

CHAPTER II

THE NATURE OF GOVERNMENT EXPENDITURES

I. Role of Government Expenditures in The Classical System

Underlying the whole system of classical economics is the concept of natural order. The classical economists such as Adam Smith, T. R. Malthus and David Ricardo believed that there was a natural law governing the activities of human beings. This was the invisible hand which guided the smooth operation of the economy. Moreover these economists identified this natural law with complete individual liberty even though their interpretations of this law differed. While Malthus and Ricardo thought that the operation of this law would ultimately lead to universal misery Adam Smith assumed that it would lead to providential harmony. However they all agreed that in any case restrictions imposed by the government could only be an obstacle to economic perfection.

Thus in view of this concept of laissez-faire it might be imagined that no role was accorded to government expenditures in the classical system. This was not true. In fact the first systematic discussion of the various aspects of government expenditures began with Adam Smith. He enumerated various categories of justifiable government expenditures and discussed them at great length. It is interesting to see what these expenditures were and to examine their economic characteristics. But before we do so we must define some concepts which we shall make use of to justify government expenditures.

Private Wants, Social Wants and Merit Wants

It is possible to classify human wants into three different types, namely private wants, social wants and merit wants. It then follows that goods can also be classified into private goods, social goods and merit goods.

Private wants are those wants which can be satisfied through the pricing mechanism of the market. People who do not pay for the private goods can be excluded from satisfying their wants. Private goods thus satisfy individual wants.

However in the case of social wants the market mechanism fails altogether. "Social wants are those wants satisfied by services that must be consumed in equal amounts by all. People who do not pay for the services cannot be excluded from the benefits that result."¹ Since consumers cannot be excluded from the benefits of social goods they will not engage in voluntary payments nor will they reveal their true preferences. Because of these two characteristics a pricing system will not work. Thus social wants must be satisfied through the public sector if they are to be satisfied at all.

Merit wants occupy a position intermediate between private wants and social wants. Merit wants are "such wants that are met by services subject to the exclusion principle and are satisfied by the market within the limits of effective demand." They become merit wants "if considered so meritorious that their satisfaction is provided for through the public budget, over and above what is provided for through the market and paid for by private buyers."²

Social wants and merit wants together constitute public wants in contrast to private wants.³

Providing for The Satisfaction of Public Wants

We have seen that public wants are provided for by the government. What precisely do we mean when we say that the satisfaction of public wants are provided for by the government? We mean that "the goods and services needed to satisfy public wants must be paid for out of general revenue. The goods and services must be supplied free of direct charge to the user; at the same time they need not be produced under the direct management or supervision of the government."⁴

Bearing this definition in mind we may now return to our discussion of government expenditures which were considered justifiable by Adam Smith.

¹R.A. Musgrave, Theory of Public Finance, MacGraw-Hill Book Co. Inc., New York 1955. Page 8.

²*Ibid.*, Page 13.

³The implicit assumptions made in this section are that individuals can evaluate private and social wants.

⁴R.A. Musgrave, *op. cit.*, Page 15

Adam Smith and The Proper Role of Government Expenditures

In Book V of his "An Inquiry into The Nature and The Causes of The Wealth of Nations" first published in 1776 Adam Smith devoted a whole chapter to the discussion of government expenditures entitled "Expenses of the Sovereign and Commonwealth".⁵ He enumerated four categories of government expenditures which he thought were justifiable; (1) expenditures on defence against external attack, (2) expenditures on maintenance of justice and internal order, (3) expenditures on some public works and institutions which private individuals would not undertake, and (4) expenditures for supporting the dignity of the Sovereign. We shall discuss these separately except the last category which seems too obvious.

Expenditures on National Defence

National defence is concerned with the security of the country as a whole. The services produced by national defence expenditures include protection against enemy attack and the minimisation of damage in the event of an actual war. The benefits of these services obviously accrue to the community as a whole and are consumed in equal amounts by all the members of the community. Moreover those who do not pay for the costs of these services cannot be excluded from enjoying the benefits. The government cannot possibly isolate a private individual and refuse to protect him from an attack launched by an enemy country.

National defence thus possesses the characteristics of a social good; it is consumed in equal amounts by all and the exclusion principle does not apply. Being a social good national defence is therefore provided for by the government.

Adam Smith of course did not justify national defence expenditures in terms of social goods and social wants. He argued that as civilisation progressed the government had to incur more expenditures on national defence while in primitive society the "warrior maintains himself by his own labour, in the same manner as when he lives at home. His society....., is at no sort of expenses, either to prepare him for the field, or to maintain him while he is in it."⁶ It should be noted that even in

⁵Adam Smith, The Wealth of Nations Vol. II, J.M. Dent & Sons Ltd., London, Page 182 - 277.

⁶Ibid., Page 182.

this case the benefits resulting from the services of the warrior accrued to the community as a whole and were consumed in equal amounts by all.

Expenditures on Maintenance of Justice and Internal Security

A system of order and justice is a prerequisite for any activities even in the most primitive society. To this extent expenditures incurred for the maintenance of law and order certainly needs no justification. However it should be noted that the services produced by this category of expenditures possess all the characteristics of social goods. They are therefore provided for by the government rather than the private sector through the pricing mechanism.

Expenditures on Public Works

Adam Smith realised that certain social capital items like roads, bridges, canals, and harbours could not be provided for by private enterprise on a profitable basis.⁷ Public works were subdivided into (1) those facilitating commerce and (2) those promoting instruction or education. Education was further subdivided into (a) the "education of youth" and (b) the "instruction of people of all ages."

Smith justified public works by saying that the private sector would not undertake these works because the profit could never repay the expenses incurred by private individuals or small groups of individuals. This might be true during Smith's time. But nowadays it is possible for the private sector to undertake these services on a profitable basis, and there are many cases in which these services are actually provided for by private enterprise.⁸ Nevertheless in most cases these services are provided for by the government because they are considered to be merit goods. These services are so vital to the society that the government undertakes to provide them free of direct charge to individual users. Moreover the production of these services has a natural tendency to monopoly and will become detrimental to national interest if left to the free play of market forces.

⁷ Ibid., Page 211.

⁸ In Malaysia ferry services and some electricity supplies are undertaken by private enterprises on commercial basis.

Expenditures on education have become one of the largest items of government expenditures in most countries. The right to an education is universally accepted.⁹ However it is not true that only government can provide education. Technically a system of free education can be achieved by an elaborate system of transfer payments to the parents, leaving education to be undertaken by private enterprise. The reason why education is provided for through the public sector is again found in the fact that education is a merit good. A proper system of education is of the utmost importance to the society. A high degree of educational attainment increases the mobility of personnels and is therefore an automatic remedy to unemployment. Also with increasing complexity of technology greater productivity can only be achieved with greater skill and most skills can best be learned through education.

We have so far shown that government must incur a considerable amount of expenditures in order to satisfy public wants. These expenditures were recognised to be justifiable by Adam Smith in spite of his belief of laissez-faire. Thus the common belief that Smith was a bold advocate of minimum government expenditures is not at all correct. Smith's own writings fail to support this belief.

II Some Criteria of Government Expenditures

As the role of government expenditures in the economy became accepted and as the size of government expenditures increased over time the discussion of government expenditures also changed from a quantitative to a qualitative basis. In view of the growing importance of government expenditures it is imperative that some criteria should be established to guide the use of government expenditures. Several principles have been postulated for this purpose. In this section we shall discuss two of them.

⁹In 1948 the United Nations General Assembly unanimously proclaimed in the Universal Declaration of Human Rights: "Everyone has the right to education. Education shall be free at least in the elementary and fundamental stages. Elementary education shall be compulsory. Technical and professional education shall be made generally available and higher education shall be equally accessible to all on the basis of merits." Quoted by Frederic L. Fryor: Public Expenditures in Communist and Capitalist Nations, George Allen and Unwin Ltd., London, 1965, Page 103.

Maximum Social Advantage

The Principle of Maximum Social Advantage was postulated by Dr. Dalton in his book "Principles of Public Finance" first published in 1922.¹⁰ According to this principle the operation of public finance in general, and that of public expenditures in particular, should aim at attaining the maximum social advantage of the society with regard to the production and distribution of wealth.¹¹ Improvements in production and distribution of what is produced are the chief conditions of an increase in the economic welfare of a community. Improvements in production consist of increase of productivity and the minimisation of cost and the composition of products best suited to the needs of society. On the other hand improvements in distribution consist of reduction of excessive inequality in the incomes of individuals and families.

The main difficulties in applying this principle to actual expenditures lie in the fact that it is not always possible to determine what social advantage actually is. The concept of social advantage involves value judgement as to the desirability of certain economic objectives. Social advantage cannot be measured quantitatively. Moreover in some cases improvements in productive efficiency is not compatible with reduction of excessive inequality of income.

The Principle of Maximum Social Advantage is in fact a particular example of a more general approach to the study of government expenditures. This general approach is the Principle of Marginal Benefits and Marginal Cost.

Equating Marginal Benefits and Marginal Costs

The technique of marginal analysis was introduced into the study of government expenditures by A. C. Pigou.¹² According to the marginal theory the ideal principle is to "push expenditures for each public purpose to that point where the benefit of the last dollar spent is greater than or at least equal to the dollar of cost."¹³ This principle is illustrated in Figure 2.1.

¹⁰Hugh Dalton, Principles of Public Finance, 4th edition, Routledge and Kegan Paul Ltd., London.

¹¹See Ibid., Pages 7 - 9.

¹²A. C. Pigou, A Study in Public Finance, Macmillan & Co., London, 1928

¹³Otto Eckstein, Public Finance, Prentice-Hall International Inc., EnglewoodCliffs., Page 23

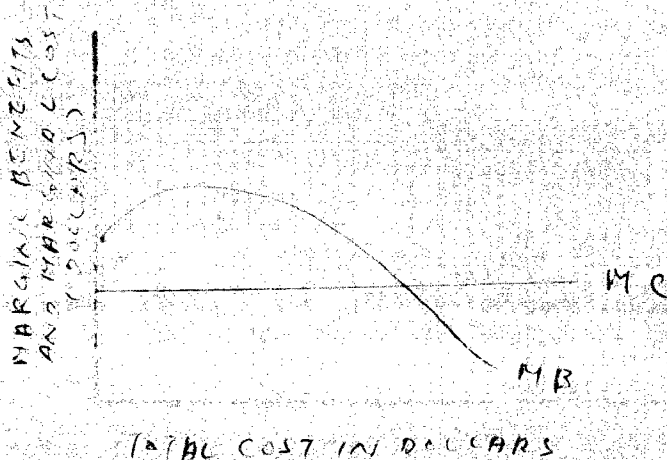


Figure 2.1. Equating marginal Benefits and Marginal Costs

(Source: Otto Eckstein, Public Finance, Page 24)

In Figure 2.1. the line MB shows how the benefits resulting from additional expenditures on a certain project first rises, then falls as more is spent. The shape of curve MB reflects the law of diminishing benefits, as more expenditures are spent on a project there comes a point where the benefits derived from the project is less than the cost involved.

Equating marginal benefits and marginal costs would solve two problems of resource allocation. "It would assure that every expenditure yields a benefit at least equal to the value of goods forgone in the private sector. Secondly, it would assure that an expenditure does not prevent a more valuable public expenditure in some other field. Thus the principle assures that benefits of marginal expenditures exceed opportunity costs both in the private and the public sector."¹⁴

The principle of marginal benefits and marginal costs is concerned with the efficiency of government expenditures. The practical application of this principle, however, is beset with difficulties. Firstly for a large part of government expenditures it is not always possible to measure benefits and costs in terms of dollars and cents. For example the benefits derived from defence expenditures certainly cannot be measured in monetary terms. Even those expenditures on education and housing which are believed to yield considerable monetary benefits have not yielded to reliable measurement. Secondly the definition of

¹⁴Ibid., Page 24.

benefits neglects the important problem of to whom the benefits accrues. In other words the income redistributive effects of the expenditures are not considered at all.

Conclusion

We have seen in this chapter that even in the classical system the range of justifiable government expenditures was fairly extensive and covered a vast field of activities.

In spite of the growing importance of government expenditures no universally applicable criterion has been established to guide the direction of government expenditures.

