Chapter 9

Mysteries of Unsustainable Public Finance and of Low Economic Growth: Trap of Low Efficiency of the State

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ABSTRACT

The authors structure the main functions of the state in the economic system as the “famous triad” of R. Musgrave. They are connected with allocating resources, redistributing income (equality in income distribution), and stabilizing economy (economic efficiency). The aim is to find the causes of their low efficient implementation by the state. This is manifested in the fact that society itself does not have the ability to adequately control the current activities of the state created and put over it in order to protect its interests; in the contradictory essence of the state itself, which is the regulator, which forms the rules of behavior of economic agents and at the same time acts as the economic agent participating in market transactions. To model the options for the effective resolution of the problems of the “magic triangle,” the authors formulated the Musgrave uncertainty principle by analogy with the Heisenberg uncertainty principle in physics. This makes it possible to assess the budget expenditures of the state in order to get out of its low efficiency trap.

INTRODUCTION

In economic theory, one of the most important remains the problem of increasing the efficiency of the state in the national economy and identifying the factors that contribute to this. The understanding of these problems can be expressed with the words of the Russian philosopher N. Berdyaev: “The state does not exist to transform earthly life into paradise, but in order to prevent it from turning into hell”
This interpretation of the role of the state allows the authors to consider the effectiveness of its activities in the marginal categories: how far it can move society to the border with paradise. Unfortunately, many years of research have made it possible to pass a verdict on the inefficiency of the state (Tanzi, and Schuknecht, 1997, 2000; Angelopoupos, Philippopoulos, and Tsionas, 2008). In the new century specific forms of this phenomenon’s manifestation have become (1) national states’ inability to foresee the global crises emergence such as the latest one of 2007-2008, and to block quickly their devastating impact; (2) national governments inefficiency to change radically the modern slow down trend of economic dynamics and of aggregate factor productivity growth; (3) inadequate state performance of its function of an equitable income distribution in society, which has increased the income polarization of the richest and the poorest members of society; (4) and, finally, the helplessness of the state to compensate financial losses from the global economy’s disintegration by activating the factors of inclusive development of its countries. Given the significant share of GDP redistributed by the state all over the world through budget channels (the taxation system and government expenditures), it should be recognized to a large extent responsible for the economic problems of all the countries. This determines the paramount importance of an adequate theoretical understanding of the essence of the state as a phenomenon that is contradictory in its essence and has ample opportunities to influence the national economic system.

In 2009 R.P. Bootle (Bootle, 2009a; 2009b) noted, that the boundaries between government and the markets are now back in the melting pot. Really throughout the post-war years until the 1980s Keynesian view of the macro-relationships between markets and government were widespread in most Western countries. According to J.M. Keynes (1936) the state is the only agent in society capable of working for the collective interest on a sufficient scale. Moreover, this is its duty—first to try to prevent a depression and then, if it occurs, to get the society out of it. As to financial markets huge uncertainty and long time horizons make them subject to wild swings of sentiment and herd behaviour. Because of the importance of the financial markets for real economic activity, they cannot be left to their own devices. They require intervention, management, regulation, and restriction. After 1980s the driving force became Milton Friedman (1962), who argued fervently that markets were rational and effective. From his viewpoint governments, by contrast, were inefficient and often irrational and could fall prey to corruption or be captured by group interests. As a result the Keynesian explanation for the Great Depression was that the last derived from a collapse of the confidence of investors, interacting with the peculiarities of a monetary economy. Friedman’s explanation was based on policy failure. The Federal Reserve made many mistakes, and the most important of them was related to the introduction of restrictions on the money supply.

But, as usual, the truth is somewhere in the middle: the society needs more of the markets to do what they are good at — incentivizing, signalling, and encouraging the best use of scarce resources, especially now in the fields of environmental protection, climate change, and road usage. However, this increases the need to adjust the rules for the functioning of financial markets, which means, in various respects, a greater role for the government. But countries do not need more government, they need to adjust the market economy as a whole. It is necessary to agree with R.P. Bootle (2009a) that it is not the wrong regulation of a particular market, it is necessary to eliminate the practice of mismanaging the entire economy. The state should improve the quality and efficiency of its management in the sphere of economics and finance as a whole without expanding the scale of its impact on the market economy.

Despite significant progress in researching the factors that predetermine macroeconomic dynamics, many aspects of this fundamental scientific problem, especially in the context of the state’s influence