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# Public expenditure

Chapter 79 – April, 2017

# THE REASONS FOR PUBLIC EXPENDITURE

- ▶ efficiency and market failure:
  - ▶ *allocative inefficiency*: free markets will produce too few public goods (i.e., defence, education, law, ...)
  - ▶ *productive inefficiency*: costs can be higher when provided by the private sector (i.e., economies of scale)
  - ▶ *dynamic inefficiencies*: perfectly competitive firms have no incentive to do R & D
- ▶ equity and equality: government will reduce inequity and inequality
  - ▶ *health care*: elderly would face largest bills
  - ▶ *education*: children from poor background would suffer most
- ▶ macroeconomic management:
  - ▶ managing individual markets (i.e., cigarette market, green energy market)
  - ▶ *tax* overproducing markets (i.e., cigarette market)
  - ▶ *subsidise* underproducing markets (i.e., green energy market)

# REASONS FOR CHANGING SIZE AND COMPOSITION OF PUBLIC EXPENDITURE

- ▶ *average income* of the country:
  - ▶ low average income country: lower percentage of GDP spent by government (no tax base to raise revenues)
  - ▶ high average income country: the higher the demands of the citizens will be to get high quality public goods (public goods are income elastic)
- ▶ *ideological differences*: government spending of countries
  - ▶ USA: 38% of GDP
  - ▶ Finland: 58% of GDP
  - ▶ OECD countries: 42% (average)
  - ▶ UK: 44 %
- ▶ *aging population*:
  - ▶ health care
  - ▶ pension payments
  - ▶ care home costs

# CURRENT AND CAPITAL EXPENDITURE AND TRANSFER PAYMENTS

TOTAL GOVERNMENT SPENDING = CURRENT EXPENDITURE + CAPITAL EXPENDITURE

- ▶ *capital government expenditure*: spending on investment goods (i.e., roads, schools, ...)
- ▶ *general government final consumption*: goods and services consumed within a short time (i.e., wages of teachers, heating of hospitals, ...)
- ▶ *transfer payments*: welfare payments made to individuals (i.e., state pension, child benefit)
- ▶ *debt interest*: interest paid on the National Debt by the government
- ▶ *current government expenditure*: general government final consumption + transfer payments + debt interest

# LIVING STANDARDS AND EQUALITY

- ▶ the efficiency of government: 2 views
  - ▶ government can be just as efficient as private sector
  - ▶ government can never be as efficient as private sector
- ▶ disincentive effects: 2 views
  - ▶ disincentive effects of taxation and welfare benefits outweigh benefits that arise from high levels of government spending
  - ▶ tax and benefits system can be designed to minimise disincentive effects
- ▶ utility: 2 views
  - ▶ government spending should be as low as possible (i.e., principal-agent problem, missing markets, redistribution of income and wealth)
  - ▶ certain spending decisions need to be made by a majority (i.e., defined by political system)

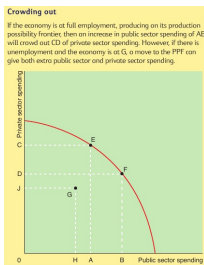
# TAXATION

- ▶ High government spending has to be financed
  - ▶ high taxes
  - ▶ oil-revenues if oil-producing country

**Note:** Sweden, Denmark, ... high government spending and high taxes without disincentive effects.

# CROWDING OUT

- ▶ Assumption: Full employment (production is on PPF)
- ▶  $\uparrow$  publ.sect.spending (A $\rightarrow$ B)  $\rightarrow$  priv.sect.spending  $\downarrow$  (C $\rightarrow$ D)



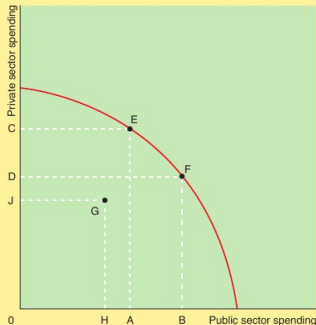
- ▶ crowding out through *financial markets* or *financial crowding out*:
  - ▶ public sector borrows money to fund rising govt. spending
  - ▶ interest rates  $\uparrow$
  - ▶ consumption and investment  $\downarrow$
  - ▶ private sector spending  $\downarrow$

# CROWDING OUT

- ▶ transfer payments (i.e., workers to pensioners)
- ▶ unemployment (G→E or G→F)
- ▶ economic growth (↑ investment by government shifts PPF outwards) - read page 509!!

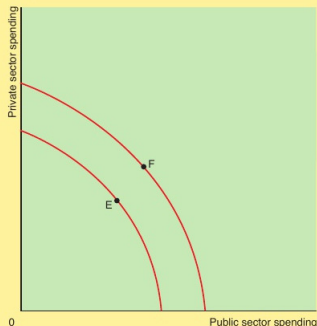
## Crowding out

If the economy is at full employment, producing on its production possibility frontier, then an increase in public sector spending of AB will crowd out CD of private sector spending. However, if there is unemployment and the economy is at G, a move to the PPF can give both extra public sector and private sector spending.



## Crowding in

Assume the economy is at full employment on its production possibility frontier at E. Public sector investment increases the productive potential of the economy shifting the PPF rightwards and moving production to the point F. Increased public sector spending has crowded in both private sector and public sector spending.





# PRODUCTIVITY AND GROWTH

## IMPACT OF GOVERNMENT SPENDING ON PRODUCTIVITY AND GROWTH

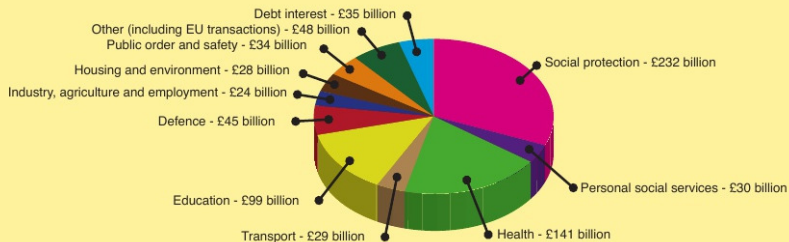
- ▶ 2 views:
  1. public sector spending is often *wasteful* and *inefficient* (free market economists view)
    - 1.1 resources should be transferred to the *more efficient* private sector
  2. public sector provides goods and services vital to productivity and growth which the private sector would otherwise not do
    - ▶ efficient road system → good for *trade*
    - ▶ good education system → increases *human capital*
    - ▶ good health care system → better health of workers
    - ▶ good benefits system → encourage to gain jobs
    - ▶ spending on R&D → competitive edge

## EXTRACT 1: PUBLIC EXPENDITURE

- ▶ Public expenditure totals in the UK:
- ▶ Trends in public expenditure:
- ▶ Capital and current expenditure:

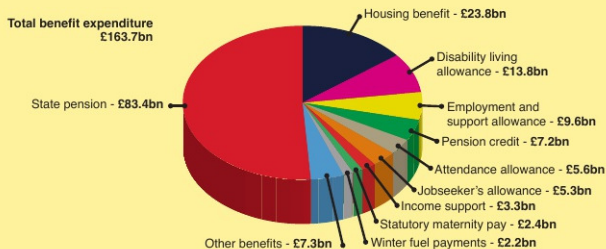
# EXTRACT 1: PUBLIC EXPENDITURE

Public sector spending by function, 2015-16



# EXTRACT 1: PUBLIC EXPENDITURE

Welfare spending by benefit, 2013-14



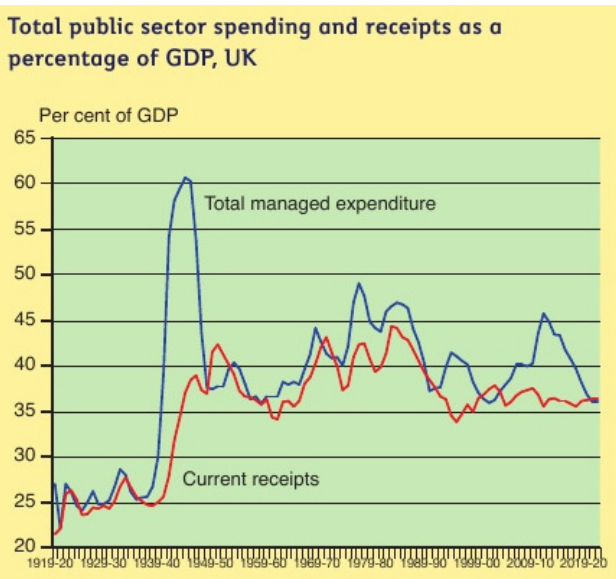
## EXTRACT 1: PUBLIC EXPENDITURE

**Table 2 Government expenditure as a percentage of GDP**

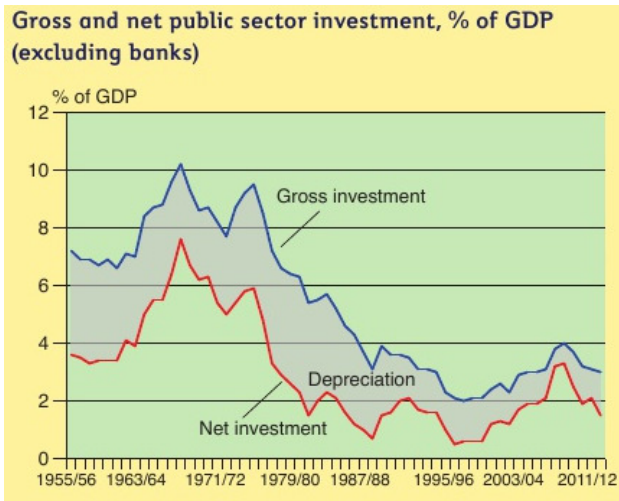
	1960-67	1968-73	1974-79	1980-89	1990-99	2000-07	2008-14
France	37.4	38.9	45.0	49.9	52.8	52.2	56.2
Sweden	34.8	44.3	51.4	59.8	63.1	54.0	53.5
Italy	31.9	36.0	38.2	47.5	51.7	46.9	50.0
UK	34.7	39.5	44.2	43.0	39.8	39.8	45.8
Germany	35.7	39.8	47.5	47.8	43.5	45.8	45.1
Canada	29.3	34.7	39.8	45.4	47.5	39.6	41.3
Japan	18.7	20.5	30.2	32.9	35.0	37.2	41.2
US	28.3	31.0	34.6	36.7	36.9	36.1	40.6

Source: adapted from OECD, *Historical Statistics*, [www.stats.oecd.org](http://www.stats.oecd.org).

# EXTRACT 1: PUBLIC EXPENDITURE

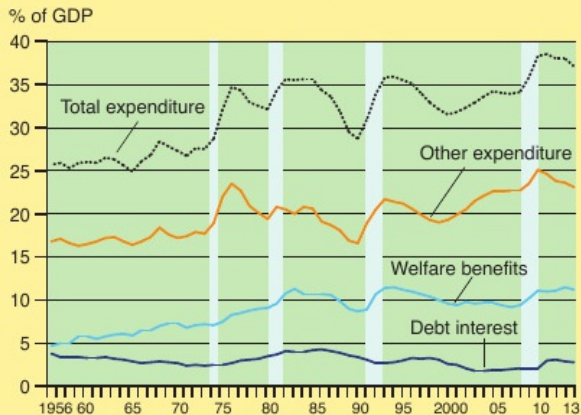


# EXTRACT 1: PUBLIC EXPENDITURE



# EXTRACT 1: PUBLIC EXPENDITURE

Composition of central government spending, % of GDP, four quarter moving average<sup>1</sup>





# KEYTERMS

- ▶ capital government expenditure:
- ▶ crowding in:
- ▶ crowding out:
- ▶ current government expenditure:
- ▶ transfer payments: