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The Changing Role of the State in the Economy: A Historical Perspective[1]

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Abstract

This paper discusses the role of the state from a historical perspective. It outlines how that role has changed over the past hundred years and discusses the forces that have promoted the changes. In the period between 1913 and 1980, there was a large increase in public spending in industrial countries and a considerable expansion in the role of the government in the economy in all countries. The paper also outlines the intellectual developments that, starting in the 1970s, have brought about a reaction to the large role that the state has come to play in the economy.

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CONTENTS

SUMMARY

At least since the 1950s, public finance economists have found useful the distinction between the normative and the positive roles of the state. The first outlines what the state should do to maximize welfare. The second outlines what the state actually does. There is normally a great difference between the two roles, in part because past policies often continue to determine current behavior. Therefore, in most countries there is a great need for reforms to bring the positive role closer to the normative role. The paper outlines the various factors that determine the government's role -- such as social attitudes, level of economic development, the degrees of openness of an economy, technological developments, and the quality of the public administration. An important conclusion is that the very countries that would seem to have the greatest need for an expanded public sector role may be the same ones where the public sector is least prepared to play that role efficiently. Therefore, when policymakers of these countries attempt to play a large role, they end up damaging economic activity.

The paper discusses the expansion of the government's role in the economy in the twentieth century and the forces that in recent years have given a greater role to the market. It also discusses the role that the government should play in the future in a predominantly market economy. This new role of the government must augment the function of the market rather than replace it. The paper emphasizes that the government must focus its attention on its core activities, which have been neglected in past years.

I. Positive and Normative Roles of the State

The French poet, Paul Valery, was reported to believe that "if the state is strong, it will crush us; if it is weak, we will perish."[2] The ideal role must, therefore, be between these two extremes. Governments play many roles, some political, some social, and some economic. The focus of this paper is on the economic role. In the pursuit of this role, the government uses many policy instruments and, by so doing, it allocates resources, redistributes income, and influences the level of activity.

At least since Richard Musgrave wrote his influential *Theory of Public Finance* in 1959, public finance economists have found useful the distinction between *the positive and the normative roles of the state. The normative* role determines guidelines, principles, or norms for welfare-enhancing public sector intervention in the economy. On the basis of fundamental economic principles, it *attempts to define what the government should do* to correct market imperfections and to complement the market in other ways to promote and maximize social welfare.

Although this is not explicitly recognized by economists, the normative role is affected by the political constitution of a country. In Western, market-oriented democracies, where much modern economic thinking originated, the normative role of the state has been implicitly tied to the individualistic, political process that assumes that there are no goals or needs outside those of the individual citizens or voters. The public interest is, thus, seen as the summation of the interests of the individual citizens or voters.[3] In a way, this explains why many see a close relationship between a market economy and a democratic process. In a market economy, individuals vote with their dollars whereas in a democratic process, they use their votes to promote their political goals. In playing its role, the state cannot have objectives different from those of its citizens. But one could assume an alternative conception of the state, such as, for example, a Hegelian conception of an organic or a totalitarian state that exists independently from individuals living at a given time and that has, thus, an existence of its own. This, however, would not be a popular view, especially with Western-oriented economists.[4]

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[2]Cited in Bardhan (1996), p. 11.

[3]Whether such a summation is theoretically feasible is an open question. See on this the seminal work by Arrow (1963), and subsequent related literature.

[4]Problems may arise also when the nature of the issue requires paying attention to different generations. This is the case with environment, public debt, and public pensions. How should the interests of future generations be taken into account? Different but related issues arise in

While the normative role attempts to define what the government should do to maximize economic welfare, *the positive role describes and analyzes what the government actually does*. In an ideal world, the two roles would merge: the ideal and the actual roles would become the same because the state would be doing exactly what it is expected to do and all the reforms needed to maximize social welfare would have been carried out. In the real world, the two roles tend to diverge and, at times, they diverge by a great deal, implying that many needed reforms have not been carried out. The reasons for this divergence are several, ranging from possible differences between the interests of those who govern and those who are governed, to mistakes and misconceptions on the part of the policymakers, to inadequate controls on the part of the policymakers over the policy instruments, and to the residual effects of past decisions.

Even when political leaders would like to achieve welfare-promoting social objectives, their economic training may not be adequate for the task. Some of them come from disciplines other than economics and are, thus, unsophisticated in economic matters. Some may have simplistic notions of how economies operate or may, in Keynes' terms, be slaves of the theories of defunct economists.[5] And yet, there are some who may confuse their own personal interest with the public interest. In the latter case, they would pursue policies that help them, their friends, their families, or their political allies, but are not optimal for the country. Unfortunately, examples of rent-seeking or even of corruption on the part of the policymakers are far from rare.

The role of the state is promoted by the policymakers--those who make the policy decisions. However, there can be wide differences between the expectations based on those policies and the final outcomes. The reasons for these differences may be several. The decisions made upstream by the policymakers must be implemented downstream by the public administration or by other institutions. Principal-agents problems are common, especially when those who must implement the policies have objectives of their own or feel that they or the relevant group to which they belong will be hurt by these policies. Therefore, in the process of implementation, the policies may be changed or distorted and the final results may differ from the

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connection with individuals who are not citizens of the countries in which they live. Should the state reflect only the views of the citizens or, even, of the voters?

[5]It is not necessary for political leaders to have advanced economic training themselves; however, they need to have the sophistication to choose competent economic advisors and to distinguish between good and bad economic advice.

anticipated results.[6] This outcome occurs also when the public administration is incompetent or corrupt. In these circumstances, the public employees, in a way, privatize to their benefit the use of some of the policy instruments.

Because many policies have long-lasting consequences, the role of the state at a given moment is much influenced by *past* policies in addition to being influenced by the theories of defunct economists. Policy decisions made by previous governments continue to determine, to a large extent, the current economic role of the state and constrain the actions of current governments. These past policy decisions often create a role for the state that is different from the one that the current policymakers might prefer. Legal, political, or administrative constraints may significantly limit the power that the current government has to change economic policies. This is an important reason why ministers often agree with the need for some reform, but argue that it would be difficult or impossible to implement the reform at this time.

Examples of decisions with long-term consequences are those related to the size of the civil service, to whether enterprises are public or private, to the level of public sector salaries, to pension rights, to tenure in public jobs, to tax incentives and subsidies to particular groups or sectors, and so on.[7] These past decisions create legal or implicit entitlements or other claims that the current government may find difficult or impossible to change, especially in the short run. In some countries, the interest on public debt and other hard-to-reduce spending, such as entitlements, account for three-fourths of total spending.[8] The reality is that no government has the freedom to start with a new slate or with a *tabula rasa*, so to speak, unaffected by past commitments.

Current economic policy is, thus, to varying degrees, a slave of past governments' decisions, which often created particular policies. Those who are

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[6]A common example is tax reform, where the actual drafting of the laws (which is supposed to just give concrete content to the decisions made) can bring many surprises. Sometimes the basic intent of the legislation is largely neutralized by some innocent-looking clause. At other times the drafting is fine but the tax administration renders the law ineffective by not making the administrative changes necessary to effectively implement the law. For a discussion of some of these issues, see Tanzi (1994).

[7]The current difficulties that many industrial countries and some developing countries, such as Brazil, are having in reforming pension laws or in scaling down the welfare state are good examples of such decisions.

[8]See especially Steuerle and Kawai, eds. (1996, Part Two, Chapters 5-7: The Yoke of Prior Commitments).

benefiting from these policies will oppose reforms even when these would be in the public interest. This is partly the reason why some economists have argued that authoritarian governments may be freer to pursue policies that are favorable to growth.[9] Current governments are often blamed for economic problems that were created largely by the policies of previous governments. In conclusion, the current economic role of the state must be seen as the outcome of present and past economic policy decisions and cannot be assumed to reflect the role *desired* by the current government.

That current role has been shaped partly or largely by historical developments. For example, in many industrial countries, it has been influenced by their experience with the Great Depression, major wars, and the threat of communism, all of which forced particular policies on past governments. In many developing countries, the economic role of the state has also been influenced by their experience as colonies of foreign powers. For example, in these countries, the nationalization of enterprises was partly because at the time of independence, many large enterprises had been in the hands of individuals from the colonial powers.

Other factors may also be important, including: (a) social attitudes, which may be determined by the cultural heritage or religion; (b) the level of economic development, which, depending on the sophistication of the market and of private institutions, may call for more or less state intervention; (c) the degree of openness of the economy;[10] (d) technological developments, which may create or destroy natural monopolies or may create or increase the need to regulate certain new activities, such as financial markets, communication, or transportation; and, finally, (e) the quality of the public administration, which may impose limits on the scope of effective governmental intervention.[11]

A priori, it would appear that the less developed a country is, the more it could benefit from a larger government role that would supplement the market and correct its many imperfections. Some of these imperfections are the consequence of

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[9]Chile, under General Pinochet, China in the past two decades, and some Southeast Asian countries are assumed to provide examples of economies that have prospered under authoritarian governments able to push growth-promoting policies.

[10]In a recent paper, Dani Rodrik argued that more open economies need and have larger public sectors because they are inherently more unstable. See Rodrik (1996).

[11]The normative role of the state requires and assumes that public administrations exhibit ideal Weberian characteristics. See Tanzi (1994),

informational deficiencies, limited mobility of resources, and excessive economic power in local markets on the part of some individuals. However, it is also true that generally, though not always, the less developed a country is, the less able its public administration. As markets develop, they become more efficient and, for this reason, they require a less active normative role for the state. However, at the same time, the ability of the policymakers and of the public administration to deal with market deficiencies (and other problems that, at least in theory, could be solved by the government), can be assumed to rise. Also, new markets that need to be regulated come into existence.

In conclusion, one of the unpleasant realities of economic development is that the very countries that would seem to have the greatest need for an expanded public sector role may be the same ones where the public sector is least prepared to *efficiently* play such a role. In these circumstances, when the policymakers attempt to pursue an ambitious public sector role, as they often do, the results tend to be disappointing.[12]

It is customary for economists and political scientists to assess the role of the state in the economy by measuring the ratio of tax revenue or government spending to gross domestic product. According to this criterion, the role of the state in the economy is much larger (on average, twice as large) in industrial countries than in developing countries. For example, such a ratio is almost five times as large in Sweden as in China. Knowledgeable observers would recognize that the reality is often different. They would be aware that, in recent decades, the public sectors of many developing countries, through regulatory policies, have played a much larger role than the governments of the industrial countries in allocating investment, credit, foreign exchange, and economic resources in general.

In many countries, permits or authorizations are necessary to engage in most economic activities.[13] In some cases, *many* authorizations from various government agencies are required. As a consequence, in some countries a large proportion of

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[12]For example, in poor countries, not only the public administration is less skilled, but the government's ability to raise taxes is much more limited. In these countries, the government's more ambitious role is normally played through a greater use of quasi-fiscal regulations. See Tanzi (1995). These quasi-fiscal regulations replace taxing and spending and often give rise to problems of governance and corruption.

[13]de Soto (1989): reported that 11 basic steps were required in Peru in the 1980s to set up a small firm. It has been reported that in Tanzania it took 28 essential steps to get approval for medium and large investment projects.

private enterprise managers' time is spent negotiating with officials.[14] This situation often gives government bureaucrats the power to delay or stop economic decisions on the part of private individuals and enterprises and, thus, it gives them the opportunity to demand payments for giving these permits or authorizations. The state has also played an extensive role in the direct production of goods and services.

II. Expansion of Government Role in the 20th Century

The classical economists, from Adam Smith onward, favored a minimal role for the public sector. They generally preferred a role limited to the provision of essential public works, the maintenance of law and order, and the defense of the country. In their view, the government should guarantee property rights and the sanctity of contracts and should protect the economic and political liberties of individuals. These can be considered *as the core activities of the public sector.* This conservative attitude was partly a reaction to the widespread interference of governments with the working of the market, which had characterized 18th century Europe. The classical economists considered this interference as damaging to economic activity and as an obstacle to growth. Perhaps, as a consequence of this attitude and experience, in the 19th century, the economic role of the government tended to be much more limited. For example, in most of the industrial countries, public spending was around 10 percent of GDP and laissez-faire was the dominant economic philosophy.[15]

The 20th century saw a gradual but large expansion in the role of the state in the economy. Such expansion is particularly evident from data on the growth of public spending as a share of GDP. For the new industrialized countries, that share grew, on average, from about 12 percent in 1913 to about 45 percent in 1995.[16] Both political and ideological factors contributed to this growth. Here we shall ignore the historical

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[14]According to a World Bank study (1995): in Morocco, it takes as many as 20 documents to register a business; in Egypt 90 percent of an entrepreneur's time is spent resolving problems with regulatory agencies; and in Lebanon it takes 18 signatures to clear goods from customs. In Ecuador, at one time, it took no less than 30 documents to apply for a tax incentive. See Tanzi (1969, p.228) For the time spent by managers negotiating with public officials, see World Bank (1997), p. 43, Fig. 3.2.

[15]See Tanzi and Schuknecht (1997)

[16]It is likely that there was also a gradual growth in economic regulations, although there are no statistics to back this view.

and political factors (such as wars and depressions) and focus on the changes in the prevalent attitude vis-à-vis what the state was expected to do. These changes in attitude were important and created the climate that made possible much of the government activism of recent decades.

Marxist and socialist thinking (which emphasized income equality among individuals) created strong pressures on the governments of the market economies to play a significant role *in redistributing income*. Such a role had not even been contemplated by the classical economists who had focused their attention on the allocative function of the state. The advent of communism in the former Soviet Union, and later in other Eastern European countries, and the attraction that central planning had for many intellectuals in the rest of the world, pushed many countries toward a "mixed" economy. A mixed economy, of course, meant one with a large government role. Income redistribution came to be seen as a major, legitimate policy objective[17] that called for policies to reduce the income of the rich and to increase the income of the poor. Income taxation, with highly progressive rates, subsidies to basic commodities, and welfare payments became common government policies. Such policies had not existed, or had been rare, in the past. The growth of public spending on education and health was also often justified in terms of its impact on income distribution.[18]

Keynesian thinking also created pressures on the government to help sustain the disposable income of individuals during cyclical fluctuations, to stabilize the economy. Public works programs and unemployment compensation, together with the expansion in the public sectors, and taxes with high built-in flexibility, were justified for this reason. Public pension schemes, often with redistributive features, and various forms of assistance to those whose income fell below certain levels were introduced in many countries. Public enterprises were used to maximize public employment. The goal was to build an economy with characteristics that reduced its exposure to fluctuations. Countries with large public sectors were believed to be less subject to business cycles. In conclusion, Keynesian thinking was used to justify an expansion in the economic role of the public sector.

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[17]In some ways, it became the dominating objective in many countries.

[18]Here one should make a distinction between the rhetoric and the reality of income redistribution. Often the impact of governmental action in redistributing income towards the poor was much more modest than one would assume from the rhetoric. The reason was that social spending was often largely appropriated by the middle classes. See Tanzi (1974); and Alesina (forthcoming).

In addition to the impact of socialist and, more generally, Keynesian thinking on the policies pursued by the governments of many countries, technical developments in economics, especially after World War II, provided additional justifications for public sector intervention. For example, the concept of *public good,* which was made popular by influential economists such as Paul Samuelson and Richard Musgrave, justified the government provision of many goods with public goods characteristics, because it implied that without such intervention the market would undersupply such goods. The private sector would not have an incentive to produce public goods due to the difficulty of excluding from their consumption individuals who would not contribute to the cost of their production (i.e., the free riders).[19]

Closely related to public goods was the concept of *externality.* The recognition that the consumption, or the production, of some goods may generate positive or negative externalities not reflected in the price of these goods created a further case of market failure requiring governmental intervention.[20] The government was expected to increase the private cost of producing or consuming goods with undesirable externalities and especially to decrease the cost of goods with desirable externalities. Externalities became often-cited and politically exploited justifications for expanding the role of the public sector into health, education, research, transportation, training, and many other areas. Some authors even argued that welfare payments to the poor could be justified in terms of externalities such as the reduction of crime. The argument made was a familiar one: without governmental intervention, the market would underproduce or overproduce such goods depending on whether the externalities were good or bad. The government role could be played through subsidies to the private sector (given either directly or through tax incentives), through the public production of some goods, as in the case of health or education, or through regulations.[21]

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[19]See Samuelson (1954); and Musgrave (1959).

[20]Externalities had been recognized for a long time, as for example by Pigou. However, it was only in the post World War II era that they became a major justification for public sector intervention. James Buchanan has often argued that externalities were politicized to justify larger governmental intervention.

[21]In more recent years, this argument has come under attack in part as a consequence of the work of Ronald Coase, who received the Noble Prize for it. See Coase (1960). Coase argued that in a market economy free arrangements among individuals would internalize the effects of externalities and thus lead to an optimum without the need for governmental intervention. Public choice literature has emphasized that while externalities create market failures,

In addition to the ideological factors mentioned earlier, which influenced the behavior of the governments of *all* countries, arguments of particular relevance for *developing* countries were also advanced.

The earlier literature on economic development often assumed that governments had abilities lacking in the private sector. For example, one of the arguments used to justify the government's role in direct production activities (through public enterprises) was that managerial skills were lacking in the private sector but, somehow, they were available in the public sector. Another was that, because of their large scale, some activities or projects required amounts of capital, or a degree of expertise, that only the public sector could generate or assemble. Still another was that information essential for the successful conduct of some activities was more available, or was only available, to the public sector. This might be the result of "rational ignorance" when, for individuals, the cost of getting information exceeds the benefit from it.

In the 1950s and 1960s, and especially in developing countries, it was often assumed that the government was the best judge in deciding which goods were "essential" or "necessary" and which were not. Therefore, the government's judgment replaced that of the market.[22] Incentive legislation accorded favorable treatment (in taxation, the provision of credit, access to foreign exchange) to investments aimed at producing "essential" or "necessary" goods. It penalized the production or even prohibited the use of some resources (credit or foreign exchange) for the provision of "nonessential" or luxury goods. In many countries, high protection was provided to the domestic production of "necessary" goods.

Paternalistic policies, which replace the preferences of the consumers with those of the policymakers, are still common in many countries as, for example, in industrial policy. The assumption is that the government has more knowledge than the private sector on how the market and the economy operate and what the citizens need most. Thus, the government can pursue an industrial policy that picks future winners

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governmental intervention is often characterized by political failure which results from rent seeking. Thus, market failure does not necessarily justify governmental intervention.

[22]This was a departure from the individualistic view of the public interest, as mentioned earlier. When the government assigns to itself the right to judge the merit of goods, it is behaving in an authoritarian fashion. The concept of *merit good* proposed by Musgrave reflects, in some way, the same assumption, although Musgrave would never support an authoritarian government.

and provides them with "temporary" protection or assistance. These infant industries are expected to be the giants of tomorrow.

The 1950s and 1960s, the golden age of public sector intervention, was influenced by some naive political perceptions of how governments operate. For example, it was implicitly, if not explicitly, assumed that:

(a) the actions of the public sector were driven by the objective of promoting social welfare--rent-seeking on the part of those who formulated the policies was assumed to be insignificant or nonexistent. The literature on rent-seeking appeared only in the 1970s,[23] and the literature on corruption and governance is mainly a product of the 1990s;

(b) the public sector was monolithic and with a clear nerve center where all the important economic decisions were made in a rational and transparent way. Thus, policies could not be inconsistent among them. For example, the policies pursued by the public enterprises or by other decentralized entities (such as local governments, stabilization boards, and social security institutions) could not be at odds with those pursued by the central government; and, of course, within the central government, there was consistency in the policies promoted by the various ministries.[24] It is puzzling how little interest there was until the 1990s in issues of fiscal federalism and policy coordination *within* countries.[25]

Policies were assumed to be consistent not just in space but also in time. The political horizon of governments would be long enough that current policies would not be allowed to conflict with future policies. Such conflicts can result either from mistakes or from political considerations (such as winning the next elections), that may lead governments to choose, in the short run, policies that are clearly inconsistent

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[23] See Tullock (1967); and Krueger (1976). See also Tullock (1989).

[24] For examples of inconsistent or uncoordinated policies within the United States government, see Krueger (1993). An extreme example for the United States is provided by the subsidies given to the production of tobacco at the same time as the government is trying to discourage smoking.

[25] For examples of inconsistent policies between the central government and the local governments, see Tanzi (1995).

with long-run objectives. Once again, the literature on the time inconsistency of economic policy is a product of recent years;[26]

(c) policy decisions were reversible. Thus, government employees could be dismissed when no longer needed, incentives could be removed when their objectives had been achieved or their implementation time had expired, entitlements could be ended, and so on. Recently, governments have had to face the unpleasant reality that it is far easier to increase benefits (such as pensions) than reduce them, or to hire civil servants than fire them.

(d) the policymakers had full control over the policy instruments. They could rely on honest and efficient public sector employees who would implement efficiently and objectively the policies decided at the top. The literature on corruption, principal-agents problems, and rent-seeking is relevant here and is once again a product of recent years;

Experience has shown that the romantic or idealized view of how policy making is made and how it is carried out is, at times, far removed from reality.[27] The reality is that public sectors: (1) are not monolithic but are characterized by several, or even many, policymaking centers which may not all be guided by the same concept of the public interest; (2) their policies may not be consistent in space or in time; (3) they may be influenced by rent-seeking and by pressure groups; (4) those who make some of the policy decisions may be ignorant of how the economy really works; (5) principal-agents problems may be prevalent; (6) actions may not be reversible; (7) bureaucracies may be inefficient or corrupt or both. They may distort the directives they receive from the policymakers, or use to their own advantage the instruments of economic policy. Intellectual developments in these areas have, in recent years, made many people wary or skeptical about the expanded role of the government and have set the stage for greater reliance on the market. These developments have been a frontal attack on the thinking that in earlier years had led to a large role of the public sector.[28]

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[26]See Calvo (1978).

[27]The extreme version of this romantic view is implicit in the work of Tinbergen (1952) and Johansen (1965). Tinbergen's work was very influential in the 1950s and 1960s.

[28]The role of the public sector in stabilizing the economy was also subjected to sharp criticism especially in the 1970s by Robert Lucas, Robert Barro, and economists associated with the rational expectation school.

The view that the government could be a solution to most problems is no longer as widely accepted as it was two or three decades ago. We now have the reality of several decades of expanded state intervention so that expectations can be compared against results. The results from this experience have been disappointing in many countries, especially in developing countries. There is now ample evidence that *large* state intervention has not improved the allocation of resources, has not promoted a faster rate of growth, has not brought about a better distribution of income, and has not provided a more stable economic environment.

Resources continue to be greatly misallocated, often as a direct result of government policies. Available evidence indicates that Gini coefficients and other measures of income inequality have not improved over time and are not much better in countries with large state intervention than in those with a more limited and more focused role for the public sector. Inflation, unemployment, and macroeconomic disequilibria continue to affect many countries and often, especially those with extensive state intervention. There is also ample evidence that the countries in which the role of the state has been more limited and better focused have *performed better.* The countries of Southeast Asia, Chile, and New Zealand are often mentioned in this context.

III. The Return to the Market

In recent years there has been the beginning of a realization that the growth in governmental intervention in the market had been accompanied by a *dereliction of attention to the core activities of the state.*[29] Given the limited time and resources available to policymakers, as they became distracted and overwhelmed by the many responsibilities they had assumed, they were unable to dedicate to the core activities the resources, time, energy, and attention that these activities required. Often, the objective of equity was appealed to in order to justify the unproductive or questionable use of public resources. The end result was a deterioration in the quality of the basic services provided by the state. The state was doing more and more but doing it less and less well. This deterioration has had negative implications for the working of the market, which depends greatly on how well the state performs its core activities. The role of the state shifted over the years from one that supports or augments the market to one that competes with and, thus, replaces the market.

In many countries, law and order, the most quintessential of the core activities of the state, suffered, thereby imposing large pecuniary or psychic costs on the

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[29]The 1997 World Development Report of the World Bank elaborates on this theme.

population. Crime became a big problem, because the services of the police and of the courts were allowed to deteriorate due to lack of resources or attention. Attempts were made to explain or justify crime on the basis of social conditions.

Disputes among citizens or between citizens and the state could not be solved expeditiously because, in many countries, access to justice became very expensive and the judicial system was on the verge of collapse. Judicial decisions were much delayed (sometimes for many years) and, when they finally came, they were seen by the relevant parties as capricious or unfair and lost much of their deterrent effect. The implementation of these judicial decisions was also capricious and much delayed. All these factors made access to the law highly unequal for different individuals and, inevitably, legal rights, including those related to property and contracts, became uncertain. The situation was not helped by the fact that the judicial systems of many countries became politicized and were susceptible to corruption.

In many countries, obtaining basic documents or permits, such as passports, drivers' licenses, authorization to open shops or to import, may take months and or the payment of some "speed money,"[30] Governments often do not enforce contracts, thus creating doubts or uncertainties about property rights and encouraging some in ignoring the terms of contracts. This has destroyed or at least hurt some markets. In some countries, the threshold costs of getting access to the justice system are so high as to discourage all but the better-off, thus creating unequal justice. A kind of bureaucratic cholesterol has, thus, clogged the arteries that energize the market economies.

In health, the provision of basic services, such as vaccinations and preventive services, suffered when the state extended its role into more complex and expensive areas, such as curative services provided in large, urban hospitals. Elementary education (a core activity) suffered when the state extended its role in the far more expensive higher education. The maintenance of the basic physical infrastructure suffered when the state became distracted by large investments and when it gave priority to investment expenditure over expenditure for operation and maintenance.[31]

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[30]In some countries, individuals who act as "facilitators' or go-betweens have come into existence, adding to the transaction costs of operating in certain areas.

[31]In many countries a larger public sector workforce has been bought at the cost of low wages. This in turn is likely to have stimulated corruption on the part of the civil service. For empirical support to this intuitive conclusion. See van Rijckeghem and Weder (1997).

In recent years, there has been a universal rediscovery of the market or at least a greater appreciation by policymakers and the public of the role that the market can play in the economy. As a consequence, there has been a gradual reduction in governmental intervention and greater reliance on the *allocative role* of the market. The role of the government is changing from one that competes with the market to one that augments the market and improves its working. In a growing number of countries:

- public enterprises are being privatized;
- quantitative restrictions on trade are being reduced or removed and import duties are being lowered, in some cases, lowered to very low levels, making trade more responsive to changes in relative prices;
- restrictions on the allocation of credit and controls on interest rates are being reduced or removed, restoring to the credit market its important allocative function;
- price controls have become less popular and many other constraints on economic activities are being reduced.

All these actions are increasing the role of market forces and, *mutatis mutandis*, are limiting the scope of governmental intervention. Policymakers are slowly realizing that the government should not replace the market in allocating resources, but rather take actions that make it work better.

It is, perhaps, not a distortion of the truth to say that the governments of many countries, though not of all countries, would now like to see the state play a smaller role in the economy. However, these governments are confronted by the legacy of past decisions and by the special interests of many groups that benefit from past decisions. These groups are often powerful enough to prevent, or at least to slow down, reform. As a consequence, it may take several years before the role of the state can be brought in line with current thinking.

What are the main changes that should take place? A full answer to this question would require far more pages and time than can be used here. However, a broad sketch of some of these changes can be suggested, fully realizing that often the devil is in the detail and that some of the points made could benefit by much more nuance than is possible here.

It was mentioned earlier that the classical economists, even those who strongly believed in laissez-faire and in the sovereignty of the market, wanted the state to play a significant role focused on the core activities, such as essential public works, law and order--including the guarantee of property rights and the enforcement of contracts--and defense of the country. In these areas, the state has simply not performed well. In some cases, the state has been the main violator of property rights and of contracts.[32] Thus, a *reallocation of attention on the part of the policymakers to these core activities would be highly beneficial to the market.*

The process of privatization of public enterprises must continue and in many countries, it must be accelerated. In a market economy, there is little reason for the state to be directly involved in production activities. If, through privatization, the state can reduce the public sector wage bill and the subsidies it often pays to the public enterprises as well as improve the efficiency of the economy, then privatization is a good policy. When interest rates on public sector debt are high and some debt can be repaid with the proceeds from privatization, then from a fiscal point of view, privatization is an excellent policy.[33] Privatization, accompanied by the opening of the market, which in many sectors introduces competition, and accompanied by rules that prevent monopolies, will usually increase the efficiency of the economy. In time, privatization will also reduce corruption, although the process can lead to a situation where corruption becomes a major issue.

The government must stop controlling prices, be they of traded goods, domestic goods, or of specialized markets, such as financial and rental markets. Price controls always distort markets and create inefficiencies and rent-seeking. The government must also stop subsidizing basic commodities; in several cases, these subsidies have reduced the prices of some commodities or services to such an extent as to lead to excess demand and waste. This is an area where some of the most extreme examples of government-induced misallocation of resources have been reported.

The government must reduce its role in allocating investment and economic activities through incentives and/or regulations. It should focus on improving the

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[32]For example, rent control laws have violated the property rights of owners of houses. Government arrears in payments have violated the sanctity of contractual obligations.

[33]In fact, in many cases this is the best use of the proceeds from privatization. In the process of privatization, a problem has been present. To set the highest price from the privatization of a public enterprise, the government should let the enterprise retain some monopoly power. However, this would reduce the efficiency of the economy. A government that is much interested in maximizing present revenue is likely to allow the privatized enterprises to retain some monopoly power.

efficiency of the market: (a) through the opening of the market to foreign competition; (b) through the elimination of unnecessary or inefficient economic regulations (be these the regulations by the government itself or by private groups, such as labor unions or professional associations);[34] (c) through the better provision and diffusion of information; and (d) through the establishment of efficient regulatory bodies that provide needed information to consumers and establish transparent rules of the game that are known to all and applied objectively to all market participants. The government can promote competitive behavior by leveling the playing field for all market participants by removing monopolies and monopolistic practices and by eliminating obstacles to entry into activities.

It may seem a bit odd that we are advocating the elimination of many existing regulations while calling for the establishment of regulatory bodies to set rules of the game. We do this because the economies of many countries are overburdened with useless and damaging regulations[35] yet suffer from a dearth of controls or rules over some, especially the new, activities. Governments need to play an important role in regulating particular sectors, such as credit and capital markets, and certain industries, such as communication, transportation, health, and energy. There is a strong need for establishing the rules of the game for a market economy and to provide needed information to the consumers, but there is no need to replace the market in allocative decisions except in extreme cases.

A brief digression on the use of regulations to pursue the objectives of public policy may help clarify the point made above. To varying degrees, regulations may be damaging and useless or useful and essential for a modern economy. A few examples of both are provided here.

(a) Some regulations have no other purpose than to give power to the government and the bureaucrats charged with enforcing them. This is the case with the myriad of authorizations often imposed by local governments required to enter into legitimate activities, such as the opening of shops and factories.

(b) Some regulations aim at achieving social objectives that could be achieved more efficiently in other ways. One example is rent control that is

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[34]Restrictions to competition through regulations imposed by professional associations are common. They have not received the attention that they deserve. They create rents for those who are already members of these associations and unemployment for those who are not.

[35]Many of these damaging regulations are imposed by labor unions, local governments, or even private associations.

presumably established to subsidize housing for those with low incomes by implicitly taxing those who own houses.[36]

(c) Some regulations have purely social, and somewhat debatable, objectives, such as those that control working hours, minimum wages, and length of work week.

(d) Some regulations are necessary to allow activities to operate smoothly, as, for example, traffic regulations.

(e) Some regulations aim at dealing with externalities until better and more flexible tools are available. For example, regulations are often used in environmental policies when the use of more efficient tools, such as taxes, is not yet feasible.

(f) Finally, and this is the area of more interest to us, some regulations have the objective of protecting the public in a market economy, especially when the public is unable to get the information it needs to make rational choices. In a modern economy that produces many products or services of which most consumers have little knowledge, there are reasons for an expansion of this type of regulation. When individuals step on to a plane, they want to be sure that it is as airworthy as it can be so that the possibility that the plane they are in will crash is very small. Because plane crashes are rare events and are due to many causes, crashes cannot provide the ex ante information to travelers about the objective probability that the plane might crash. When individuals entrust their savings to a bank, they want to be sure that the bank is following sound investment practices. Because bank failures are rare events, bank failures cannot provide a guide for the depositors. When individuals buy a medicine, they want to be sure that the medicine does not have dangerous side effects; if it does, they want to be so informed. When they buy a product, such as meat, they want to be sure that it does not carry a disease. When individuals buy shares in a publicly traded company, they want to be sure that the value of the shares has not been manipulated and that the available information on the company is reliable.

In all the above examples, it would not be rational, because of the costs, for individuals to acquire on their own the knowledge to make rational decisions. Besides, there is a public good element to that knowledge because, once available, it can be

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[36]In many cases, this policy discourages the building of new houses and the renting of existing houses and, when maintained over the long run, it ends up taxing some poorer people while subsidizing some richer ones.

shared at zero cost with others. Thus, the government must play a fundamental role in both regulating the activities and providing the necessary information to the public.[37]

The above discussion of regulations to protect individuals raises a more general issue about the role of government in protecting individuals from various risks. In a recent paper, Devarajan and Hammer (1997) have argued that much of the difference in spending between developed and developing countries (a difference mostly explained by transfer payments) may be due to attempts by the governments of developed countries to protect citizens from various forms of risks such as unemployment, loss of income due to old age, sickness, and risks inherent to some economic activities. This raises the question of why markets, even in developed countries, cannot provide the institutions (insurances, etc.) that would make it unnecessary for the government to enter this area.

Market failure in dealing with risk is often due to two reasons: *adverse selection* and *moral hazard.* Adverse selection results from asymmetric information between those who buy insurance and those who sell insurance. Normally, those who buy it have more information than those who sell it, thus it is difficult to establish the ideal price for each individual. As a consequence, markets do not develop fully, and the government is expected to intervene. Moral hazard is a consequence of the fact that insured individuals tend to be less careful than those who are not insured or may even precipitate the event for which they are insured, as with fire insurance.

The role of the government in protecting individuals from risk comes in three forms: government *spending*, *regulations*, and *guarantees*. In some cases, as in the area of pensions, regulation may be an alternative to spending, for example, as the Chilean pension reform has shown.[38] This approach has been endorsed by the staff of the World Bank and by various economists. In this case, the government regulates that individuals must allocate a given share of their income to pensions bought from highly controlled private managers. Thus regulation replaces government spending. However, regulations do not seem to work well in the health area where, within a country, the amount of money that individuals spend for health cannot be related to their income. Whether one is rich or poor, given medical procedures cost the same, so that an insurance scheme would generate highly differentiated health care. This is the

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[37]Whether the government should also provide some guarantees (for example, for bank deposits) is a difficult issue that cannot be addressed here. Issues of moral hazard become relevant in this context.

[38]For an analysis of Chile's pension reform see Holzmann (1997).

reason why the government continues to be heavily involved through public spending in the health sector.

Government guarantees have replaced government spending in various areas such as banking and more and more infrastructure . Especially in the latter, in recent years, there has been a trend towards privatization, at times accompanied by guarantees for investors provided by the government. In this way, governments reduce their current spending and fiscal deficits but at the cost of exposing themselves to potentially large costs in the future. As the guarantees are not shown as expenditures, they may at times create the illusion that governmental intervention and spending have fallen more than they have actually fallen.

The general role of the government in dealing with risks is an extremely difficult area in which major economists, including Arrow, Samuelson, Stiglitz and others, have made important contributions. The extent to which improvements in the private sector plus government regulation will be able to replace government spending remains an important development to watch. It is a development that will largely determine whether public spending as a share of GDP, especially in industrial countries, will fall in the future.

The government should rethink its role in income distribution. Broad and vague policies (such as general subsidies, price controls, and higher spending for activities like education and health) that are *justified on grounds that they benefit the poor* should be questioned. These policies do not necessarily benefit the poor. If the government wants to help redistributing income, it will have to do it through well-focused and targeted policies both on the expenditure and on the revenue side of the budget.[39] These policies should be designed so that they do not have significant disincentive effects or high administrative costs.

Finally, in most countries, there is a great need for a reform of the public administration. It is within the public administrations that one finds extreme cases of unproductive spending. At times, one is reminded of the Russian joke to the effect that during central planning, the workers pretended to work and the government pretended to pay them. An efficient public administration must expect *all* workers to give a full day's work and must pay them a reasonable wage. There are too many public institutions that give realism to an observation attributed to Pareto: that in

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[39]Some conservative writers, such as James Buchanan, argue that the government should pursue only policies that affect everyone equally. They rule out selective or targeted policies and thus active, redistributive policies. See Buchanan (1997).

public institutions 20 percent of the workforce performs 80 percent of the useful work. The employment policies of governments in past decades, often justified on grounds of income distribution, produced large civil services with too many poorly paid workers. The efficient and core role of the public sector can be best promoted by a small and well-paid civil service that is made fully aware of its responsibilities and is penalized when it does not perform.

IV. Concluding Remarks

This paper has discussed the changing role of the state in the economy. It has described the forces that, over much of this century, led to an expansion of that role, and the reaction against that expansion, which started a few years ago and is continuing. That reaction is less the result of ideology than of the realization that not much welfare has been gained by the increased role of the state in recent decades. At the same time, many shortcomings associated with the expanded state role have been identified by scholars; their work, inevitably, has affected the way we now feel about the government's role.

There is the danger that the pendulum might swing too far from a view that assigned to the state the solution of most problems, to one that maintains that the state is the problem. There is a clear, important role for the state to play. To again quote Paul Valery, if the state is weak, we may perish.

At this time, many economists and political scientists are thinking about the role of the state in a world where technology is making major strides and where the countries' economies are becoming more integrated. We know that in this world the role of the state will have to be different than what it was in the past, when economies were less developed and less open, technology was less advanced, and information was more difficult to obtain. In this new globalized world, the state will have to play a more significant and intelligent regulatory role; the private sector will have to carry a greater burden in areas that have traditionally been the responsibility of the governments, such as the provision of infrastructure and of services traditionally provided by public utilities, and in areas such as pensions, education, and health.

Given the recent technological advances, even the traditional "natural monopolies" may be exposed to some competition and may no longer provide an obvious justification for governmental intervention. For several "natural monopolies" (railroads, power, and communication), the part that is a genuine monopoly can be separated from the other activities of the traditional monopolies. For example, the generation and the distribution of electricity can be separated from the carrying of electricity, so that competition can be introduced in the former while monopoly is maintained in the latter.[40] In some countries, private investment is now playing a major role in several of these traditional monopolies.

In this brave new world, strict but intelligent public supervision of economic activity and clear rules of the game will be necessary. It remains to be seen whether governments will be able to rise to this new challenge. It also remains to be seen how national governments will behave in a world in which many economic decisions may be pushed down to local governments or up to international organizations.

Globalization and tax competition are likely to reduce the scope for redistributive policies, especially those promoted through progressive taxation. Tax competition will reduce the revenue of *central* governments much more than the revenue of local governments, because the latter generally rely on tax sources, such as property and business taxes, less exposed to tax competition. Globalization will reduce the scope for stabilization and redistibutive policies by reducing the resources available to the national governments. At the same time, the role of national governments in regulating activities will increase. This will involve a major change in the role of the government, especially that of the national government, in the economy.

I will conclude this paper with a final comment on the role of the state in income redistribution and in providing safety nets. This issue was only touched upon in this paper, which mentioned that: (a) classical economists did not recognize income redistribution as a legitimate governmental function; and (b) many inefficient policies were pursued in recent decades under the justification of redistributing income.[41] Under proper conditions, markets are very good at allocating resources. They are not very good at generating a distribution of income that reflects the conscience or the prevalent view of society. Therefore, the government cannot abdicate this role even though it is indeed a difficult one and will become more difficult because of globalization and tax competition. It must, instead, pursue this role differently than it did in the past. It must learn how to make redistributive policies efficient and well

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[40]In the past, natural monopolies often played some redistributive or nation-building role by providing some of their services at reduced prices to poorer families and to far away places. For example, the privatization of the railroad in Argentina has left some rural and far away places without the services of the trains. With privatization, a decision must be made whether to preserve this role through the use of other policy instruments.

[41]Because of their inefficient policies, it can be argued that the limited redistribution that has taken place has been achieved at a very high cost.

targeted. And it must not forget that growth is the best medicine for curing the disease of absolute poverty and for providing productive jobs.

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