Student Economic Review Vol. 7 1993

Issues Associated with Public Expenditure as a Mechanism for Government Intervention

by Cloda Lane

THROUGHOUT THE WORLD governments are intervening in their economies. Adam Smith's "invisible hand" is not sufficient as a regulatory mechanism so in this essay I am going to take as given that government intervention, because of the existence of externalities, public goods and imperfect information, is acceptable in principle. What I intend to investigate is what the optimal level of public expenditure, the most frequently used tool of intervention, is and what are the factors which cause it to deviate from this amount.

An Optimal Expenditure Level

In order to have an optimal level of expenditure the government must satisfy the condition that the marginal benefit of expenditure is equal to its marginal cost. A form of cost benefit analysis must be carried out on all existing and proposed expenditure plans to determine whether they meet this criteria. Benefits of expenditure tend to be clearly visible. The benefits from a new motorway, a new school or a new hospital can be quite easily evaluated. However, benefits of expenditure are often shortlived, so there must be continuous scrutiny of the services to see if they are still relevant to public needs. This will cut back on much of the annual increments that are paid to unneeded existing services. When measuring benefits we should also be aware that different forms of expenditure have different effects on economic growth. As Barro (1990) emphasises, public investment expenditure tends to be advantageous for growth but public consumption expenditure is not. This argument is verified by Barth and Bradley (1987) who found a negative relationship between the growth rate of real GDP and the share of government consumption for 16 OECD countries between 1971 and 1983. When choosing between expenditure proposals, therefore, the government would be better able to influence economic growth with investment rather than consumption plans.

The marginal cost of expenditure is more difficult to evaluate because it includes the actual real costs of financing the expenditure and the external or social costs of that expenditure. Obviously, any expenditure proposal that needs large levels of financing should have very definite and substantial benefits attached to it. As Honohan and Irvine (1987) propose "a spending proposal must have a social benefit large enough to cover not only the cash costs, but also the deadweight loss resulting from the taxation that will be needed" in order to finance it. The external costs of expenditure programmes on the private sector must also be considered. The evidence from Bacon and Eltis (1978) research shows that periods of expansion in the public sector have put pressure on the amount of resources available for other uses. It must be clear that the resources used could not have been utilised in a more efficient way. Calculations of marginal cost should take into account the loss of private expenditure on consumption and investment that arise because of the resources needed for expenditure proposals. When trying to decide whether or not to undertake a particular plan the government must follow the guideline of the Public Capital Programme (1984) that "public investment will not be undertaken unless it can be clearly shown on realistic assumptions that it will yield a sufficient return". To optimise overall public expenditure the government must be sure that the aggregate marginal benefit from all levels of expenditure is equal to the marginal cost of the expenditure.

Deviation from the Optimal Level

Unfortunately, it is very difficult for the government to actually reach this optimal position. First of all, it is difficult (and sometimes costly) to carry out all the calculations necessary to measure the marginal benefit and cost of expenditure, and secondly there are rigidities in the system which continuously cause expenditure to deviate from its optimal level. These rigidities are caused by technical and political factors and they make public expenditure an inflexible, and therefore inadequate, means of government intervention.

Technical factors explain the determination of the level of public expenditure by regarding it, perhaps unjustifiably, as being independent of the government's ideology. There are four main technical factors that influence the size of the public sector share, and thus influence how extensive government intervention in the economy is. Firstly, public sector expenditure increases when there is increased demand from the electorate for public services, most notably health and education. In Ireland in the 1970s the increased demand was due to a general higher level of wealth among voters and a "demonstration effect" from other countries. The second factor that can explain high levels of public expenditure is that, over time, the costs of public services rise faster than the costs of other goods and services but, because of Baumol's disease, the increased costs are not matched by increased productivity. Huge increases in public sector recruitment in the 1970s and 1980s are now having a detrimental impact on government expenditure. Strong unions have been able to demand large increases in wages for a large number of people. This demand-led expenditure, epitomised by the PESP agreement, reduces the flexibility of the government in managing public expenditure today and in the future.

The third, and perhaps most fundamental, technical factor determining public sector expenditure are demographic changes. As the birth rate slows down and the population gets older there will be increased expenditure in the form of pension payments. At the same time, however, there should be decreased expenditure on education, as the proportion of the young population decreases. Overall, if the effect is balanced, there may be no need for any dramatic change in government expenditure levels. The problem facing government expenditure plans now is how to provide unemployment benefit to 300,000 people. The high unemployment level in Ireland severely restricts any government attempts to decrease expenditure as the increasing numbers of people "signing on" all have to be provided for. A secondary effect is that the increases in unemployment leads to a decrease in GDP. This means that the overall level of the public sector share increases two-fold. As benefit levels can't be reduced, because they have to be within EC limits, the only way that the government will be able to reduce the public sector share is if there is economic growth.

The final, but by no means most insignificant, technical factor that determines the level of public sector expenditure is past borrowing. The government today can not control this part of public expenditure. The financing of public expenditure through borrowing in one period will lead to increased public expenditure in the future. Debt interest payments make up about 10% of public sector expenditure. As well as being dependent on the activities of past governments, the size of debt service obligations are influenced to a significant extent by the interest rate and by exchange rate movements which are largely outside the direct control of the government. The relevance of this and the other technical rigidities are clearly evident in the Irish economy but they by no means explain fully the divergence from the optimal expenditure level.

Political factors also cause public expenditure to deviate from its optimal level. The arguments surrounding these factors are based on the claim that public expenditure decisions are the outcome of a complex decision-making process involving the electorate, the bureaucracy and politicians. Fiscal illusion is the factor that causes the electorate to influence expenditure levels. Benefits of expenditure are visible and are directly related to specific groups but the costs are spread over the whole electorate and are often hidden. The electorate, therefore, demands increased public expenditure on the misperception that the benefits of it are greater than the costs. While this phenomenon was evident in the early 1980s it is not as widespread in Ireland in the 1990s. The electorate has learnt, from the past decade, that there are high costs attached to the financing of public expenditure and they are now more reluctant to push for increased public sector expenditure. The present absence of fiscal illusion can best be explained by two facts. First of all, people are now painfully aware that debts have to be repaid with interest. Secondly, the existence of "fiscal drag", which explained why some people did not perceive the true costs of public expenditure in the past, is no longer a major problem in Ireland because our inflation rate is low and relatively stable.

Another political argument which, in my opinion, does not have much relevance for Ireland today, is that the efforts of public servants to increase their own "empires" influences the level of public sector expenditure. This argument claims that the civil servants, whose main objective is to protect their own jobs, possess enough information and power to control the expenditure decisions of the government. Since 1987, government departments have lost any such untrammelled power they once had. The introduction of the Expenditure Review Committee in the public sector has taken power away from the civil servants who may have wanted to push expenditure up and given it to those who are trying to control expenditure levels. Civil servants now have to justify all expenditure proposals. So theories of them being able to push expenditure in Ireland upwards are now unsubstantiated .

The final political factor that influences the level of public expenditure is the type of government that exists. The key problem with government intervention is that the politicians always take a short-term view of the economy. Getting re-elected is a priority and expenditure decisions tend to revolve around four year tenure periods. Only in a system where the government is guaranteed a long-term existence will there be long-term plans for the economy. Barro (1990) has emphasised this fact that government policies often deviate from optimal policies because government cannot commit itself to future action.

In the Ireland of 1993 a discussion about the influence of type of government on public expenditure would not be complete without reference to the relationship between coalition governments and public sector share. Many arguments have claimed that short-term policies and high expenditure levels are prevalent amongst coalition governments. The argument claims that lack of cohesion and a belief that the government could not be anything but temporary, leads to a haphazard treatment of public expenditure plans. There is often a "prisoner's dilemma" problem amongst coalition partners with regard to cutting public expenditure: both parties may favour cuts but each partner wants to protect its particular part of the budget against such an action. In the absence of any agreement the noncooperative solution would be to have no decrease in expenditure. The problems with reaching such an agreement would only be increased by multi-party ("Rainbow") coalitions and alternating ("Rotating") leadership. There is no substantial proof in Ireland, as yet, that coalition governments are more prone to increase public expenditure than single party governments. The existence in the Programme for a Partnership Government (1993) of a number of expenditure items, without substantial reference as to how they are going to be financed, may be a warning sign of things to come however.

CONCLUSION: EXPENDITURE EXPERIENCES

All of these technical and political factors show that the level of government expenditure is often forced to deviate from its optimal level. It is political judgement and technical commitments rather than economic calculations which influence public expenditure levels over time. In the 1970s there was worldwide consensus that high levels of public expenditure were desirable. The 1980s, and the rise of the New Right, enlightened the world to the dangers of increased growth in the public sector and there was a general effort to "roll back the state" by cutting public expenditure. What will happen in the 1990s is uncertain. Public sector share has been on the increase yet again since 1990. It has gone from 36.8% in 1990 to 38.5% in 1992. Expenditure will probably also be high in 1993 with the move into the E.C. internal market and the currency crisis having to be paid for. What should be avoided for the 1990s, however, is any large increase in public sector expenditure and especially in any form of long-term expenditure commitments. While the Western world is trying to stabilise this more acceptable level of public sector share the recently "liberated" eastern bloc countries are just starting to discover how valuable government expenditure can be for the economy. Fortunately, most of these countries, notably Poland, Czechoslovakia and Hungary, have learnt from the mistakes of the West. They are reluctant to run up large deficits in order to increase their recovery programmes and are determined to take a more long-term approach to improving their economies. They have come to realise, like the Western world, that public expenditure is not always the best intervention tool if technical and political factors are allowed to cause it to deviate in a large way from its optimal level.

BIBLIOGRAPHY

Barth and Bradley, OECD Working Paper 1987

Barro, R.C., (1990),"Macroeconomics", New York;Wiley

Bacon and Eltis, (1978), "Britain's Economic Problems-Too Few Producers"

"Public Capital Programme"(1984),Government Publications;Dublin

Honohan,P. and Irvine, I.(1987), "The Marginal Social Cost of Taxation in Ireland",Working Paper(U.C.D. Centre for Economic Research)