1. Introduction:

Economic growth, which reflects the overall performance of a country, is one of the most important macroeconomic goals that a country seeks to achieve and maintain. Economic growth in one-way or another refers to the increase of the country’s potential GDP. It must be sustained in order for economic development to be achieved (Desmond, et al, 2012).

Besides taxes as an instrument of fiscal policy, governments might use their expenditures, as another instrument, to achieve economic growth. ‘Public expenditure was born out of revenue allocation which refers
to the redistribution of fiscal capacity between the various levels of government or the disposition of responsibilities between tiers of the government’ (Okoro, 2013). Therefore, understanding the relationship between the government expenditures and revenues and the implementation of an efficient fiscal policy is necessary to give a clear indication of how effective the government’s policies used in managing the country’s resources, establishing price stability and maintaining sustainable economic growth (Hamdi and Sabia, 2013).

In the past two decades, the Palestinian economy was going through fluctuating behavior. It was affected by different social and political situations. Gross domestic product (GDP) the most important indicator of economic growth varied with different percentages over these two decades. For example, in 1996-1999 GDP reached its maximum in 1999 with US$4,534.9 million with 8% growth rate while GDP was US$3,744 million with a growth rate of 14% in 1997. Moreover, GDP started and continued to decrease as a result of Israeli military measures during the years of the second intifada (2000-2004). In fact, it reached its minimum in 2002 with US$3,301.4 million with a rate of -13% growth. This fluctuating behavior continued where GDP started to improve in the following two years (2004-2005) where it reached US$4,559.5 million in 2005 with 9% growth. However, it started to decrease back in 2006-2007 to reach US$4,554.1 million with growth rate of 5% only. After that, GDP started recovering and continued to increase (2008-2012) and reached the maximum in 2012 with US$6,797.3 million and 6% growth (Palestinian Central Bureau of Statistics, 2013).

Therefore, it can be said that Palestine, as an occupied small country, has a very fragile and sensitive political, economical and social situation due to the Israeli occupation. Much attention should be paid to the Palestinian economy, in particular to the governmental policies used in order to analyze the reasons and effects of such a fragile economy on the other aspects of life. Government expenditures and its components, as an example of such policies, will be studied and analyzed through this study to give an indication of how effective the Palestinian policy makers’ strategies in managing and controlling the Palestinian economy and resources.

2. Theoretical Background and Literature Review:

One of the definitions of economic growth is ‘the increase in the total output of an economy that happens as a result of a society acquiring new resources or learning to produce more using the existing ones’. ‘New resources may refer to an increase in capital stock or in labor force’. ‘Accumulation of capital and technological advances are two of the most important sources of economic growth’ (Case, Oster and Fair, 2012). According to McConnel, Brue and Flynn (2009) economic growth is ‘an outward shift in the production possibilities curve that results from an increase in resource supplies or quality or an improvement in technology’ or it’s ‘an increase in real GDP or in real GDP per capita over some period of time’. This study uses the definition of economic growth as an increase in real GDP.

Economic growth can be measured by comparing real GDP for different years. Real GDP is defined as ‘the value of total production of farms, factories, shops and offices of a country measured in the prices of a single year’. One of the main approaches for calculating GDP is the expenditure approach which equals ‘the sum of consumption expenditure, investment, government spending on goods and services and net exports’ (Parkin, Powell and Matthews, 2005).

Government spending (expenditure), which will be the main focus of the study, is the acquisition of goods and services either for current use, to directly satisfy individual or collective needs of the members or for future benefits such as infrastructure investment. It includes all government consumption and investment but excludes transfer payments made by a state (Barro and Grilli, 1994).

There have been several schools of thoughts regarding the impact of government expenditure on the economic growth. The classical school viewed that countries with higher government expenditure would experience lower economic growth (Ricardo, 1821). While the Keynesians viewed that the increase in government expenditure leads to higher economic growth (Keynes, 1936). However, the neo- classical viewed
that there is no long run impact of government expenditures on the economic growth rate (Solow, 1956). Wagner (1893) argued that there is a positive correlation between economic growth and government activity in the long run (Wagner’s law or the law of increasing state spending). Moreover, Economists of Endogenous Growth Theory such as Barro (1990) suggested that government expenditure induces economic growth.

There have been several studies interested in the impact of government expenditure on economic growth. For example, Mohammadi, Maleki and Gashti (2012) analyzed the effect of governmental expenditure composition on the Economic development of economic cooperation organization countries ECO: Iran, Kazakhstan, Kyrgyzstan, Pakistan, Tajikistan and Turkey annually for (1995-2009). They focused on three types of government expenditures: health expenditure, education and defense. The real per capita of GDP in period t was the dependent variable where real per capita of GDP in period t-1, government expenditure on health to GDP ratio in period t, government expenditure on education to GDP ratio in period t, government expenditure on defense to GDP ratio in period t, the investment in period t, total of Population growth rate, technological growth and the depreciation rate in period t and other financial variables as a share of GDP in period t formed the independent variables. The dynamic panel data method, the generalized method of moments (GMM) and the Sargan test were conducted. The results showed that the health expenditure has significant and negative effect on growth, educational expenditure has significant and positive effect and the governmental defense expenditure has significant and positive effect on the economic development of ECO countries.

Moreover, Dao (2012) using cross sectional data, analyzed the impact of the growth of the share of various government expenditure programs in the GDP on economic growth in 28 developing countries (Argentina, Armenia, Azerbaijan, Belarus, Brazil, Bulgaria, Colombia, Cyprus, Czech Republic, Egypt Arab Republic, Hungary, India, Iran, Israel, Kazakhstan, Kyrgyz Republic, Lithuania, Madagascar, Moldova, Poland, Portugal, Russian Federation, Slovak Republic, Slovenia, South Africa, Tajikistan, Thailand and Ukraine) for 3 years (2008-2010). The dependent variable in this study was per capita GDP growth while the growth of per capita public health expenditure in the GDP, growth of per capita public spending on education in the GDP, population growth, growth of the share of total health expenditure in the GDP and the share of gross capital formation in the GDP formed the independent variables. Data for all variables were obtained from the World Development Indicators (2008 and 2010). Least square multiple regression analysis and t-test were used to estimate the specified model. Results showed that the share of gross physical capital formation in the GDP is not significant, developing countries in which the government continues to increase per capita spending for health care and education relative to income are expected to grow faster and that the growth of the share of total health expenditure in the GDP also influences per capita GDP growth of countries included in this study.

Also, Yu, Fan and Saurkar (2009) assessed the impact of the composition of government spending on economic growth in 44 developing countries (1980-2004). The aggregate national GDP were used as the dependent variable while the explanatory variables included labor, gross capital stock, and capital stock of various government expenditures. Total government expenditures and its composition were collected from the International Monetary Fund’s Government Finance Statistics (GFS) Yearbook sectors. The World Development Indicators (World Bank, 2006) were used for exchange rates. Dynamic GMM model and a panel data set for 44 developing countries, Dickey-Fuller unit root test and Levin-Lin-Chu (2002), Im-Pesaran-Shin (2003) and Hadri Lagrange Multiplier (2000) panel unit root tests were also conducted. Results showed that the various types of government spending have different impact on economic growth. In Africa, government spending in human capital was particularly strong in promoting economic growth. In Asia, capital, agriculture, and education expenditure promotes economic growth. In Latin America, none of the government spending items has any significant impact on economic growth.

3. Problem Statement:

This study will be designed to highlight one of the fiscal policies’ instruments and how it can be used in managing the Palestinian resources and maintaining the stability of the Palestinian economy. The main
The question that will be answered: what is the relationship between the government expenditures and the economic growth in Palestine? This will be achieved by answering the following sub-questions:

- How does the gross domestic product (GDP) in Palestine change over the period of 1996-2012?
- What is the impact of employment as an indicator for the labor force on GDP for the period?
- What is the impact of capital, which will be estimated using the Incremental Capital Output Ratio (ICOR) approach on GDP for the period?
- What is the impact of technology on GDP for the period?
- How do government expenditures change over the period?
- What is the impact of the overall government expenditures on the GDP for the period?
- What are the components of the government expenditures?
- How much does each component form as a percentage of the overall government expenditures?
- What effect does each component has on GDP for the period?
- What are the recommendations that can be extracted from the results of the study and how would they benefit the competent authorities?

4. The Objectives of the Study:

The main objective of the study will be to analyze the impact of government expenditures as a total and its components on the Palestinian economic growth. Moreover, the specific goals to be achieved are:

- Estimating capital using the ICOR approach for the period.
- Observing how GDP, labor, capital, and government expenditures change over (1996-2012).
- Identifying the components of the government expenditures for the period.
- Calculating the percentage each component form of the total government expenditures for the period.
- Estimating an econometric model where GDP is a function of labor, capital, technology and total government expenditures.
- Estimating an econometric model where GDP is a function of labor, capital, technology and the four components of government expenditures (wages and salaries expenditures, non-wage expenditures, development expenditures and net lending).
- Analyzing the effect of each component on the overall government expenditures and GDP for the period.
- Comparing the effect of labor force, capital, technology and components of government expenditures on GDP for the period.
- Suggesting some recommendations and address them to the competent authorities to enhance the palestinian economy through this instrument (government expenditures).

5. The Importance of the Study:

Since the Palestinian economy is directly connected to the Israeli economy, this limits the Palestinian policy makers’ options in setting up the policies needed to enhance the Palestinian economy. Monetary policies are not an option in the case of Palestine since it’s an occupied country and has no full control over the currency. The Palestinian don’t have their own currency, instead they are forced to use the Israeli currency (shekel). However, government expenditures and taxes are two tools of fiscal policies that can be used to achieve the desired economic growth in Palestine. Government expenditures are more controlled by the Palestinian authorities, which give them the preference over the other instruments of fiscal policy in this study. Since part of the taxes are under the control of the Israeli authorities in certain circumstances and up to certain levels, the recommendations that will come out of this study will be more effective in the case of government expenditures rather than taxes. Israel can affect the Palestinian economy in two different ways; directly through taxes’ collection prevention, since they have control over the international borders, and indirectly by tax revenues’ base reduction (Issac, et al, 2011).

This study will be directly addressed to the Palestinian policy makers, mainly the Ministry of Finance. This
study will help the policy makers in the Ministry of Finance to take into their consideration the effect of the
government expenditures on the economic growth when they formulate and create the Palestinian Authority
budget. This will make the budget more effective and the Palestinian resources will be allocated in a more
efficient and productive way. This study will also be very helpful to the Ministry of Planning in setting up the
social, economical, financial and political plans that would enhance the overall performance of the country in
the previously mentioned fields. Since there is a direct relationship between GDP and unemployment rate,
this fiscal policy instrument will be very helpful for Ministry of Labor in preparing its annual strategies in
decreasing the unemployment rates. In addition, this study will benefit the Ministry of National Economy in
choosing the projects that should be given licenses, in particular, the ones that enhance the economy growth
the most. In addition, this will help the individuals as being part of the labor force to determine how and
where to invest their money so as to help in achieving better GDP growth.

6. The Scope and Limitations of the Study:

This study will be analyzing the impact of government expenditures as a total and its components on the
economic growth in Palestine (1996-2012). It will have an important limitation, which will be the shortness of
the time series that will be taken in analyzing the impact of the government expenditures on the GDP. The
time series coverage will be (1996-2012) since the Palestinian Authority was established in 1994 as a result of
the Oslo Accords between the Palestine Liberation Organization and Israel. The data available in the
Palestinian Ministries and the Palestinian Central Bureau of Statistics (PCBS) start mostly from 1996.

7. The Methodology:

The study will be based on secondary annual data (1996-2012) of total government expenditures and its
components from the Ministry of Finance whereas the GDP, capital (estimated using the ICOR approach) and
employment to be taken from the Palestinian Central Bureau of Statistics.

This study will be consisting of two models. The dependent variable of the first model will be the GDP
whereas the independent variables will be capital, labor force, technology and total government expenditures
(Mohammadi, Maleki and Gashti (2012). As for the second model GDP will be the dependent variable while
labor, capital, technology and the components of government expenditures will be the independent variables
(Bader, 2012). According to the Ministry of Finance (2013) government expenditures in Palestine are divided
into four types; expenditures on wages and salaries, non- wage expenditures, net lending and development
expenditures. These four types will form the independent variables of the second model. The stationarity of
the two models will be first tested using Augmented Dickey-Fuller and Phillips-Perron unit root test for
stationarity. Then the impact of government expenditures as a total and its components on the GDP will be
examined using multiple regression analysis where the R2, F-test and t- test will be calculated. Moreover,
other tests will be performed such as White test of heteroscedasticity, Ramsey RESET test, Durbin-Watson test
of autocorrelation.

The models to be used in this study are:

Model 1:
GDP = f(L, K, T, G)
Where:
L: labor.
K: capital.
T: technology.
G: total government expenditure.

Model 2:
GDP = f(L, K, Wexp, NWexp, NL, Dexp)
8. Contents of the Study:

This study will consist of five chapters. Chapter one will contain seven sections: the introduction, the problem, the objectives, the importance, the scope and limitations, the methodology and finally the contents of the study. Chapter two will outline the theoretical background and a literature review of previous studies that have the same problem of this study. Chapter three will be a detailed descriptive analysis of the data on the variables of interest focusing on the allocation of the government expenditures. Chapter four will be analyzing the data statistically. It will contain detailed description of the methodology of the study with the models to be estimated addressed in functional forms using symbols representing the dependent variable along with the independent variables. Finally, the estimated models will be discussed and tested economically and statistically in order to highlight the impact of government expenditures along with its components on economic growth. Chapter five will give the final conclusions of the study and the recommendations that will be addressed to the competent authorities.

References:


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