What are the major economic functions of government in transition economies? Should government play a minimalist role in transition economies?

"…the transition of the state is perhaps the most important transitions of all."(Lago, Stern, Buiter, 1997, p.33)

The term government is used in economics in a broad sense to include all public officials, agencies, government bodies, and other organizations belonging to or under direct control of central and local governments (Lipsey, Courant, Ragan, 1999, p.55).Generally, governments have important influences on economic activities through their expenditures, taxes, transfer programs, regulations and debt management.

In all different models of transition the role of the government is central for establishing a particular pattern of the transition process. Effective government policies *and intervention are vital and essential for successful transformation of the planned economies into a free market.*

Although, the end-point of transition for the Shock therapy is establishing of free market with minor government intervention, the key issues of this therapy such as: rapid reduction of the excess demand; swift, simultaneous external and domestic price liberalization; mass privatization and import of new market institutions, are seen as exclusively state responsibilities.

In Gradualism, government provides basic macrostabilisation, sequences structural changes and price liberalization in the economy. Also, it oversees industrial policy where is needed and is responsible for institution building. The ultimate outcome is achieving a free market in which state intervention is commonly required.

Institutional approach attributes to government the task of introducing price liberalization combined with cushioning and protectionism when necessary. Building appropriate market institutions, which may take years, is another government priority.

In Keynesian model of transition government avoids sharp price hikes (inflation) and devaluations. Levels of public investment are high and crucial for the economic *growth. Government, also, determines industrial policy and is responsible for institutional development.*

Minimum Bang just, as the Shock Therapy, sees the state responsible for rapid price liberalization, mass privatization and import of new market institutions in the transition economy.

The state performs many different roles in market economies, but there is general agreement on a list of basic functions that need to be provided by the government for the proper operation of markets in transition economies:

- *Providing public goods and services*
- *Maintaining macroeconomic(as well as microeconomic) stability*
- *Maintaining legal and social frame work (law and order)*
- *Maintaining infrastructure and competition*
- *Redistributing the income*
- *Fair and transparent tax system*

The extent to which the state fulfils these functions in efficient and non-discriminatory manner is a measure of the quality of the state's governance of the economy (EBRD, Transition Report 1999).As well, appropriateness of government role in transition economy can be assessed in terms of its size and scope.

Providing public goods and services is the first essential government function. Public good or service has the features of non-rivalry and non-excludability and that markets may find troublesome to provide because their nature makes it difficult or costly to establish a close link between payments and receipts of such goods[1]*. Examples of public goods and services are: flood-control dams, pavements, national defense, police and fire protection.*

There is a problem in transition economies in relation to state provision of this type goods and services. How these public goods are defined in economy, where state used to own nearly all resources, no too long time ago. Where are the boundaries between public and private sector? It could be said, that in transition economies of Eastern Europe are in unique situation in which state is defining what public good and service is, and then makes

[1] *Non-rivalry* means that the consumption of this good or service by one person will not prevent others from enjoying it. *Non-excludability* means that it is not possible to provide this kind of good or service to one person without it thereby being available to others to enjoy (Sloman, 1999, p.301).

its necessary welfare provisions in relation to that, while economy is undergoing profound changes

Maintaining macroeconomic stability is a prime task for every government. There are usually four macroeconomic policy objectives that governments typically pursue: high and stable economic growth, low unemployment, low inflation, the avoidance of balance of payments deficits and excessive exchange rate fluctuations. Normally, macroeconomic stability is brought in through suitable fiscal and monetary policies. Because these goals are likely to conflict, which policies a government adopts will depend on its order of priorities and on which school of economic thought it adheres to. What government has to decide on is which policy (or combination of policies) could be implemented, what the size of taxation and government expenditure should be, as well as controlling of the money supply and exchange rate.

What all transition economies in EE have in common, in relation to their macroeconomic conditions is: falling output levels, high and in most cases hyper-inflation, soaring unemployment, deficit on balance of payments and devaluating currency.

In order to supply the public good of macroeconomic stability[2] *government in transition economies needs to carry out the following tasks: enforcing hard budget constraints, establishing price and exchange rate stability as well as controllable inflation, regulation and supervision of the financial sector, tax administration and supplying social safety net (Lago, Stern, Buiter, 1997, p.34).*

Enforcing hard budget constraints is the first rule of a market economy. Without it, liberating markets freeing prices and privatizing state enterprises is pointless in transition economies. Any subsidies should be explicit in the government budgets and given only they are necessary.

If a market economy is to function properly, prices must be undistorted as possible. Most prices should be left to arrive at their equilibrium levels. Only goods and services such as energy, some essential medicals, housing can be subsidized. What is more, after

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[2] *in a sense it is non-rival-one person's consumption does not diminish another's, and non-excludable –it is not possible to exclude consumers from using the good,(Stern,1997,p.3)*

reaching their equilibrium levels price stability is needed to be maintained in order to avoid potential inflation.

Government in transition has to decide on the type and size and exchange rate. Establishing of appropriate exchange rate and maintaining its stability is new state task, which favorable outcome promotes confidence and encourages growth of trade.

Supervision and regulation of the banking system is a top government priority, as well. Inherited, undeveloped financial system could be serious obstacle to success of introducing transition reforms. Its reorganization, supervision and regulation are government main concern, as well.

There has been a clear relationship between macroeconomic stability and economic performance in the transition economies. The countries that have shown the strongest commitment to reform are those that have kept tighter macroeconomic control (see Table 1 by N.Stern).

Table 1.Progress in transition and macroeconomic performance

	Private Sector GDP share%	*Score on enterprise restructuring &privatization*	*Score on markets' liberalization*	*Score on Banking reform*	*Score on Investment Laws*	*Annual Inflation Rate% 1992*	*Annual Inflation Rate% 1996*	*GDP Growth% @1995*
Advanced Countries	*60*	*3.7*	*3.3*	*3*	*3*	*93*	*22*	*5*
Intermediate Countries	*42*	*2.7*	*2.8*	*2*	*2*	*237*	*28*	*0*
Early Countries	*27*	*2.0*	*2.3*	*1.8*	*2*	*1364*	*128*	*-5*

Source: EBRD Working Paper 19, 1997

Thirdly, government provides the rule of law and order, basic administration and external defense. These responsibilities include the protection of the system of private property rights and contracts in a scale unknown for transition economies. Also they are basic to the functioning of a marked system based on decentralized, private decision – making (Stern, 1997, p.10).In particular, government should encourage institutional development and strengthen the legal framework, which in turn would enforce contacts *and protect property rights in these changing economic structures. Firm bankruptcy and collateral legislation would create incentives for much needed investment and capital market development in transition economies.*

Fourthly, as we are moving away from situation in which state, at least in theory, guaranteed 100% employment to one in which soaring unemployment is a reality another main role of the government comes to play. This is the role of redistributing the income and provision of social safety net. State gradually establishes itself not as job guarantor but as a provider of minimum income when it is necessary. Distributional objectives are pursued, particularly protection from poverty or destitution. Government is now responsible for provision of a new social safety net which would both cushion the impact of stabilization and structural transformation and shape new attitudes, away from the former overall protection system provided by the communist state.

Government maintains competition and regulates natural monopolies[3]*. In inherited, highly monopolized economies creation and enforcing of antitrust legislation is critical for development of competitive microeconomic environment. Proper regulation of natural monopolies enhances infrastructure of transition economy and boosts its long-term growth potential.*

Setting up and maintaining of fair and transparent tax system is the next, key economic function of government. The new tax system should provide resources to the budget, be transparent, as simple as possible, and not heavy on enterprises and individuals so as to avoid stifling entrepreneurship (Lavigne, 1999, p.194). Appropriate, working taxation is important for government (as a revenue basis) as well as for enterprises and individuals. (as an incentive determinant).

[3] *Natural Monopoly* is a situation where long-run average costs would be lower if an industry were under monopoly than if it were shared between two or more competitors (Sloman, 1999, p.164).Examples of natural monopolies are: rail track, electricity transmition grids, water distribution, sewage collection etc..To prevent natural monopolies from exploiting their unique position with high prices, they are regulated by government.

In addition, government enforces the rights of future generations, particularly in maintaining a safe and habitable environment; and subsidies the provision of merit goods[4] *like education or protects citizens from their own inadequacies as drug-abuse, pensions, health insurance (Lago, Stern, Buiter, 1997, p.15). What's more, governments of transition states should participate in building of international economic institutions.*

Generally, government role in economy has two dimensions. These are the size and the scope of government activities. The size refers to the ratio of public spending to GDP. Alternatively, the size could be computed in terms of public employment as a share of the population or the share of government consumption in total consumption. The scope is associated with the composition and structure of the government spending.

There is no comprehensible, agreement among economists on explicit and appropriate size and scope of government in transition economies. Some support the rule that the size and scope of government are optimal when the social marginal cost of public resources is equal to their social marginal benefits. Other argue that the size of

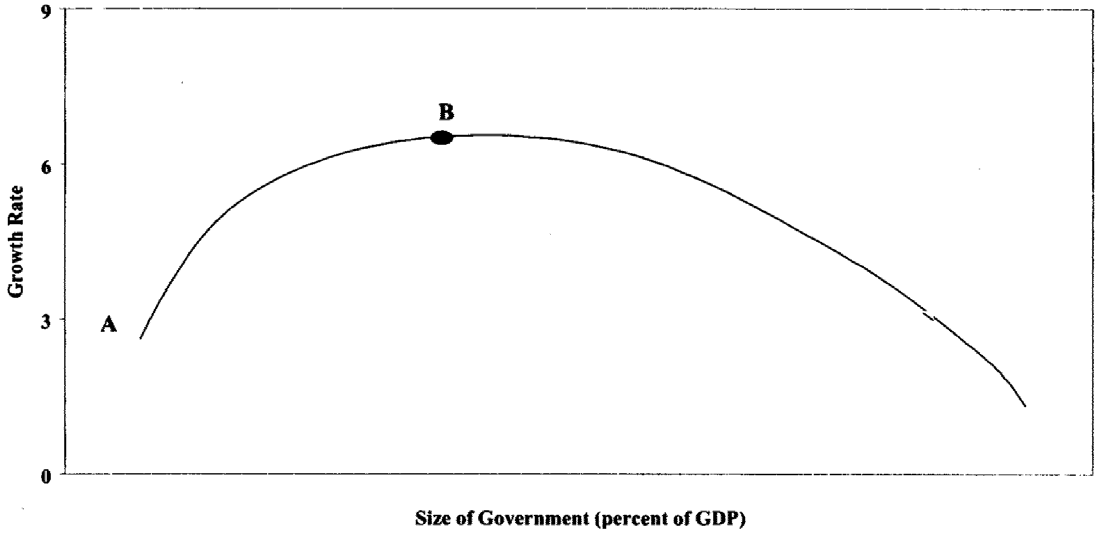
[4] *Merit Goods* are goods which the government feels that people will underconsume and which therefore ought to be subsidized or provided free (Sloman, 1999, p.304).

government is best possible when the marginal product of capital equals unity. In addition, There is no consensus on what is appropriate from a practical point of view on should government play minimalist role while transition economy is undergoing deep changes(Gupta, Leruth, De Mello, Chakravarti, 2001, p.4,p.6,p.7).

If size of the government grows persistently, more and more resources are allocated by political rather than market forces. At the same time, higher taxes and/or additional borrowing are required to finance rising government expenditures. As government takes more and more of the earnings of workers and from the profits of companies, their incentives to work and invest decreases further.

If the expansion in government size continues, new expenditures are increasingly channeled into wider range but less productive activities for which state is less suited than the market. Resultantly, diminishing returns from government actions are set in. Gradually, beneficial effects of government spending as stimulator on economic growth may wane and eventually become negative (see table2).

Table2.The size of government – Economic growth curve Source: Mansfield&Behravesh, 1992, p.592



If governments undertake activities in the order of their productivity, at first government expenditures would promote economic growth (moves from A to B above), but additional expenditures would eventually retard growth (moves along the curve to the right of B).

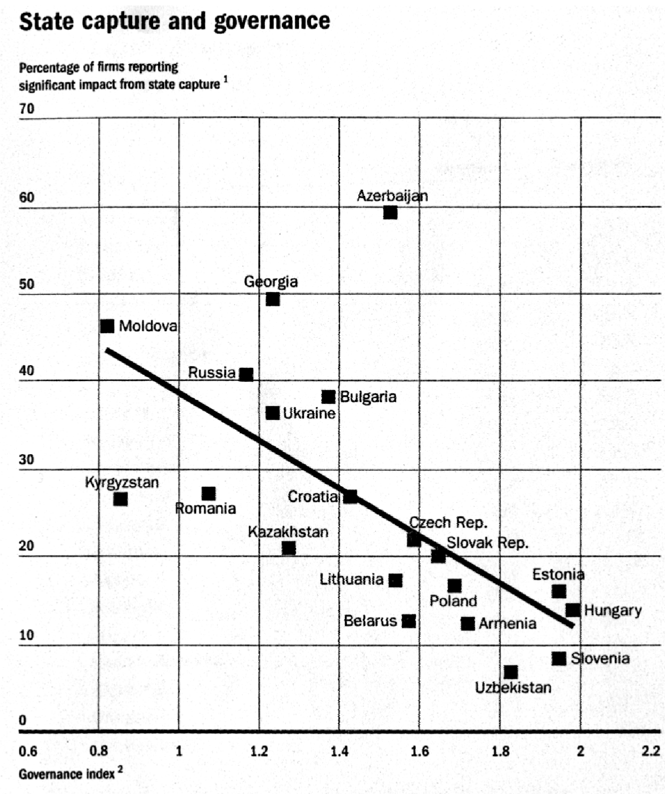
It could be said that, excessive government size may hamper economic growth and reduce expansion of the private sector activities-two ultimate aims of the transition process in EE.On the other hand, while transition economy undergoes profound changes and free market is not fully developed and able to fulfill all its functions, government intervention is essential. This is in a way consistent with the empirical data from transition economies (IMF working Paper 01/55, 2001, Appendix Table5).Although some indicators point to a contracting size of government; others suggest that state continues to play too large role in the economy.

More attention needs to be paid to rationalizing the scope of government in transition economies than to its size. The composition of state activities should be consistent with its economic functions and marginal social benefits. The scope of government, in terms of how resources are allocated across different and often competing uses and functions, has to be in line with the increasing market orientation of the economy.

Political economic determinants of the role of government also necessitate addressing. Government role could be directly influenced by powerful political interests. High levels of state capture[5] are associated with weaker system of governance (see Table3, EBRD, Transition report 1999, p.121). Also, greater capture of the state has a powerful negative impact on the quality of governance in transition economies.

Table3.State capture and Governance

[5] *State capture* commonly refers to the extent to which government policy-making is unduly influenced by a narrow set of interest groups in the economy who provide private benefits to politicians(EBRD, Transition report 1999.p.117)



Source: EBRD Transition Report 1999

With increasing market orientation, the focus of the government in transition economy should have shifted from engaging in wide-ranging economic activities as under central planning to providing public goods and services, achieving society's distributive needs, ensuring macroeconomic stability, maintaining law ,order as well as fair competition and taxation-the classical, major economic functions of government. The size and scope of government should be balanced so that they integrate and harmonize the complementary functions of state and market.

It should be also kept in mind that appropriate tasks for government in different transition economies vary, depending on initial conditions, economic structure, political circumstances, and cultural differences.

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