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The Economic Function of The State

Summary. The debate over the role of the state in the economy reaches the times when the science of economics has emerged. While the economic activities of the state are inevitable especially in times of crisis, these activities have always been criticized in terms of side effects other than affecting the crisis. This study examines the work done in the literature in terms of public sector size and the failures in economic activities. The reasons for the economic borders of the state, especially under the view of the liberal state, are the most prominent points in the study.

Key words: state, economic activity, liberalism, public sector size

Introduction

Since the Mercantilist era when “economics” has existed as an independent science, there has always been a competition between the State and the Individual in directing the economy. The medieval point of view that ignores the individual, with the Renaissance and Reform movements, has at least changed on the basis of thought.

During the past hundred years, the role of the government in the economy has followed a course of ups and downs. Until the crisis of 1929, Classical Economics emphasized that the state should fulfill only diplomacy, justice, defense and infrastructure services, and that economic activities should be organized by the invisible hand in the market system. However, when the crisis can not be overcome with the recommendation of the Classical doctrine, the economic organization of the state has come on the agenda. Keynesian economics, advocating the economic organization of the state, revealed the reasons for this organization with the theory of failure of markets.

The state has been successful in organizations of economic activity until 1970s. However, when the responsibility of stagflation in 1970s is tied to the state, as it's slow process of public decision-making, extravagance, corruption and productivity declines, this time, the classical doctrine tried to reduce the role of the state by advocating public failure theory instead of market failure.

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Methodology and literature

In this study, literature review method was used to examine the views of the state economic activities and the size of the public sector. In this context, the issue of taxation of public sector size is examined firstly. In the following section, the size and causes of the failure of the state in economic activities have been examined and the reason why the economic activities of the state should be limited. The final section is the result and comment section.

Scale of Public Sector and Taxation Requirement:

Since the existence of social life, there are some services that people expect to meet as their collective life demands. It is understood from the system preference of the government that which services it undertakes. In the socialist system, the state owns all means of production. And it has undertaken all the services. The financing of these services is financed by the means of production that already owned by the state. At the other end of the system debate, the minimal state deals with the elimination of basic physiological needs. Financing of the minimal government is the tax ¹.

Today, the number of countries adopting these two end system definitions is very small. Countries have embraced the understanding of the social state which is between the two systems. However, whatever the system is, the boundaries of the tasks the government undertakes are bringing along the problem of financing. Financing of public services is possible in two ways: First; taxation, the second is; borrowing which will also require taxing in future periods².

The limitation of the state's economic role lies in the limitation of public spending and the limitation of public power on taxing. The price of change in social life is taxation. In the first phase of change, taxation was only financing the services that needed for people to live. But with the increase in the need of public services, taxation has become limitless. This unlimited power has then been abused by those possessing the power. Although some restrictions have been imposed on the state's taxation authority, taxes are still a burden on the public in some modern economies³.

Battaglini va Coate has also stated that the public sector can finance its expenditures in two ways. First; the taxation of labor income, the second; borrowing from capital markets. As a third way, the government can finance future public expenditures by trading of bonds using the interest rates. However, it should be remembered that whichever method of financing is used, the use of public spending, or in other words, the increase of the economic role of the state, will bring about taxation in future periods ⁴.

¹ M.C. Güran, S. Cingi: Devletın ekonomik müdahalelerinin etkinliđi, 2002, retrieved from: www.akdeniz.edu.tr/iibf/yeni/genel/dergi/sayi03/04guran.pdf (accessed: 27.08.2018).

² C.C. Aktan, D. Dileyici, Ö. Saraç: Anayasal perspektiften vergi reformu ve 'Vergi. Anayasası' önerisi. *Public Choice and Constitutional Economics Journal*, 2001, vol.1 Issue no. 3, p. 34.
³ C.C. Aktan: *Anayasal İktisat*. Political Bookstore, August 2002, p. 427–434.

⁴ M. Battaglini, S. Coate: A dynamic theory of public spending, taxation, and Debt. *S.*, March 2006, retrieved from: <http://www.nber.org/papers/w12100> (accessed: 27.08.2018).

Although the requirement of taxation is accepted by everyone, there are important debates on the subject, scope and methods of taxation. Since the first known liberation movement, Manga Carta, it has been emphasized that the power of taxation of government should not be in the hands of one person or a fraction, and that this power should be determined by the communities in which the large masses of people are represented⁵. It should also be noted that population growth increases public spending and tax revenues. For this reason, it is inevitable that the volume of the public sector will increase with the increase of the population. Growth in the volume of the public sector will also bring additional constraints on freedoms⁶.

In order to ensure individual freedom, the authority and powers of the state must be limited. J.M. Buchanan defined an overgrown state as „Leviathan”. Leviathan is an object that represents evil. Increase in the size of the public sector will bring with it a number of political and economic corruption. The most important indicator of economic corruption is that the increasing public spending constantly increases the tax burden on individuals. Financing these expenditures at sources such as borrowing and emissions at a time t will also mean that the tax burden will increase in the period $t + 1$. And the increase in the tax burden will indirectly bring about social corruption.

Authorities on the subject of taxation of the state must be defined and limited by a separate constitution. This determination will save the individual from the burden of taxation. Thus, the frequently change in the tax rates or the scope of taxation with the political preferences will be prevented, so that a rapid and effective decision-making mechanism will be created and the rent-seeking activities of both politicians, bureaucrats and other interest groups will be reduced⁷.

Battaglini and Coate argued that the value of goods and services produced by the public is uncertain, such as wars or natural disasters. In this uncertainty, they say there are two ways of making policy: First; as they call it business-as-usual (BAU), the government invests in areas where the private sector can not invest, especially in infrastructure investments. The second is; termed as Responsible-Policy-Making (RPM), states that the government should give up such investments for the purpose of maximizing national interests, and only take a role on guiding the private sector or showing the new paths. Under the BAU regime, the public increases public welfare by producing necessary public goods or by making investments. In the RPM regime, however, the state allows all proceeds to be earned by the private sector and let them make the necessary expenditures. This difference in the public benefit view will, of course, affect public debt and tax rates, which are the means of financing. In RPM, the requirement for taxation will be lower than BAU⁸.

⁵ C.C. Aktan, D. Dileyici, Ö Saraç: Anayasal perspektiften vergi reformu ve ‘Vergi Anayasası’ önerisi, *Public Choice and Constitutional Economics Journal* 2001, no., vol.1 Issue 3.

⁶ C.C. Aktan: *Anayasal İktisat*, Political Bookstore 2002, p. 427–434.

⁷ C.C. Aktan: *Anayasal İktisat ve Ekonomik Anayasa*, İz Yayıncılık, İstanbul, İstanbul 1997, p. 31–35.

⁸ M. Battaglini, S. Coate: *A dynamic...*, op.cit.

Inadequacy of the state in economic activities

As we have already mentioned above, the basic stance of the state's economic activity limitation is the public failure theory.

In the market economy system, the presence of the state in economic activities is regarded as an intervention in the market system. This intervention will distort the market balance, so economic success and growth will be adversely affected. This view of Smith was adopted by many economists such as Friedman, Hayek, Kuznets, Lewis, Myrdal and Schultz. However, in spite of these views of the mentioned economists, it is observed that after the second world war, the regulatory role of the state economic activity and the private sector is increasing gradually, especially in the underdeveloped and developing countries. The large size of the public sector will reduce productivity and slow economic growth. The reasons for this:

- the public sector generally operates with low efficiency. The regulation process of the activities usually leads to overloading and increasing the cost of the economic system;
- the fiscal and monetary policy instruments the state uses to intervene in the economic system often cause to overload and leading to an increase in the cost of the economic system⁹.

In the 1960s, the reasons for the failure of the public in the Public Failure Theory of Public Preference economists are listed as follows:

- Voters do not have enough preferential knowledge about public goods because of propoganda, advertising, low level of education, heterogeneity of cultural levels.
- The rent-seeking activities of the press and interest groups prevent voters' real preferences from reaching political power.
- To be able to get more votes, the concentration of budget resources in certain regions, that is to say the service favoritism, prevents the public economy from making an optimum decision.
- Policies to reduce short-term unemployment and increase output to finance re-election are financed by non-tax routes. This policy choice will mean long-term debt and inflation¹⁰.

Public preference theory states that three elements play an important role in the creation of public policies. The first of these is the voters. Voters will want to hear policy recommendations about themselves. For example, a voter who is a farmer will be interested in agricultural policies, and will not have knowledge of nuclear policies, although it would be known that vote they give would not have much effect in the political decision-making process. The other element, politicians, has more knowledge than voters. However, since the politician is also a voter, the decisions to be made must be related to his or her own interests. The third element, bureaucrats, will want to direct public policies to protect and develop their own status. As can be seen, the preferences of all

⁹ S. Ulutürk: Kamu harcamalarının ekonomik büyüme üzerine etkisi 2001, retrieved from: http://www.iibf.akdeniz.edu.tr/iibf_dergisi/1.dergi/uluturk.zip (accessed: 27.08.2018).

¹⁰ C.C. Aktan: Anayasal İktisat..., op.cit.

the three elements have deviations from optimal public preference. In Sümer the presence of information asymmetry between the decision-makers and the policy makers in the absence of communication will result in the failure of the state. One of the main reasons for the decline in the central plan in the last 20 years is the information asymmetry and the lack of communication. The public sector is so big in centrally planned economies that it is unlikely that policy makers will have the full knowledge¹¹.

Altay also counted the reasons for the failure of the state in countries with centralized planning. According to this; the existence of state-protected industrialists, inefficient and inferior production of manufacturing industry, suppressed inflation due to the financing need of public expenditures, the ineffective distribution of public spending and the existence of a social security system promoting ineffective work or not working are the main reasons for the failure of the public sector¹².

Egeli referring to these failings of central planning, says that living negativities lead to growth declines, economic depression, and social unrest by increasing the cost of economic activities¹³.

Contrary to this view Li argued that central planning failed not because of the above failures but because of the rise and strength of liberal policies, which he characterized as pro-capitalist. According to him, especially in socialist economies, the state has been really successful in meeting the basic needs of citizens, such as housing, nutrition and education. However, it is important to remember that for economic growth and development, much more is needed to raise living standards¹⁴.

Yüce emphasized in his article that the state should not be as effective as the central planner. The state should only intervene in the economy in order to establish an efficient market economy. To reach this aim, he has argued that the government must undertake two basic tasks. The first is to organize individual fundamental rights and freedoms in norms that developed market economies possess. The second is to prepare and improve the market competition environment. Particularly, it is necessary to educate the knowledgeable people who know the market economy and its operation, and to collect culture economy of the market economy in this way. This is clearly a task that the government must undertake. In this case, approaches that abstract the economic activities that minimize the effectiveness of the state will not be correct. The State will

¹¹ K.K. Sümer: Merkezi planlı ekonomilerden piyasa ekonomisine geçişte planlama ve bağımsız devletler topluluğundaki Türk Cumhuriyetlerinin iktisadi potansiyelleri, Yüksek Lisans Tezi, İstanbul Üniversitesi Sosyal Bilimler Enstitüsü, İstanbul 1992, p. 37.

¹² A. Altay: Geçiş ekonomilerinde devletin ekonomik rolleri, görevleri ve KOBİ'lerin Durumu, 2003, retrieved from: <http://www.econturk.org/turkiyeekonomisi/gecis.pdf>. (accessed: 27.08.2018).

¹³ H.A. Egeli, Ö.S. Emsen: Geçiş ekonomilerinin makro ekonomik performansları ve Kırgızistan üzerine bir değerlendirme. International symposium on Globalization and Transition economies 2-4 May, Bishkek, Kyrgyzstan, Kyrgyzstan-Turkey Manas University 2002, p. 379.

¹⁴ M. Li: After neoliberalism: is Empire, is social democracy, is socialism?, 2004, retrieved from: <http://www.antimai.org/bs/mingili0204.htm> (accessed: 27.08.2018).

inevitably carry out economic activities if necessary while carrying out those activities it undertakes¹⁵.

Another argument of those who argue that the state should be effective is the theory of growth. Theories of growth say that economic modernization or change activities naturally increase the effectiveness and role of the public. Even though this emphasis on the role of the public is necessary, growth theories also acknowledge that resources and capital go to useless places.

For the growth or the modernization of the economy, state plays a central role in the beginning. The administrative system may be able to change itself. However, in addition to the prerequisite administrative restructuring of economic development, it also requires radical changes in the political and social system. To this end, the state must develop commercial markets, organize educational needs, meet social health care demands, and create key social and financial structures. All these tasks require the state to increase its role in the economy.

Tobin studied Wagner's legislation, in terms of the Chinese economy, explaining the relationship between state activity and economic growth, which was indeed constituted for developed countries such as America and Europe. The study also includes an implementation of Wagner's laws on China¹⁶.

Adolf Wagner is a German economist who has formulated an increase in state activity and increased state spending. Wagner has argued that urbanization has evolved with industrialization, and that the growing dimension of health, social and cultural expenditure has also magnified the dimension of the economy in the economy. In other words, Wagner's law explains the role and reasons for the role of the public in economic modernization. According to Wagner laws, economic growth and development will spontaneously increase the role of the state. Wagner's law also explains the economic and political reasons for interfering with the failures of the state's market system.

In his study of the Chinese economy, Tobin concluded that the economic transformation in China resulted in a labor movement in the services sector from urban to urban migration and industrial sectors. Urbanization, by itself, requires a flow from low-income agricultural communities to modern life. As this movement will change the composition of individual demand, it will bring about an increase and change in the activities of the state. These increases and changes in the state's activities will also increase costs. The state is now obligated to not only increasing its own income but also increasing the income of the migrants and providing them better public services¹⁷.

¹⁵ M. Yüce: The Problem of Harmonization of the Kyrgyz Republic with the Free Market Economy, *Economics and Society* 2004, vol. 6, no. 1, retrieved from: www.isguc.org (accessed: 27.08.2018).

¹⁶ J. Tobin: Economic liberalization, the changing role of the state and Wagner's Law, 2005, *China's development experience since 1978*, p. 29. www.elsevier.com/locate/worldder (accessed: 27.08.2018).

¹⁷ J. Tobin: *Economic...*, op.cit., p. 30.

The views on the boundaries of the state and liberalism

Neoclassical model suggests that financial variables such as taxation and public expenditure affect income levels but do not have long-term effects on economic growth¹⁸. Furthermore, according to Neo-classical economists, the increase in the economic role of the state will distort the distribution of resources in the economy by preventing price signals from fulfilling the role of providing effective resource allocation. This approach, however, ignores the need for increased activity of the public in industrialized countries. Keynesian theory is; argues that national income can be increased by increasing public expenditures under the existence of inactive capacity and inadequate demand. Both theories states that the increase in income will also affect public activity. However, defining the boundaries of these activities will be important both in effective allocation of resources and in economic growth.

Many of the new generation of Development Economists have said that state action should be operated if it is the only way to do a particular task, and it should be ended when it is no longer useful. The idea that “whatever non-state institutions can do better than or as good as the state, should never be made by the state” is a general acceptance of the new generation of development economists. No matter how loudable the government’s activity is, it should not be made to serve any political purpose, the assumptions it is based on should not change, and it should focus on a specific performance for the public. If the rules of the state’s activities deteriorate, the event becomes politicized. This always leads to a rapid degeneration in service¹⁹.

However, there are some things that, if all the conditions exist for the effective execution of the state, the state can not do these things well even if all the rules are met. The most important factor in this is the deterioration of the performance of the oppressed state in order to please the voters who have different values and different demands. Performance requires concentration in a single objective.

In the comprehension of a limited state or minimal state, the economic activities of the state must be minimized. The social state gains importance at this point, and it is engaged in a limited number of activities that the market can not achieve. These are services such as education, health, prevention of environmental pollution, justice and defense. However, understanding of the social state leads to the opinion that any problem in society is solved by the political process and therefore by the state. This is where the boundaries of the state emerge. Indeed, in the 1970s it became clear that in some countries the social welfare state had not been able to achieve the expected successes²⁰.

The current economic system is liberalism. However, in developed and developing countries, some reasons may be mentioned that require government intervention in the economy. These; market failures, the existence of public goods, lack of information,

¹⁸ S. Fölster, M. Henrekson: Growth and the public sector: a critique of the critics 1999, p. 26.

¹⁹ P. F. Drucker: New Facts (Seventh Edition). Minpa Matbaacılık, Ankara 2000, p. 296.

²⁰ A. Altay: Geçiş..., op.cit.

the existence of stiffer competition conditions in some sectors, and the excess of movable assets that the state possesses. These reasons are somewhat different from the reasons listed in the theorem of wealth prosperity. The theorem of welfare economics argues that the state should intervene in the economy due to some dynamic and static failures of the markets. In other words, there is a market economy, but the state is interfering with the operation in error. On the other hand, it is believed that the state should intervene in the economy in the transition economies since that the market has not yet developed.

Prior to capitalism, the production system was determined according to military objectives. The distinctive feature of Capitalism compared to pre-capitalist production methods is its new marketing principle. To be rich, it is not enough to have the accumulated capital accumulated in a single time. A cumulative capital accumulation is an achievement of the socialist system. However, it will be necessary to invest these accumulated funds in areas that will provide consumer satisfaction repeatedly. This is what the liberal economic order has achieved. The market process is like a referendum that repeated every day, and pushes those who do not use their own property, in the direction of the orders given by the people, out of the ranks of those who make profits²¹.

Liberal economics, which advocates that the state should limit its economic activity, bases this view on the idea that individual freedom is as important as public good. In this sense, the state should be a means to secure individual freedoms and fundamental rights. That is, the state should not undertake any functions other than internal and external security and justice services that will provide these security. In other words, 'it should not be a subject in the system.' This limitation will also prevent conflicts of politicians, voters and interest groups in the decision-making process. Economic agents turning to profit maximization and pursuing profit will also strengthen the state²².

According to the liberal economic thought, while the individual pursue his own interests, the state will also develop. This phenomenon is seen as the assumption that the consumer is dominant. It has been argued that this sovereignty of the consumer will provide economic growth and that income will be distributed in relative justice, not in absolute justice²³.

In the 1980s many efforts have been made to identify the role of the state in the economy, especially in the field of economic growth. The new role of state in these studies is very different from the role of Keynesian investor and producer state. The new role of the State is to do work that will increase the effectiveness of private enterprise such as education, R & D, technology transfer, protection of property rights, strengthening of communication networks, reduction of transaction costs. The more successful the state is, the better the economic performance is assumed to be²⁴.

²¹ L.V. Mises: Liberty and Property, Market Journal 2004, 3, p.10, p. 87–103.

²² E.A. Güvel: Political-economy interactions in Turkey's, Nobel Yayınları, Ankara 2003.

²³ L.V. Mises: Liberty..., op.cit., p. 10.

²⁴ O. Demir: The Changing Role of the State in the context of Internal Growth, retrieved from: http://www.kilgonetimi.org/cm/pages/mkl_gos.php?nt=181, (accessed: 13.11.2017).

In his work on the reasons for the failure of the state, Friedman found that politicians, bureaucrats and public officials who spent the state's money were not meticulous in doing these expenditures. According to the Friedman Matrix, the individual will spend his money in a way that maximizes his or her benefit with minimal cost. In the public economy, however, the individual spends someone else's money for someone else. This leads the individual to ineffective spending and extravagance without making profit maximization. For this reason, if the amount of money to be spent by public is reduced by reducing the role of the public in the economy, this waste or inefficiency can be avoided²⁵.

Conclusion

The restructuring of the state, and in particular the downsizing, is a topic that has been discussed and argued all over the world lately. The state nowadays has become a very centrist, bureaucratic convict, and a great tutelage authority. The economic, social and political powers that the state possesses should be limited. These powers are dangerous for the social structure. State administration must be downsizing while being transparent in order to remove corruption from every scene and must evolve from being a means of subject for rent-seekers.

The only condition for being a strong state is not the existence of a large public sector. The indication of the power of the state is that state being active and enables the citizens to lead a life at the desired level of prosperity. State can achieve this power, by not producing goods and services, but by meeting all the physiological needs of people and societies, leaving all remaining economic activity to the market system.

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²⁵ C.C. Aktan: Anayasal İktisat. Political..., op.cit., p. 427–434.

- Güran M.C., Cingi S.: Devletin ekonomik müdahalelerinin etkinliği, 2002, retrieved from: <http://www.akdeniz.edu.tr/iibf/yeni/genel/dergi/sayi03/04güran.pdf>. (accessed: 27.08.2018).
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