The Size of the Public Sector[1]

Dhori Kule and H.-Dieter Wenzel

1 Introduction

The World Development Report 1997 was devoted to the role and the effectiveness of the state. What the state should do, how it should do it, and how it can do its tasks better in a rapidly changing world – those were the central aspects in this annual World Bank publication six years ago.[2] What were the reasons for this particular focus on the aspect of public sector activity? After the Cold War and the collapse of command-and-control economies, most transition countries – in a first wave of enthusiasm about the liberation from the chains of oppressive patronage by the state – had as a motto: the smaller the public sector, the better. In many of those countries it was hardly understood that the state plays an important role even in competition-based market economies. It took and still takes quite a lot of powers of persuasion to make this evident.

Many people in the transition countries of Central and Eastern Europe were surprised to notice that the Western countries were mixed economies and not pure market economies. However, it remains to be seen whether in the transition countries a ratio of government expenditures to gross national product (a typical measure of state influence) of far more than 40 percent (and partially more than 50 percent), as it is the rule in the EU member states is an example worth following. Moreover, it is questionable whether Europe should not orient itself by the far lower ratio of government expenditures to GDP of the USA (currently at about 32 percent).

This paper aims at questioning in a general way the role of the state from a theoretical perspective. Thereafter, particular attention is turned to how traditional justifications for public sector activity have to be adapted in the light of the ongoing globalisation of markets and the integration of political systems.

In this paper we use the terms „state", "public" and "government" colloquially as it is often done in discussion and writing. And we regard state as consisting of the three distinct powers of legislature, executive and judiciary.

From a Public Economist's perspective three public sector activities which can be derived from that are of particular interest: government spending, government taxation and governmental regulation of private market activities.

A fourth, equally important public sector activity must not be forgotten: debt financing, i.e. the state's borrowing powers. Even if those borrowing powers do not belong to the state's coercive powers (as government bonds are normally purchased on a voluntary basis), they have the same effect on future generations as a tax, and that is because of the transmission of the interest burden.[3]

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[1] The authors thank Jörg Lackenbauer, Björn Saß, and Julia Bersch for helpful comments and research assistance.

[2] WORLD BANK (1997, p. III).

[3] As public sector debt financing is done without limiting the sovereignty of those who purchase bonds, one could conclude that debt financing is the most adequate instrument in market economies. This however is not the case, because (long-term) public bond financing contracts are entered into without taking account of third parties affected (i.e. future generations).

Hence, if in this paper we talk about the „size of the public sector", we understand „size" as measured by the four public sector activities mentioned above.

Before we attempt to measure the „size", we want to investigate the reasons for public sector involvement, as size and scope have to be derived from an analysis of the justifications of public activities.

Hence, in the second part of this paper, we aim at investigating the factors that make public sector involvement necessary in market economies. The goal of allocative efficiency and the First Fundamental Theorem of Welfare Theory play a central role in this context. We demonstrate that conflicts of rationality and distributional objectives are the causes for public sector involvement.

The third part is explicitly dedicated to the respective areas of public sector activity. We show in detail how real-life economic policy internalises market failure and realises distributional objectives.

The fourth part deals with the question of measurability and the measurement of the size of the public sector. We show that from an economic perspective, this question can only be answered if it is known to what extent public sector activity ties down economic resources. Measurements of the expenditure side as well as of the revenue side do not adequately take account of this claim, as hidden costs are not considered.

In the fifth part, we investigate, on the basis of available data, how the Albanian public sector has evolved during the 1990s with respect to the public sectors of other Western Balkan countries.

The paper concludes with a short bottom line on economic principles of "good public sector policy".

2 Why Public Sector Activity?

There are several reasons that justify the role of the public sector even in a competition-based market economy. Those reasons result from the fact that the constituting principles of a market economy can either not be implemented or only be implemented incompletely. By "constituting principles" we understand, according to Walter Eucken (1952),

- a private property order,
- free price formation and perfect competition,
- freedom to conclude agreements,
- functioning sanctioning mechanisms of the market
- the predictability of economic policy.

A central result of welfare theory shows that so-called competitive equilibria, which grow out of the aforementioned principles, are **Pareto efficient**. This is a strong argument in favour of the superiority of free-enterprise competition systems. Indeed,

with functioning markets the ensuing market results cannot be improved if they are Pareto efficient. However, Pareto efficiency doesn't tell us whether the resulting income and wealth distribution can be considered fair and socially acceptable.

Summing up, in two respects there is a case for involvement of an external player with coercive power – the state. Firstly, in case of an allocative inefficiency arising from a mismatch of the individual rationality of market participants on the one hand and the collective rationality (which means most advantageous for the economy as a whole) on the other. We call this a **rationality conflict**. Secondly, if the allocative efficiency doesn't lead to a desirable and "fair" distributional outcome. We call this a **distributional conflict**.

In Public Finance literature it is undeniable that the efficiency goal as well as the distribution goal are cornerstones of the justification of public sector activity in competition-based market economies, and hence they legitimate the very existence of a public sector. It is more disputable whether a third goal, the stability goal formulated by Richard A. Musgrave (1959), is of equal importance. There are extreme opinions, which allege that the public sector's macroeconomic control mechanisms even generate the business cycles they intend to fight.

Leaving aside this aspect for now, we want to look closer at the two first-mentioned goals. If those were to put into an order for real-life economic and budgetary policy, then the efficiency goal would be, without any doubt, more important from a welfare perspective. Figuratively speaking, allocative efficiency is necessary to make a pie as big as possible. The fair distribution of a smaller pie's slices (if there is no allocative efficiency) isn't helpful to anybody.

Hence, if an efficient resource allocation is the first goal of a competition-based market economy, we still have to ask which situations are typically for rationality conflicts in real-life economic activity and thus call for public sector involvement.

Indeed, there are many of such situations. In many markets for example, there is generally an underprovision of **public goods**, as non-rivalry in consumption combined with non-excludability from consumption makes private users with individual rationality behave as free-riders and disguise their preferences. But very often **private goods**, too, cannot be efficiently allocated through the market. This happens when markets fail to internalise spillover effects generated by private goods. In case of negative externalities, this leads to an overprovision of such goods, in case of positive externalities we can observe an underprovision.

A **lack of individual private property rights** can very often cause inefficient allocations, too. The recent past, whether in the former German Democratic Republic or in other post-socialist states, has alarmingly shown that the case of common property rights was an essential cause of the systematic overexploitation of economic resources. The combination of the two last-mentioned causes of market failure is known in Economics under the name as **Tragedy of the Commons** (Allmende Problem in German) Even today, this kind of rationality conflict is still typical for many efficiency problems.

Especially in economies in transition, the problem of **market power** and **asymmetric or insufficient information** is very often a cause of economic welfare losses. The same is true for an imprudent privatisation of production structures that are characterized by **economies of scale**.

This enumeration could be continued, but already at this point we can note that due to the multitude of allocative inefficiencies the markets should not be "completely left to their own devices".

In the following chapter we want to illustrate with examples in which fields and in which way government activity is necessary for welfare improvements.

3 Where Public Sector Activity and of Which Kind?

In principle, the state has three possibilities of intervention: through revenue policy, expenditure policy and regulation policy (i.e. laws, directives etc.). Each of these instruments should be primarily used to control the economy. The basic principle should be to change the framework conditions for private decisions in a way that makes individual rationality and collective rationality mutually compatible, and not to remove market failures through orders, bans or other forms of direct coercive measures. Clearly, especially a tax doesn't meet these requirements. That's why tax policy on the one hand is such an easy instrument for the state, and yet on the other a **good** tax policy is so difficult to reach. Taxes, too, should be primarily used to control the economy. The fiscal goal of taxation exists only insofar as necessary expenditures have to be financed. Hence, the secret of a good tax policy is to avoid as much as possible the distortion of price structures that developed in the markets.

In the following, we want to illustrate with some examples how allocative inefficiencies can be removed through the use of the aforementioned types of instruments. It ought to be kept in mind that transfers or subsidies are nothing but negative taxes, and public debt is a particular source of revenue.

3.1 Public Goods

Examples for public goods are the legal system, the national defence, the judiciary branch, law and order in a country, the protection of natural resources and the infrastructure. Those goods are useful to everybody, but due to the non-rivalry in consumption and the non-excludability from consumption they wouldn't be offered by private agents. The state can produce these goods on its own or have them produced by others. In any case production involves costs. The costs have to be financed through the budget, because free-rider behaviour makes a market-based allocation impossible. As there is no market price for public goods, their value is normally calculated through the costs of production. In this context, we speak of **public consumption expenditure**.

In Germany expenditures of these kind account for approximately 20 percent of GDP, and that ratio has been relatively stable over the years. With a ratio of government

expenditure to GDP[4] of around 50 percent, public consumption expenditure accounts for no less than 40 percent of the entire public expenditure. As public consumption expenditure is a non-attributable item, there is a strong case for financing these costs from the current budget. The same is true for the use of the existing infrastructure up to the level of economic depreciation. An increase of the capital stock beyond that would be equivalent to net public investment, which generates intertemporal utility and would have to be financed from the capital budget[5].

3.2 Spillovers

The separation between public goods and externalities is sometimes not very clear. Why do we mention the fields of education, universities, research and development and health in this paragraph and not in the last one? This is because these goods are characterized by dynamic and intertemporal spillovers. Public education expenditure (schools, High schools, Universities) alone amounts to a relatively constant 4 percent of GDP in Germany each year (or 8 percent of total government expenditure). There is a strong argument for education vouchers, which would allow for price formation in the education market, instead of financing the education sector via taxes. This is not socially unfair if needy people who are talented are financed through supporting education subsidies.

These education vouchers should be valid in all fields of education. This would allow for a neutral allocation, which cannot be reached if Higher Education is largely subsidised and access free (as is the case in many European countries).

The question is a completely different one for externalities in the field of environment. Theory shows that negative externalities can be internalised through taxation as well as subsidisation of the responsible party. Concerning allocative effects, both ways are equivalent. However, a subsidisation of the pollution reduction creates budgetary problems and, at the same time, wrong incentives for potential newcomers. It's the internalisation of negative externalities that shows most clearly the control character of a so-called Pigouvian tax. In this context, a good tax is a tax that renders itself superfluous.

3.3 Private Ownership

Without any doubt, this field concerns one of the main tasks of the public sector: to create and to ensure private ownership. The costs related to these tasks are to be found in the financing of law and order and the legal system in a country. In the transition process, these expenditures have a revenue counterpart: the proceeds of privatisation. In practice, things often look quite different. The reason is that the sales of enterprises are often related to social or labour market policy requirements. In Germany in the 1990s, this practice has lead to tremendous losses of the Treuhandanstalt, which was

[4] The expenditures of all territorial authorities including the social insurance systems accounted for 48.6 percent in Germany in 2002.
[5] In Germany, the yearly expenditure for public investment is calculated to meet the requirements of Article 115 of the German Grundgesetz, which prescribes that yearly net borrowing must not exceed the expenditures for public investment.

responsible for the privatisation of public enterprises of the former German Democratic Republic. Apart from that, this strategy showed us that private-enterprise development was slowed down, too. Until today, Germany has to bear the consequences of this unsuccessful privatisation, as the need to transfer funds from the West to the East still amounts to approximately 80 billion Euros every year. More than half of the German deficit to GDP ratio, which today exceeds the 3 percent limit imposed by the EU's Stability and Growth Pact, can be attributed to the unsuccessful public property privatisation.

A general lesson from this is: a fast privatisation without labour market policy requirements saves costs and creates wealth. To tie together privatisation and social policy targets, however, leads to the contrary.

3.4 The Problem of the Commons

The problem of the commons is rooted in a lack of private property rights, which leads to a lack of incentives to use resources in an efficient way. If the respective goods are scarce, there is a problem. Let's take the example of the free usage of water and energy by the population. In real-life economic policy, such practices are often sold as "social". The contrary is true. If market prices were charged that reflect production costs, and if needy customers were given income transfers, there would be welfare gains for all, as the theory of public finance shows. Hence, in two ways there is a necessity to act for the government. On the one hand, it has to ensure the provision of such goods through the market – if necessary by privatising the supply of these goods – and on the other, it has to make sure – through adequate income transfers – that all households can finance their basic needs.

Environment is another important example. For the use of environmental resources there are no rights of use. Overexploitation through environmental pollution is the consequence. This reflects individual rationality, but it is detrimental to the overall economy objectives. Let's look at the example of tourism development. Here, opportunity costs due to missed development possibilities can lead to net welfare losses for all (even the polluters) through damages to the environment. Evidently, there is a need for regulatory restrictions of government in this case.

3.5 Asymmetric Information and Incomplete Markets

Symmetric information on both sides of the market are the most important condition for efficient allocations. The famous lemon-market example of George Akerlof (1970) vividly illustrates this. What can the public sector do in this case? As typically consumers are disadvantaged by imperfect information, a public sector strategy close to the market consists of subsidising institutions that take care of consumer information about quality and prices of supplied goods.

However, there can also be inefficient allocations if, as with intertemporal contracts, both sides of the market cannot exchange their products on an equal footing. The role of the state in the field of pension systems is an important example. Here, the state acts to guarantee the inter-generation compact which involves three generations: the old,

the young and those not yet born. In the pay-as-you-go-system all the generations are parties to the contract. If the public sector didn't ensure the performance of the contract by the third generation, there wouldn't be any insurance contract, but only individual provisions. This would be individually rational, but not optimal. The example of Germany shows that in practice, the state can be part of the inter-generation compact in two ways. Firstly, if it acts to guarantee the solvency of the Social Security Fund (Gesetzliche Rentenversicherung, GRV), which yearly effects expenditures amounting to approximately the volume of the central government budget.[6] Secondly, the state finances, through the central government budget, roughly one third of all GRV-related expenditures.[7] This high co-financing ratio also is a consequence of the unsuccessful economic reunification of Germany, which put too great a strain on the inter-generation compact. This becomes far more evident when looking at the German social security budget, which covers the big life risks such as ageing, illnesses, unemployment and accidents. In 2002, social welfare expenditure amounted to roughly a third of GDP. 50 percent of that were financed by the public sector, 20 percent by private companies and only 30 percent by the insured parties themselves. This example shows two things. On the one hand, the public sector has a role as contracting party in the inter-generation compact. On the other hand however, it must not become the main financier of the big private life risks.

3.6 Market Power and Increasing Returns to Scale

Welfare losses in situations with market power (monopoly or oligopoly etc.) result from the fact that producers charge prices that are much higher compared to a situation of perfect competition, and the quantity supplied is too low. In the case of ordinary monopolies such a situation doesn't necessarily call for government intervention. There are two reasons for this. Firstly, monopoly profits can be the reward for innovative Schumpeterian entrepreneurs – in this case, public sector absorption of the profits would be – from an efficiency perspective – as detrimental as e.g. the abolition of patent protection. Monopolies are only problematic when they persist. However, the theory of monopolistic competition shows that this doesn't have to be expected in the case of ordinary monopolies. In this context, the mission of the state is to prevent cartels and price fixing so that monopoly profits can be taken away by competitors. There are examples of monopolistic competition in the beverage industry. Birra Tirana for example is the only supplier of Albanian beer, but there is no reason to fight this monopolistic position, as there is competition of substitute goods.

The situation in the telecommunications sector is different. This sector is a natural monopoly, and thus characterized by increasing returns to scale. There are economies of scale, and there is no monopolistic competition. In such a situation, through regulatory restrictions the state has to prevent that competitors are squeezed out of the market. For this very reason, in Germany a regulation agency has been founded in order to monitor the market and to set price ceilings for tele- and communication services. At the moment German Government provides the legal base to include in the agency's responsibility the energy- and gas- regulation,too.

[6] In 2002, GRV's expenditures amounted to approximately 230 billion Euros, i.e. around 13 percent of GDP.
[7] For 2003, general government payments to GRV of 77 billions Euros are already put aside.

3.7 Redistribution and Economic Development Promotion

In the discussion up to now, public sector activities have mainly been justified on efficiency grounds. A big part of public expenditure in EU Member States however goes to households in the form of transfers and to companies in the form of subsidies.[8] Transfers to households serve distribution purposes. Subsidies to companies however are part of economic development promotion. In real-life budgetary policy, expenditures for economic development promotion are by far the biggest group. This contradicts the logic of a market economy. If at all, measures to spur the economy can be taken temporarily only, and they serve their purpose if they can be abolished soon. If such measures are persistently taken, they maintain structures that are economically not competitive and induce high welfare losses. The EU's Common Agricultural Policy is surely a warning example in this context. Roughly 50 percent of the yearly EU budget of around 100 billion Euros are used to subsidise European agricultural products, i.e. to bring their cost prices down to world market level. This long-term "promotion of competitiveness" of European agricultural producers is, without any doubt, an immense distortion of free market competition, which induces huge welfare losses European consumers

Other examples of economically ridiculous subsidisations are the tobacco production in Europe or the hard coal output in Germany. The former is even more contradictory insofar as the state simultaneously aims at preventing tobacco consumption through high tax rates. The latter is ecologically highly counter-productive. Both examples have in common that a discontinuance of the production subsidies by directing those payments directly to households engaged in the production process are budgetary neutral, but amount to higher-than-average yearly household incomes[9].At the same time, this solution would create welfare gains by removing price distortions

Those few examples make clear that especially public expenditure for economic development promotion has to be watched like a hawk. However, there is another, "invisible" expenditure category: the tax breaks. In this context, we talk of tax expenditures, as tax breaks are nothing but a renouncement of tax revenues. In Germany, federal tax expenditures amounted to approximately 6.4 percent of federal tax revenues in 2002.

Table 1 illustrates with the example of the German federal budget for the budget year 2002 that in many fields expenditure directed to transfers and subsidies characterizes the overall expenditure.

[8] In Germany in 2001 the total volume of transfers and subsidies amounted to approximately 6 percent of GDP, see BMF (2001).
[9] In 2000, the subsidisation of German hard coal output amounted to approximately 70.000 Euros per employed person (!).

Table 1: The magnitude and composition of German Federal Government Expenditure for the Budget year 2002 in Billions of Euro and in percentage of total expenditure (rounded values)

	Euro	Percentage
Social Security	**105.353**	**42,57%**
hereof:		
1. Social Insurance Contributions	72.179	29,16%
2. Labour Market	15.316	6,19%
3. Family Benefits	3.940	1,59%
4. Residential Payments	2.100	0,85%
5. War Victims' Support	3.787	1,53%
6. Social Policy Measures in Agricultural Sector	4.103	1,66%
7. Other Social Policy Expenditure	2.767	1,12%
Defense	**23.761**	**9,60%**
Consumer Protection, Food and Agriculture	**1.450**	**0,59%**
1. Community Tasks (Federal and States Level)	872	0,35%
2. Other Expenditure for Agriculture	578	0,23%
Economic Development Promotion	**8.297**	**3,35%**
1. Energy	3.276	1,32%
2. Other sectoral promotion	640	0,26%
3. Small and Medium-Sized Enterprises, Research and Technology	793	0,32%
4. Regional Economic Development	1.021	0,41%
5. Warranties etc.	2.567	1,04%
Transport	**20.865**	**8,43%**
hereof:		
1. Railways	11.368	4,59%
2. Highways	5.519	2,23%
3. Transport Facilities in Municipalities	1.677	0,68%
4. Waterways	1.588	0,64%
Construction	**2.587**	**1,05%**
1. Housebuilding and Urban Development	1.990	0,80%
2. Relocation of Parliament and Government	597	0,24%
Research, Education and Science, Cultural Affairs	**11.025**	**4,45%**
1. Science, Research and Development (Others than in Universities)	6.520	2,63%
2. Universities	1.427	0,58%
3. Promotion of Aprenticeship and Young Scientists	1.113	0,45%
4. Professional Education and other Fields of Education	492	0,20%
5. Cultural Affairs	1.473	0,60%
Environment Protection, Health, Sports	**2.109**	**0,85%**
Internal Security	**2.692**	**1,09%**
Economic Cooperation and Development	**3.621**	**1,46%**
General Public Expenditure	**65.740**	**26,56%**
hereof:		
1. Interest Payments	38.971	15,75%
2. Retirement Payments	14.443	5,84%
Total Expenditure	**247.500**	**100,00%**

Source: BMF (2002) and own calculations

4 How to Measure the Size of the Public Sector?

The size of the public sector can be measured in terms of the expenditures of the state. These expenditures can be classified either according to the scope of functions of the state as is indicated in Table 1 for the case of the German federal budget or according to the type of expenditures. Both classifications, however, lead to the same result if all public budgets are integrated in a **unified budget**. Such a budget contains the expenditures of the federal government, of the states and the local authorities (after internal consolidation). There are also considerations in favour of integrating the social security budget into the unified budget. When setting the total of public sector expenditures in relation to the GDP this will result in the **government expenditure ratio** which indicates the percentage of total expenditures of an economy that is realized in state responsibility per year. As mentioned at the beginning, this government expenditure ratio is with around 50 percent, astonishingly high in most European states. When eliminating the social security from total expenditures and considering these payments rather as "social security contribution" than as "social security tax" this will result in a "narrow" government expenditure ratio of 30 percent for Germany instead of 50 percent. In the international context, this narrow ratio is much more representative as there are huge differences in the financing and the level of coverage of the social security systems in different countries. When regarding the narrow government expenditure ratio it is possible to judge independently from demographic influences, whether a public sector has expanded or decreased over the years. The example of Germany shows that the actual amount is around the same level as it was in 1965. Nevertheless, there have been substantial increases and decreases in the last decades. These movements correlate with different governments and their specific preferences for market or non-market activities.

Unfortunately, conventional budget expenditures can convey a misleading impression of the extent to which a society's resources are under government control. There are at least two reasons for this, the existence of off-budget items and hidden costs of government[10].

The aspect of **off-budget items** contains all state-owned companies and participations in private companies held by the state. The second aspect of **hidden costs of government** contains all those regulatory activities of the state which do not directly affect state expenditures, but which result nevertheless in high costs for those who have to adapt to the regulations. So, over-regulation and an extensive bureaucracy for example lead to hidden costs because growth is hampered and at the same time private resources are bound inefficiently. These two examples illustrate that the question of the size of the public sector can easily be answered when considering formal or fiscal criteria only. An economically satisfying answer though would need to integrate into the government expenditure ratio the share of economic resources the private sector can not dispose of. Without going into the details of this question here, we can assume that the use of such a government expenditure ratio would enlarge the difference in the comparison between Europe and the USA even more.

[10] For this aspect see for example Rosen (1992).

If one tried to measure the size of the public sector by the number of state employees this would be misleading as well. In the transition process the number of state employees might be a useful indicator for the success of the restructuring process towards a market economy. Nevertheless, the real role of the public sector could only be measured if the resources bound in publicly used labour were weighted by their productivity. The actual number of government employees as well as their remuneration need not be a sufficient indicator for this.

So far, we have referred to the public expenditure side for measuring the size of the public sector. Of course, we could also consider public revenues as a basis for this measurement.

Table 2 shows the structure of the German Unified Budgets of the year 2002 in aggregated form. The (fiscal) size of the public sector can also be measured as the sum of the ratio of tax revenues to GDP, the ratio of the social tax to GDP, the ratio of special revenues (e.g. revenues from privatisations, profit of the Bundesbank) to GDP and the ratio of the deficit to GDP.

Table 2: Structure of the German Unified Budget for 2002 in percent of GDP (and rounded values)

Expenditures	**Percentage to GDP**	**Revenues**	**Percentage to GDP**
Federal, States, and Local Budgets	30	Taxes	20
Social Security	20	Social Security	20
		Capital Budget, and others	7
		Deficit	3
Σ	**50**	**Σ**	**50**

Source: Own calculations

From the viewpoint of the revenue side the financing problems of public budgets can be outlined. The German ratio of tax revenues to GDP in 2002 is one of the lowest since 1949 and in 2002 it was the lowest in the whole of Europe as well. Consequently, the ratio of the deficit to GDP still was 3 percent although there has been a very high ratio of special revenues to GDP of 7 percent. This example makes clear that a low ratio of tax revenues to GDP does not at all give an indication of the **burden** levied on the private sector or of the degree of the role of the state in the economy. Essential for the determination of this burden are the hidden costs which are caused by growth hampering regulations. And it is this hidden costs problem which is responsible for the situation that Germany has the lowest rate of economic growth in Europe at the moment. Consequently, an economic policy which aims at reducing the size of the public sector by tax breaks only will therefore have no impact on the origins of the growth problems.

There are two conclusions we can derive when summing up this chapter's results. On the one hand, the size of the public sector implies in economic terms the degree to which the state claims economic resources. On the other hand, this degree can certainly not be measured by regarding the total revenues of the state. When measuring this degree by regarding the expenditure side, it is essential to integrate all off-budget items to attain a more realistic result.

5 Public Sector Developments in Western Balkan Countries

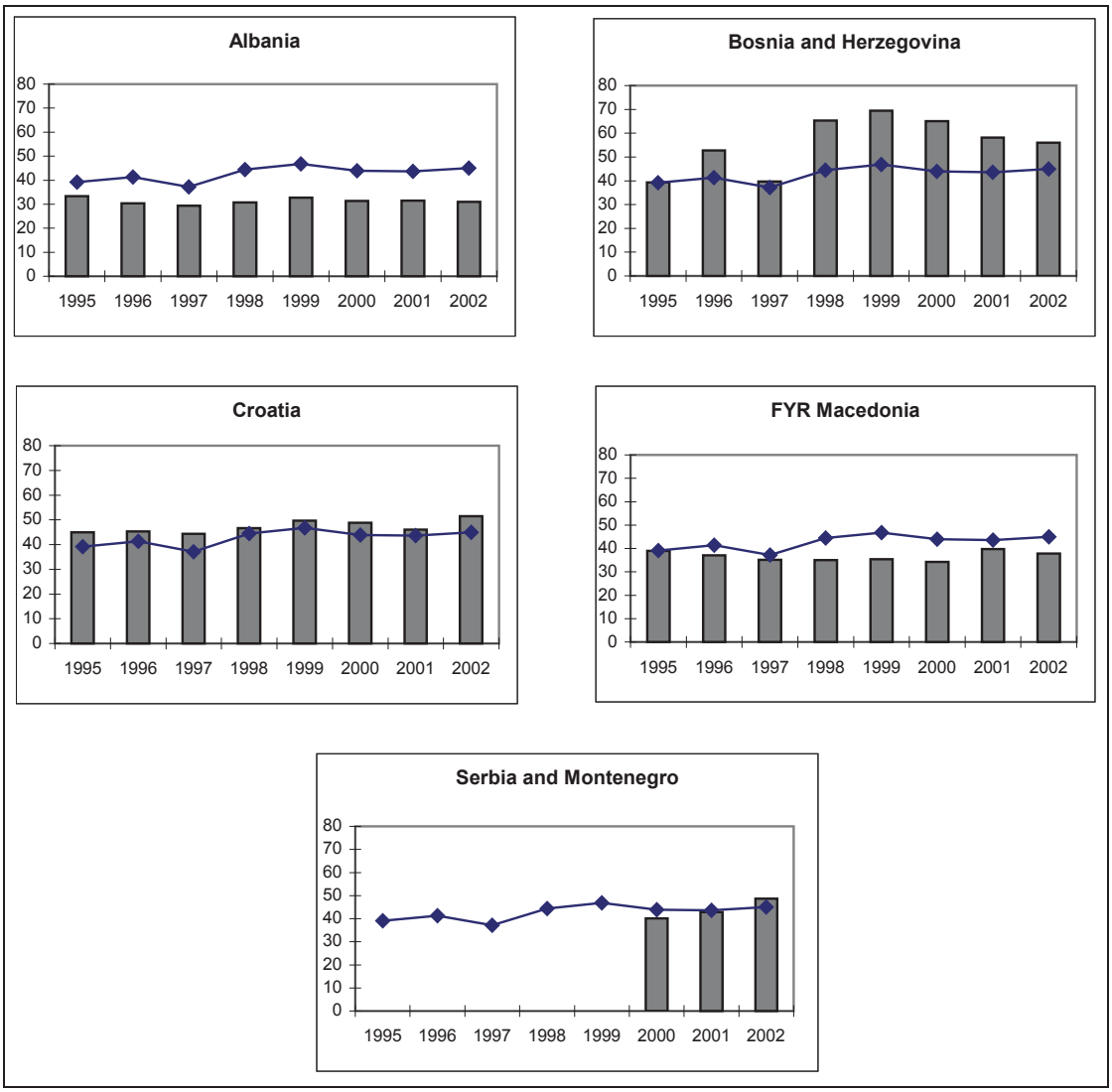
In Albania general government expenditure (which includes the state, municipalities and extra budgetary funds) in the time bracket from 1995 to 2002 is comparable to the German case if measured by the definition of the narrow government expenditure ratio to GDP as table 3 shows. Moreover, this relationship is a relatively stable one in the whole time period, and at the same time the lowest in comparison to Bosnia and Herzegovina, former Yugoslavian Republic of Macedonia, and even Croatia.

As table 4 shows, the fiscal deficit before grants, however, is with 7 to 8 percent more than average. This can be explained by a poor situation in receiving own revenue by taxation and privatisation proceeds. Compared to the beginning of the transformation process the situation has improved a lot, but in comparison with other Western Balkan countries the Albanian fiscal deficit problem is the worst.

Interpreting this point in the light of output growth of the Albanian economy, which slowed down from 6.5 per cent in 2001 to 4.7 per cent in 2002 – but was and still is the highest one compared to other Western Balkan Countries – the bad performance of the general government fiscal deficit shows even more that the problem originates from a badly functioning tax system.

Fiscal deficits add to general government debt and as we see from table 5 in 2002 Albania has a dept ratio to GDP of nearly 65 per cent which is higher than the Croatian one which is around 57.5 per cent in 2002. This is the bad interpretation of the data compared. The good one is, that, where the debt ratio in Croatia steadily increased, the Albanian one remains relatively constant.

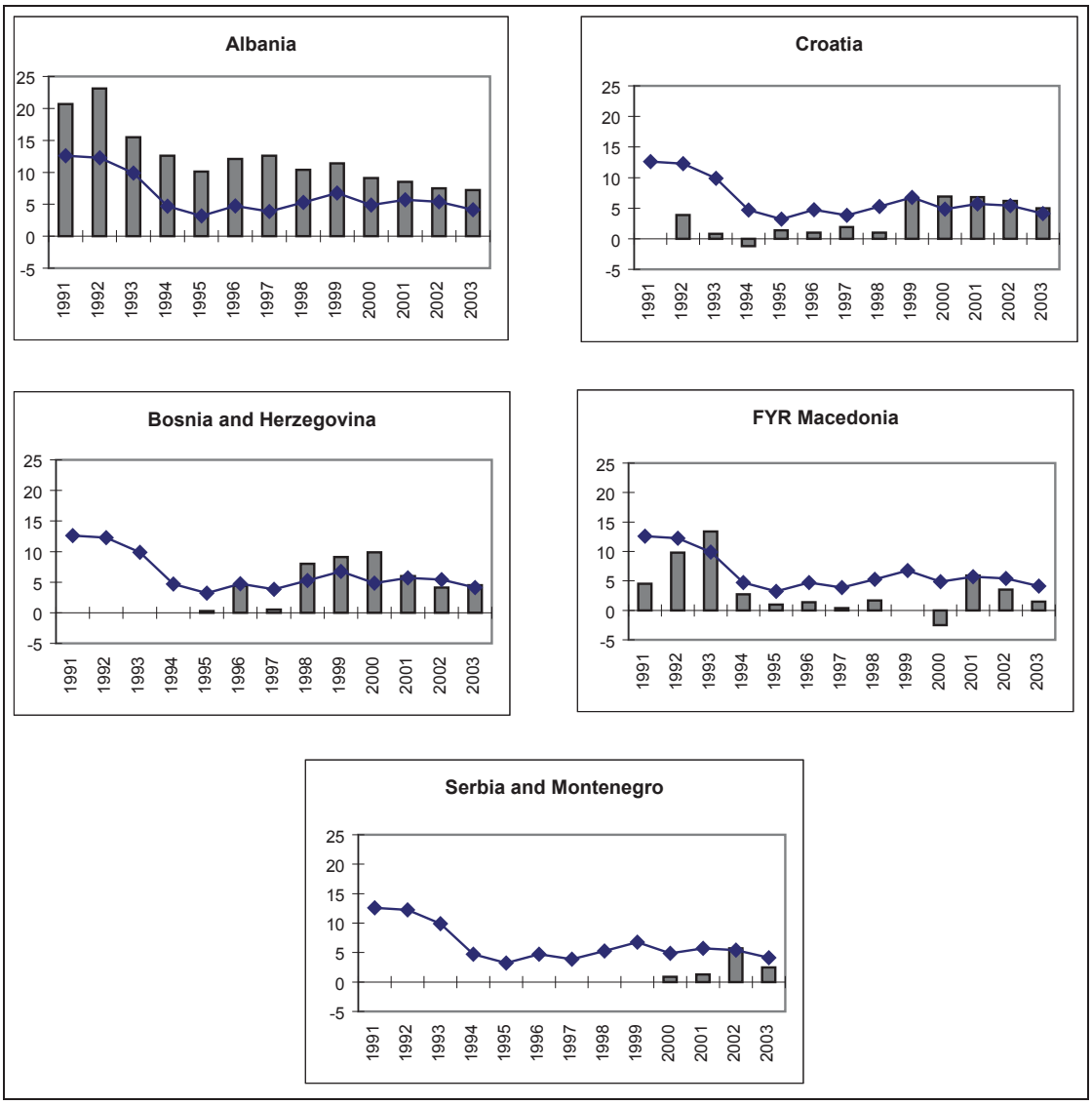
Table 3: General Government Expenditure in Western Balkan Countries and (unweighted) arithmetic mean 1995 – 2002 (in per cent of GDP) [11]



Source: EBRD (2003), Transition Report Update May

[11] The data for 2002 are estimates. The development of the general government expenditures for each country is represented by the columns and the arithmetic mean by the bold line.

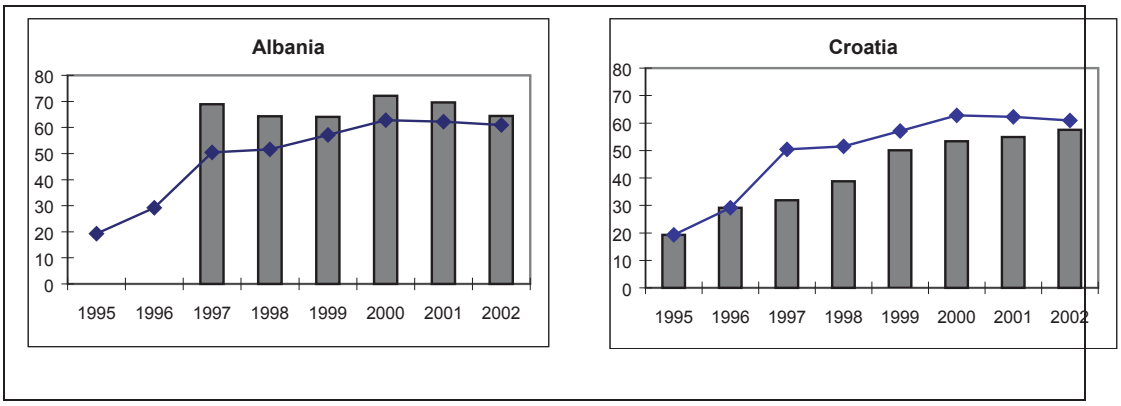
Table 4: Fiscal Deficit before grants in Western Balkan Countries and (unweighted) arithmetic mean 1991 – 2003 (in per cent of GDP) [12]



Source: EBRD (2003), Transition Report Update May

[12] The data are estimates for 2002 and projections for 2003. The development of the fiscal deficit before grants for each country is represented by the columns and the arithmetic mean by the bold line.

Table 5: General Government Debt in Albania and Croatia and (unweighted) arithmetic mean 1995 – 2002 (in per cent of GDP) [13]



Source: EBRD (2003), Transition Report Update May

6 Concluding Remarks

Economists know that government expenditures and the share of GDP governments spend are not the right criteria to judge whether the public sector in a certain country is too small or too big. The deciding factor is to compare the **benefits** of government expenditures and the **cost of financing** that spending, including the deadweight losses associated with the method of financing that spending.[14]

Tax financing involves two burdens, the burden of the tax itself and the excess burden resulting from tax distortions. The first burden cannot be avoided, and the second one can only be reduced through an intelligent taxation with wide tax base and low marginal tax rates. Debt financing by contrast doesn't involve the first burden, but only the second one by limiting future taxpayers' options to choose. As costs arising from that can be transferred to the future, governments are typically tempted to act in a myopic way. That's the reason why this way of financing is normally limited by regulatory restrictions.

Apart from the costs of financing and the utility of expenditure programmes there is a third category: the hidden costs of government that arise from regulation. Those hidden costs are difficult to measure, but one can assume that they are considerable.

Hence, what is the essence of a good public sector policy? It is to limit public expenditure to the core areas of public activity, i.e. financing public activities with low tax rates and wide tax bases, borrowing only to the extent of public investment expenditure and a rigorous reduction of restrictive regulations.

[13] The data for 2002 are estimates. The development of the general government debt for each country is represented by the columns and the arithmetic mean by the bold line.
[14] See Feldstein (1996).

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