Public Spending Efficiency: The Missing Factor through Financial Crisis

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ABSTRACT

Public expenditure is efficient if its planning and policy objectives are achieved and inefficient if they are not. Efficiency is measured by an index of observed and desired performance and involves a comparison of actual performance with optimal performance located on the relevant frontier. Research is concerned with the identification of various ways that might depart from efficiency, the specification of an appropriate method of measuring inefficiency, and an exploration of the implications of each type of inefficiency, comprising a) academic interest, b) managerial decision making, and c) public policy relevance. This paper attempts to focus on defining efficient public expenditure performance, investigating the attainment of efficiency, and examining efficiency in public expenditure as a way to recover from the current financial crisis.

Keywords: Efficiency, Efficiency Function, Inefficiency, Public Expenditure, Stochastic Frontier Analysis

1. INTRODUCTION

Economic growth literature on endogenous economic growth has provided some insights into why countries grow at different rates over long periods of time. In some of these models, the government’s choices of tax rates and expenditure levels influence rather significantly the long-term growth rates (Barro & Sala-i-Martin, 1992), as well as productivity growth.

Analysis based on an aggregate production function provides some insight into these differences, an approach taken by Mankiw, Romer, and Weil (1992) and Dougherty and Jorgenson (1996), among others. Differences among countries can be attributed to differences in human capital, physical capital, and productivity, with differences in each element of the production function to be important. Their hypothesis is that differences in capital accumulation, productivity, and therefore output per worker are fundamentally related to differences in social infrastructure across countries. Social infrastructure favorable to high levels of output per worker provides an environment that supports productive activities and encourages capital accumulation, skill acquisition, invention, and technology transfer (Hall & Jones, 1999, p. 84).

Within this macroeconomic framework, productivity has always played a leading role in raising economic growth and development, by boosting output, improving quality, and saving capital and other resources, allocating
resources to more productive uses, either in existing or new ones. This paper attempts to focus on defining efficient public expenditure performance, investigating the attainment of efficiency in public expenditure as a way to recover from the current financial crisis.

2. ECONOMIC GROWTH AND PUBLIC SPENDING

Governments undertake expenditures to pursue a variety of goals, only one of which may be an increase in per-capita income. We focus on growth because (1) inasmuch as growth is one of the objectives of a government, it is useful to know the contribution of different components of expenditure to this objective as a means of assessing the cost of pursuing other goals, and (2) per-capita income is easier to measure than some of the other objectives of government. Neither economic theory nor empirical evidence provides clear-cut answers to the question of how the composition of public expenditure affects economic growth. The theory develops a rationale for government provision of goods and services based on the failure of markets to provide public goods, internalize externalities, and cover costs when there are significant economies of scale. Furthermore, when there is a failure in one market, government intervention in a related market can be justified. Sound as they are, these theoretical notions do not translate easily into operational rules about which component of public expenditure is to be cut (Devarajan et al., 1996).

Within the literature on the determinants of economic growth, some papers (e.g., Easterly & Rebelo, 1993; Fischer, 1993) consider the effects, if any, of government expenditure and revenue on economic growth. Overall, the findings of these studies paint a mixed picture; the relationship between growth and government is sometimes significant and positive, sometimes significant and negative, and sometimes not significant (Miller & Russek, 1997, p. 603).

Since the decade of 1960, researchers have been looking at the relationship between fiscal policy and the economy’s growth rate. The seminal contribution was by Arrow and Kurz (1970), who developed a model where consumers derive utility from private consumption as well as the public capital stock. In addition, private production benefits from the services of this capital stock. Arrow and Kurz assumed (implicitly) that all government investment was productive. Furthermore, their model was in the neoclassical tradition where public spending only affected the economy’s transitional growth rate; the steady-state growth rate remained unaltered (Devarajan et al, 1996).

Since then, there is a body of literature on the welfare effects of public expenditure (Ashchauer, 1988; Barro, 1989; Ardagna, 2001; van der Ploeg, 2004; Mastromarco & Woitek, 2005). Since the classic analysis of public infrastructure by Arrow and Kurz (1970), a number of empirical studies have examined the role of public capital as an input in the production process (For examples, see Ratner, 1983; Ashchauer, 1989a, 1989b; Munnell, 1990, 1991; Tatom, 1991; Holtz-Eakin, 1994; Nadiri & Manuneas, 1994; Andrews & Swanson, 1995; Garcia-Mil, McGuire, & Porter, 1996; Mullen, Williams, & Moomaw, 1996; Otto & Voss, 1996).

As analyzed in Mastromarco and Woitek (2005), there is a body of literature investigating the impact of public capital on productivity. Empirical evidence suggests that this impact is considerable (Gramlich, 1994; Sturm & De Haan, 1995). Ashchauer (1989) and Munnell (1990) show that the decline in public investment is very important in explaining the productivity slowdown occurred in USA between seventies and nineties. Subsequent research, however, has serious doubts on the robustness of the results (Holtz-Eakin, 1994; Evans & Karras, 1994; Baltagi & Pinnoi, 1995; Garcia-Milla et al., 1996). In particular, state specific effects play an important role in productivity analysis, as emphasized by Islam (1995) and Temple (1999). This issue is important if research focuses on the effect of public capital on productivity. The positive effect of public capital on productivity may depend on correlated omitted variables. These omitted
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