or lesser measure, the product of the longer-term investment. It is to facilitate such gains that, in the largest sense, they are made.

Some academic research has found a negative link between government spending and economic output:

-A study in the *European Economic Review* reported: "The estimated effects of GEXP [government expenditure variable] are also somewhat larger, implying that an increase in the expenditure ratio by 10 percent of GDP is associated with an annual growth rate that is 0.7–0.8 percentage points lower." [3]

- A *Journal of Macroeconomics* study discovered: "The coefficient of the additive terms of the government-size variable indicates that a 1% increase in government size decreases the rate of economic growth by 0.143%." [4]

- A National Bureau of Economic Research paper stated: "A reduction by one percentage point in the ratio of primary spending over GDP leads to an increase in investment by 0.16 percentage points of GDP on impact, and a cumulative increase by 0.50 after two years and 0.80 percentage points of GDP after five years. The effect is particularly strong when the spending cut falls on government wages: in response to a cut in the public wage bill by 1 percent of GDP, the figures above become 0.51, 1.83 and 2.77 per cent respectively." [5].

Conclusions:

In all countries public expenditure causes growth in national income either in the short or long run. Various types of government spending have differential impacts on economic growth, implying greater potential to improve efficiency of government spending by reallocation among sectors Asia's investments in agriculture, education, and defence had positive growth-promoting effects. However, all types of government spending except health were statistically insignificant in Latin America. Structural adjustment programs promoted growth in Asia and Latin America, but not in Africa. Growth in agricultural production is most crucial for poverty alleviation in rural areas. Agricultural spending, irrigation, education, and roads all contributed strongly to this growth. Disaggregating total agricultural expenditures into research and non-research spending reveals that research had a much larger impact on productivity than non-research spending.

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