FISCAL CONVERGENCE TO THE COUNTRIES OF EUROPEAN UNION AND THE STATE BURDEN

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There is no doubt any more now that the same economic regularities are effective in economies in the stage of advanced economic transformation as in traditional market economies. But the low productivity and relics of institutions from the totalitarian system in the former make them very different. Some immature markets of these economies, e.g. labor, money, capital and real property ones, are combined with a huge burden of the non-market public sector, which is mainly borne by budgets of central and local governments.

It is not true in any case that any of the former Comecon economies have suffered in the recent past from an excess of "market dictate". It would be worth asking a question, however, to what extent all these economies have suffered from market imperfections (e.g. absence of some markets or rent seeking) and from the fact that the government and bureaucracy are still involved in numerous non-market and regulatory responsibilities. As shown by some comparative studies (see e.g. Coricelli, Dabrowski and Kosterna, 1997; Winiecki, 1996), the government's economic influence significantly goes beyond the scope of their rampant state budgets.

1. State Budget Size

At the first glance, development of the Czech state budget (SB) size seems to have made giant strides toward its normalization since the era of central planning. It decreased from the original share of the state budget revenues in gross domestic product (GDP) from 67.2% in 1989 to 45.8% in 1995 (measured by the tax quota method – see Vašková, 1996). It would be almost the same proportion as in industrialized countries of European Union in 1993: e.g. in Austria (43.6%), France (43.9%) or in Germany (39%). A conclusion could be apparently drawn that the accepted strategy of rigorous fiscal reduction is closely approaching its point of normality. **To compare the tax burden in Czech Republic with some of the most industrialized countries is, however, incorrect in methodological terms because in market economies the share of SB in GDP is not a constant but it dynamically evolves as an increasing function of the country's wealth**. In other words, only very rich countries can afford to channel a high proportion of GDP through SB in order to fund public goods. Poorer democratic market economies have thus a much lower share of SB in GDP then rich countries. There is a marked empirical observation that as poorer economies become wealthier their SB grows at a faster rate than their GDP per capita (Fakin and Crombrugghe, 1995). Hence Germany with its 29,000 USD GDP per capita in 1995 cannot be an adequate country for comparison with the Czech Republic, in which the GDP per capita was at that time only 4,600 USD, or around 9,000 USD when estimated according to the fictitious purchasing power parity.

Therefore Portugal with nearly 10,000 USD per capita in 1995 and 31% SB share in GDP, or Spain with 15,000 USD per capita and 35% share, are countries which fit much better for such a comparison. Possibly Germany or Austria could be used for comparison, but only with their figures for 1960-70 when their GDPs per capita were comparable with the present Czech one. For example, at that time German SB share in GDP was about 33-38% and it should be noted that this figure was already too high because of a political bias to welfare state aspirations prior to Reagan and Thatcher policy shocks. Also it would not be possible to compare the Czech state budget even with contemporary budgets of some advanced industrialized economies with liberal governments, e.g. with the United Kingdom (33.6% share of SB in GDP) or with industrial countries of South-East Asia where this share ranges around 25-35% of GDP.

It can be inferred from the above facts that the government's influence on the Czech economy has not been reduced very much in the last seven years. It was comparable with transformation processes in most European countries of the former Council for Mutual Economic Assistance. That means the Czech right-wing government was not able to reduce SB as a means of redistribution to a greater extent than did the neo-communist or social-democratic governments in most countries. For example, as for the proportion of SB revenues out of GDP (including health insurance), it made 50.4% in this country in 1995, 47.2% in Poland, 51.3% in Hungary, 45.9% in Slovenia, 44% in Russia, while the average share in the EU countries was 45.4% in 1994 (see Coricelli, Dabrowski and Kosterna, 1996, p. 35). A conclusion can be drawn on the basis of similar comparisons that **both the share of the government in GDP redistribution and the tax burden in the Czech Republic have remained among the highest in the world,** the great changes notwithstanding. If the Czech tax burden should be compatible with the standards in market economies on a similar level of development (i.e. with GDP ranging from 4,000 to 12,000 USD per capita), it should amount to 28-38%, and not to 44% at present. It can be said that expected budget cuts should not lead to a complete liquidation of activities that have been previously financed by the state authorities but rather to their transfer to other forms of funding, ownership and functioning.

2. Welfare State Illusions

Not to draw rather a demagogic conclusion that the Czech liberal government failed completely in the role of a market builder, we can admit realistically that the government took such steps they were allowed to take under the given social and political pressures. Such a pressure has always been guided (or directly determined) by requirements of populist parties and by a public mood instigated by these parties by who the present financial interventions of the government are considered insufficient. For unveiling the core of the problem, we must know the structure of SB expenditures in greater detail.

Taking SB expenditures for the whole Czechoslovakia in 1989 as reference data for comparison, the structure of expenditures in 1995 was markedly reduced in subsidies only (from 19.3% to 3.1% GDP). The other items showed the following increases (as a share in GDP): expenditures for goods and services from 11.7% to 13.5%, civil servant salaries from 2.6% to 3.3%, interest on the national debt from 0 to 1.3%, transfers to the population from 18% to 19.4% and investment expenditures from 7.2% to 7.6% (data from IMF statistics, as quoted by Coricelli, Dabrowski and Kosterna, 1997, p. 29). It is evident that **redistribution transfers continue to represent the bulk of SB expenditures and their role in the majority of items has not been reversed during transition**. Comparison of these data with those in industrialized market economies shows that the Czech economic policy did not manage to avoid the trap of its former "planned" development and has implicitly retained the idea of government-directed welfare state. This is not a situation typical exclusively for the Czech Republic. Similar paternalistic role of the government has been retained in all post-communist countries in Europe. In addition, some residuals of this philosophy of the state have survived in many countries of Western Europe.

The risk of a strong central administration consists in weakening the autonomous mechanisms in the behaviour of economic agents at the grass roots. Self-reflection, and hence the individual responsibility for their particular acts, growth and prosperity, are shifted to the responsibility of (mostly anonymous) collective bodies which are attributed with a certain metaphysical form of intelligence and morals. When these fail, which is inevitable in the long run under these circumstances, the individual persons find themselves in a position of a crowd without its own will, initiative and self-confidence, and at the mercy of demagogy by various powerful vested interests.

While this country's GDP is considerably lagging behind its level in the EU countries, its structure of budget expenditures is copying them. E.g. while SB expenditures for social welfare and health care amounted to 19.4% of GDP in 1995, which is almost the same figure as in the Germany, France or Denmark, the EU poorer countries expended much less for these purposes – Portugal 11%, Spain, Greece and Ireland 16%, and the United Kingdom even only 14%. The expenditure on pensions, which are included in this item, has increased from 7.6% of GDP to 9.7% in the last seven years. Such an increase was fully beyond the scope of the world standards.

An analysis conducted in 92 countries of the world (see EBRD, 1996, p. 95) showed that the budget expenditures for the pension scheme were closely correlated with the age structure of the population. E.g. in the countries where approximately 17% of inhabitants are over 60 years (the Czech situation in 1995), the average level of state budget expenditures has been about 7.5% of GDP. The Czech actual position was by almost a third above this standard. The situation in the Czech health insurance is very similar: these expenditures amounted to 5% of GDP in 1996. Hence this relatively poor country should not pretend that its SB spending for social safety net, pensions or healthcare can be proportional to that one in Germany or Switzerland. If it does so, we should be aware of the fact that such spending is at the expense of the future economic growth and future prosperity.

The high tax burden and high social security contributions of the companies are discouraging and hinder their investment and development plans. That means every lobbying for further increases in budget expenditures for public health system, pensions, unemployment, social allowances, exports, investments, heating, housing, electricity, transport, agriculture, public administration, indebted banks, ailing investment funds, etc. is a threat to the long-term dynamics and stability of the economy. To increase taxes in a country, the share of which in GDP is above the West European average, while its GDP per capita lags behind the EU standards, and moreover, where the public administration is very inefficient, is simply a moral hazard. High taxes are accompanied by effects of adverse selection (e.g. in rewarding the vices and punishing the virtues) and "black hole" (see Winiecki, 1996) causing any funds to disappear in inefficient activities not yielding any positive social results. The expended resources are then missing for the expansion of efficient private activities. A question arises whether the bias to a non-market allocation of resources stems from shortsighted preferences of the population or from a failure of the political system, similarly like in Czechoslovakia in 1945-1948.

The tragedy of welfare state is that the procedures of democratic and civil society are either fully ignored (like in the totalitarian systems) or the vested interests of pressure groups are enforced against the will of the other not so well-organized citizens. It can materialize in the political pressure of insiders on behalf of the poorer "majority" in order to obtain from public resources a certain rent or share in wealth. Catastrophic impacts of this redistributional policy are best illustrated by an example of Czechoslovak economic history, which suffered an enormous loss of living standard in the years 1948-91 (e.g. in relation to Austria), most probably one of the highest in modern European history.

The importance of the government and bureaucracy with respect to a decision-making process in the society can be quantified by the share of SB expenditure in GDP. Obviously, it is hardly possible to reduce the role of the government in post-communist countries to the level common in comparable market economies. A significant part of the population is not yet able to take the responsibility for their welfare and productive aspirations of many economic agents are shaded by more lucrative chances in the process of redistribution of the public or semi-private wealth. A decline of some industries or firms under the pressure of restructuring is often interpreted as an error in economic policy which should be prevented by public intervention. Political opportunism gets ground in such an environment. It can easily come into power by promising miracles from the position of an "enlightened" autocrat or a less enlightened "new" bureaucracy. The Czech fiscal policy, nevertheless, deserves a praise since, as one of rare exceptions among the former Comecon countries, it has withstood a temptation to cover SB expenditures by loans beyond the scope of taxes or by an inflation tax aiming at the same motive. Unfortunately, the Czech Ministry of Finance was extremely successful in tax collection and could maintain the burden of budget expenditures at a level of a socialist state, even without large debts and inflation.

3. The State is not a State Budget Only

The state budget is not, however, the only instrument for the reallocation of resources from private to public sectors. Although extrabudgetary channels exist in all market economies, their number and size have increased to an unprecedented extent during transformation. Revenues from privatization are a typical example, amounting annually to about 3% of GDP in this country. The majority of this budget revenue was used as bailouts to banks and loss-making former large state owned enterprises. Èeská Inkasní Ltd., an organization established by the Ministry of Finance to cover debts of some banks from extrabudgetary revenues, plays a similar role.

The other tools of government interventions in the economy are less transparent, so they are less easy to be quantified. First, they include operations of the Czech National Bank, which also is a part of the state administration, although it is separated from SB for preventive reasons. In economies in transition the revenues form seignorage can be significant because their inflation is considerably higher than in stabilized economies. Thus even with a low inflation of 9% the Czech National Bank earned in this way an additional income amounting to 1.6% of GDP in 1995. Inflation tax is another instrument associated with the extent of money supply: it results from the fact that inflation reduces the real purchasing power of all money of the monetary base, and its effect is the same as that of a direct tax on income in an economy without inflation. Inflation tax in this country amounted on average to 3% of GDP annually. A part of this amount was used indirectly to finance the national debt.

Reserve requirements of commercial banks deposited in the CNB which are not subject to interest payments, are another tool of the government control over the economy. Since monetary policy in this country was more restrictive than in the countries of Western Europe, the revenues of the CNB through this channel were also above current standards. The central bank thus blocked assets amounting to more than 6% of GDP at the end of 1995, which can be interpreted as a specific tax levied on commercial banks. An increase in the rate of reserve requirements from 8.5% to 11.5% in August 1996 produced a similar effect like a tax increase at a rate of 2.7% of GDP.

Income from monetary sterilization, due to the impact of foreign capital inflows on the money supply, is another important public revenue of the central bank. As the relatively poor transient economies have to receive large volumes of foreign capital to fill the gap between their domestic savings and the demand for investments, the uncontrolled additional money supply must be neutralized by selling bonds and treasury bills to the private sector. This hidden "income" of the central bank amounted to approximately 12% of GDP in 1995. Its actual net impact on the state budget corresponds only to the difference between the high interest paid domestically and the lower interest on central bank's foreign exchange reserves deposited in foreign banks. This forced expenditure from public funds is estimated to make about 1% of GDP in 1995.

Let us describe other transactions typical for imperfect (transforming) market economies in which the actual value and sign of the public budget balance are uncertain because of the intransparency of these quasi-fiscal transactions. So the government's role in the economy can substantially increase beyond the scope given by the traditionally defined state budget, controlled by the parliament. First of all, levied but never paid taxes should be mentioned. They can be taken as grants to pre-selected tax-payers where the lack of ethics is a selection criterion. Outstanding debts to the National Property Fund from privatization or the unpaid social insurance play a similar role. The total weight of this shadow fiscal system (measured as a stock variable), so typical for the economies in transition, can be estimated to make at least 4 % of the Czech GDP in 1996. We can only guess how this figure might increase if the full annual flow of tax evasion is included. The estimate of these enormous losses in SB revenues, as a form of implicit subsidies, could be speculative only. Therefore this problem will not be dealt with here.

4. Hidden National Debt

The instruments of external macroeconomic control, such as Maastricht criteria or International Monetary Fund criteria, are devised to prevent the emergence of uncontrollable public debt, currency destabilization and a loss of growth. While the upper limits on the SB deficit at 3% of GDP and on the public debt up to 60% of GDP are considered as sufficient for stabilized market economies, these limits do not provide satisfactory barriers in transforming economies. Because in these countries the separation of the private sector from the public sector was not fully implemented, there are possibilities of hiding the potential national debt into many intransparent operations. The commercial banking sector is an example how a hidden national debt can arise. Due to an incomplete privatization of banks, they must be safeguarded by a massive safety net provided by the government in order to avoid a domino of bankruptcies. A high proportion of classified loans (often more than 30 % of the portfolio of bank credits) and a low efficiency of commercial banks are a result of several factors:

– creditors' non-transparency, e.g. due to their unknown credit history, hidden ownership links, rent-seeking motives, etc.,

– loopholes in legislation, judiciary and real estate register,

– lack of experience and skills resulting in failures of bank employees to analyze properly the applicant's credit worthiness,

– inclination of many agents on both sides of a credit transaction to unethical economic practices (insider trading, moral hazard, corruption, embezzlement, etc.),

– lack of international competition on the Czech banking market.

Banks are becoming time bombs due to all these factors. And the bankers know well that it will be finally the government who will have to bail them out in the last instance. The resources are expected to be provided by the National Property Fund, SB or specific quasi-fiscal operations by the Èeská Inkasní, Ltd. The behavior of many banks is influenced by continuing soft budget constraints, well-known from the central planning. The value of grants and expenditures of public resources for the bailout or liquidation of Czech indebted banks alone is estimated to approximately 37 billion Czech crowns in 1996, i.e. to about 2.5% of GDP.

The situation in health insurance companies and investment funds, which are all private, is very similar. The danger of a higher calibre, and with long-term timing, is inherent in pension funds. They are the most important instrument for the formation of savings. For example, the accumulated potential liabilities of the Hungarian pension system (i.e. liabilities to pay retirement benefits to pensioners) have been estimated by the World Bank to about 250% of GDP at around 2005. Translated to the Czech situation it would mean that a 10% deficit in the books of pension funds could result in a default in payments to pensioners of approximately 200 billion Kè. This debt would have to be finally covered by the government.

5. Cost Burdens Shifted in Time

Arguments concerning too close links between the institutions of public administration and the Czech private or semi-private sectors should always be viewed upon in the perspective of more than one fiscal period. The point is that the government can give up their explicit responsibility for some segments of the public sector and transfer the resultant short-term "savings" for patching politically more sensitive failures. This myopic policy can lead to a situation where the government will resign from being involved in the duties of their exclusive domain (e.g. in providing public goods) and get involved in caring for other less exclusive activities which could be otherwise provided by private enterprises. Economic activities with extensive positive externalities, the shortage of which is not seen instantaneously or which do not have an adequate political voice, are appropriate victims. They can be neglected for some time, and such a debt can be transferred to budgets of successive governments and political parties. In the present Czech environment this can apply to the functioning of legal and judiciary systems, effective competitive markets, infrastructure, public utilities, education, culture, science, health, security, defense, public information, etc. By the way, these are economic sectors which are considered by the theory of public finance among the main domains of the government.

Disregard of these very costly systems of public interest, the inefficiency of which has great indirect impact on the long-term development of the whole society, can also be considered a burden of the state, similarly like high taxation, inflation, national debt or the external indebtedness. If no appropriate measures are taken to solve these problems, they result in a vicious circle of high taxation and slow growth. The present high transfers from the private to the public sector cannot be compensated by promising tax cuts in the near future. The problem is how to find ways for cuts in the present public expenditures.

The public sector and government interventions in the economy in the process of economic transformation cannot be unfortunately deleted with a single stroke of a pen, so relieving the government of old burdens. In addition, transition requires that the government has to take unexpected new responsibilities. Therefore the weight of the public sector responsibilities is necessarily larger in all transition economies (if their social organization has not broken down) than it would be expected in traditional market economies at a similar stage of development. Various quasi-public systems also play their role. Therefore, it should not be a great surprise to estimate that the recent Czech government's involvement in the public finance and the economomy did not cover mere 42% of GDP (as the share of the SB without health insurance would indicate for 1996), but potentially 60%, at least. Though it is a paradox for a government with a liberal rhetoric, this alone need not signal its failure.

Thus it can be argued that a supernormal government participation in the economy could be justified in the initial stages of a rapid transformation, provided the government has at its service a network of an efficient public administration. The government's ability to transfer the bulk of economic activities under the patronage of markets by the implementation of rapid transformation programs, and by concentrating on the buildup of efficient markets and market institutions, has its intellectual, organizational, financial, motivational and political constraints. Markets are social organisms, and, as reflections of the society, their development is evolutionary. Evolution of the more sophisticated markets (e.g. capital and labour markets) can take a long time. If a government wants to represent a state with a European cultural appeal, it must necessarily support some infant economic segments and get involved in more responsibilities than in stabilized mature economies. These duties will take more time and will be subject to more intellectual challenges than most economists and politicians were willing to admit just after the breakdown of Communism. Therefore it is not surprising that the size of the fiscal sector has not been substantially reduced in any of the European economies in transition. Even in Eastern Germany, where many markets and specialists could be "imported" from the West, the role of the government in the whole German economy has increased, which is reflected in explicit social cost and transfers estimated now to one thousand billion DM, while the end of transformation is still not at sight. Moreover, various quasi-public and quasi-fiscal requirements appeared in every transition economy, and their pressure has been increasing proportionally with the extent how the society failed in establishing functioning markets and their institutions.

6. Buildup of State Administration

The situation described above should be a reason for purposeful buildup of the state administration as an elite class of public management. This management should be able to effectively exercise standard duties of state administration, as well as to prevent the private sector from spilling over to the public one. This includes especially the establishment of a system of indirect management of goods under public administration (under both permanent and temporary domain) and their transfer under the patronage of markets, subsidiary regional administrations, autonomous private institutions or bodies of public regulation. **It is unfortunately in this key point of social management where the state administration has failed in most cases**. Most probably it is beyond human powers to change this outcome by mere wishful thinking. Budget cuts in outlays for public administration and public goods are considered the most easily enforceable in this country. On one hand, the Czech Republic lags behind in the development of human capital, infrastructure and institutions necessary for catching up with the EU countries, on the other hand there is an enormous increase in the number the poorly paid bureaucracy [1] often liable to pursue their own vested and short-term interests.

Expressed at a purely hypothetical level, the government should retain only those activities which cannot be effectively provided by private sector. Unfortunately, as is suggested by definition of transforming economies, a part of the private sector is only emerging, some of their market institutions are at their infancy and the behavioral patterns of many agents are biased more to redistribution than to productive motivations. These conditions are highly biased against growth or low taxation (see Olson, 1997). Thus, willy-nilly, it remains on the government to become more actively involved in eliminating some of their adverse impacts. The assistance to emerging markets can be implemented by transferring some underdeveloped segments of the economy under the surveillance of public control. It should not mean establishing bureaucracy for their direct management but **getting involved in the responsibilities for creation of standard institutional conditions stimulating the growth and efficiency of the markets**. The aim is to decrease the transaction costs. For instance, these responsibilities could concern the buildup of the following institutions:

- effective legal, judicial, accounting and fiscal systems regulating the functioning of businesses, contracts and ownership,
- education and especially the development of human capital in public administration,
- free flows of public information,
- surveillance over the economic competition and regulation of imperfect markets,
- institutions regulating the capital, money and labour markets.

It is an illusion to believe that legal collapse, blocked markets and redistributional motives of economic agents will be temporary and that they will fix themselves spontaneously. The power and ownership networks that were established under their adverse patronage will have little motive for a change and they will have sufficient means at their disposition for preventing the changes. It is also an erroneous idea that the process of the public administration slimming can start by decreasing taxes. Taxes are not a cause but only an effect of the politics of welfare state. Without a systematic pressure of the government to cut down first on some of the existing fiscal expenditures, there will be no potential space for lowering the receipts. It also means that the government should be aware that because it cannot discard its financial responsibilities in large social catastrophes (like floods or bankruptcies of banks or pension funds inflicting the general public), it must also accept its responsibilities in preventing such losses.

If the markets are not competitive, such behavioral patterns of agents like rent-seeking, bureaucracy, risk aversion, collusion, protection of inefficiency, etc., well-known from planned economies, can continue during the transition. Lobbies for manipulation of the SB receipts and expenditures would proliferate. For example, state budget expenditures for those items in which no instantaneous explosion is imminent can be cut down in order to transfer the resources to ventures with higher momentary political or personal yield. Paradoxically, it can be at the expense of the long-term social interest. A large size of the SB offers wider space for such opportunism. Therefore **a gradual adjustment of the share of all public expenditures in GDP up to the level corresponding to the country's economic level should be adopted as an indisputable part of the transformation strategy**. The risk of delay in this process comes mainly from politicians, lobbies of vested interest and bureaucracy. The instinct for their self-preservation can find its way in offers of populist promises and in patching the consequences of problems instead of changing their causes.

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[1] It is a well-known fact that the system of central planning was administered by an army of bureaucrats. In the Czech Lands in 1989 there were 92,000 employees in the public administration, plus 50,000 aparatchiks in the Communist Party. In 1996, with the introduction of markets, with 76% of GDP provided by private or non-state firms and with cuts in the public administration, secret police and political administration, the number of employees in the Czech government sector has increased in 1996 to 161,000 persons.

The principle of transforming centrally planned economy to an effective market economy rests in a gradual reduction of the government's rampant economic responsibilites and in a derogation of the myth of welfare state. To ensure a sustainability of few macroeconomic variables is therefore only a necessary but not a sufficient condition for stability and growth. The problem concerns with the performace of the economy at its microeconomic roots. It is a process making extremely heavy professional and moral demands on the government and its administrative machinery because it is a struggle of the state authorities against their own importance as a monopoly. Transformation of this type is certainly a process that will last longer than mere seven years.

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