Chapter 1: Introduction

The link between public expenditure and national income has always been an intensive study in the public finance literature in both theoretical and empirical level. Level of public expenditure directly measures the extent of involvement of the government in the economy. In the field of economics, the role of government in the economy was one of the main focuses of the two major intellectual traditions in macroeconomics.

Classical economists have long favoured a small public sector and limited scope for government intervention in the economy. They believed that people rationally pursued their own self-interest and prices adjust quickly to achieve equilibrium in all markets. Thus, free markets are at their best when conducted by the invisible hand. In contrast, the Keynesian paradigm constructed during the Great Depression tend to be skeptical about the invisible hand and more inclined to believe that government intervention in the economy may help to improve economic performance. Since then, the Keynesian orthodoxy was widely adopted by policy makers to pursue public expenditure as a fiscal policy to correct short-term cyclical fluctuations in aggregate expenditures. However, recent developments include the emergence of rational expectations theory have brought the focus back to the classical approach. Agents in the economy are predicted to practice forecasting of various economic indicators based on reasoned and intelligent examination of available economic data. Any changes in the economy will then result in prompt responses from the economic agents, almost similar to Classical perceptions of immediate adjustments in the markets. Despite the Classical-Keynesian debate, the fundamental question was what is the right size of a government and what role does it have in an economy?

Empirical data have verified that public sector, measured as a percentage of GDP, has grown over time in almost all countries. Vast literature has been dedicated in analysing the relationship between public expenditure and national income for various countries using both time-series and cross-sectional data. Most of these studies were set within the context of Wagner's Law which states that there is a long-run tendency for public expenditure to grow relative to national income. Wagner's Law of increasing state activity links the scale of government's activities to economic development. Implicitly, Wagner's Law implies that public expenditure is an endogenous factor and is dedicated to a passive role in economic growth. Causality runs from national income to public expenditure.

This proposition is totally opposite from the famous Keynesian paradigm. Following Keynes, public expenditure to date has been one of the most popular used fiscal policies to smoothen business cycle fluctuations. In contrast to Wagnerian models, Keynesian treats public expenditure as an exogenous factor that portrays an active role in stabilization purposes. Compared to the former approach, causality in the Keynesian framework is expected to run from public expenditure to national income. The different directions of causality between public expenditure and national income offered by these hypotheses became one of the most explored empirical studies in this field.

This paper aims to analyse causality between public expenditure and national income in Malaysia for the period of 1970-2000. The goal of this paper is to increase understanding of the role played by public expenditure in the Malaysian economy. Public expenditure is delegated to a passive role if Wagner's Law prevails and indicates that public expenditure plays no role in contributing to economic growth. Conversely, public expenditure is delegated to an active role if the Keynesian hypothesis is found to be valid and can be effectively used as a fiscal tool. With a better insight in the impact of public expenditure on national income, more efficient macroeconomic policy can be formulated in the future to promote economic growth.

This paper is laid out as follows. Chapter 2 provides the theoretical aspects of Wagner's Law and relevant literature reviews on the subject. Chapter 3 consists of a brief explanation of public expenditure pattern in Malaysia since post-independence. Data and empirical methodology would be explained in chapter 4 and the results are discussed in chapter 5. Finally, conclusions of this paper will be laid out in chapter 6.