Private Goods vs. Public Goods Under Transition

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I

In most developed economies, especially in the European Union, public expenditure has long accounted for about 50 percent of gross domestic product. Consequently, public and private goods have roughly been divided at a 50:50 ratio.

Even though public expenditure covers more factors than just public goods, its expansion in developed market economies was one of the most prominent processes of the second half of the 20th century. The causes behind this trend varied, with individual countries displaying various specific conditions. Still, it seems that at least seven general factors can be listed in this context; for reasons of space, let me list them without a detailed analysis:

1. Surging costs of defense and internal security, chiefly due to new types of weapons, technological advancement, a continually large number of troops and the spread of organized crime;
2. Modernization projects in the economy and society, most of them handled by the state and local governments (including the development of infrastructure, environmental protection, modernization of agriculture and the development of new industries based on a major contribution of science);
3. Educational and innovative functions: Free education has become the norm at elementary level, with many countries additionally providing free education at secondary and even higher levels;
4. Ecological functions: Environmental protection has become an important priority for the state and local authorities, calling for new, far-reaching legal regulations;
5. The promotion of welfare state functions, both in response to the shortcomings of the market and deep income differences among households;
6. The development of the democratic system and civic society;
7. Efforts to offset fluctuations in business trends, coupled with the promotion of sustained growth.

II

The 20th century, especially its second half, saw two opposing trends. One was characterized by the conversion of private goods into public goods, and the other involved the reverse process. The appearance of these trends in individual countries varied in time and scope.

In the first trend, after private goods were transformed into public goods, the latter became more expensive, both globally and in terms of a situation in which a growing share of GDP was intended for the "production" of these goods. Per unit costs and global expenditure displayed an upward trend.

These developments were due to three key factors:

a) Technological progress was especially dynamic and consequently expensive with regard to some public goods referred to as "pure" public goods;
b) A growing number of private goods took on a public or social character (creating problems in defining and identifying "public" and "social" goods);
c) Society increasingly participated in the consumption of public and social goods.

This process produced the following results:

1) The share of public spending in GDP displayed an upward trend;
2) The efficiency of these funds showed a downward trend;
3) A bloated public bureaucracy sector emerged to manage these expenses (goods) at both central and local levels.

As a result of these processes, the start of the 1980s witnessed the emergence of the reverse trend characterized by efforts to convert some public and social goods into private goods. This process was designed to counteract the excessive expansion of the state and "distortions in the state's functions," as liberal economists put it. While staying away from a theoretical dispute in this area, I would like to point out that some market economy rules and democratic, civic society principles were quite seriously undermined in the process.

Still, an especially prominent trend involved the expansion of state expenditure, which in effect deteriorated into a public debt. Almost everywhere, this debt tended to grow. For example, among the five key market economies in 1998, it ranged from 60 percent for Great Britain to 94 percent for Canada, with the United States reporting 65 percent, Germany, 66 percent, and Japan, 93 percent. At least two questions crop up in this context: What are the limits of public debt, and, in consequence, what effects does it produce for economic effectiveness and freedom? So far, clear theoretical answers to these questions are unavailable. At best, one can look at this problem from the practical perspective, concluding that the costs of growth and the room for maneuver in the economy have both been limited.

As a consequence, the business freedom of individuals has been limited. To an extent, public debt necessitates high taxes. But this problem has been sufficiently highlighted in both economic theory and practice, so let me ignore it here. On the other hand, one trend especially worthy of note in this context involves the excessive influence of the state on the behavior of households and entrepreneurs whose freedom of choice has been restricted. This is one of the important dilemmas of the democratic system. Political equality in a democratic system is expressed by factors such as a more equitable division of incomes, which frequently stands in conflict with the rules of the market. After all, income disparities are an inherent feature of a market economy.

Demand for both pure and impure public goods has substantially contributed to the development of the state enterprise sector. As the continued existence of state-owned enterprises (SOEs) in a market economy has generated mixed reviews, let me highlight three facts. It is beyond doubt that the production of some public goods by SOEs is justified. Even though the proponents of the Public Choice theory have suggested that private businesses would do a better job handling such "production" from the perspective of economic effectiveness, it should be remembered that SOE operations, once under way, have their logic as well. It involves their constant growth, which applies to both already-existing enterprises and newly emerging entities. Paradoxically, this situation undermines various market rules, because SOEs, when they operate in a market economy, differ considerably from private businesses (chiefly because state enterprises benefit from tax breaks, subsidies and various forms of preferential treatment).

Finally, this situation invites a trend whereby central and local government bureaucracy seeks autonomy. It not only performs service functions with regard to the public sector, but pursues its own specific interests. Usually, these interests promote the takeover, legal or semi-legal, of a growing share of funds from the public finance sector.

All these factors have forced developed countries to consider limitations in business activities financed from public funds. Consequently, it should come as no surprise that the past decade has seen a dynamic privatization of SOEs, especially those which operated in areas normally reserved for private businesses. Consequently, market rules are undergoing expansion, not only in countries such as Britain or the United States, but also Germany and France. But this is not the only outcome of the trend whereby public and social goods are converted into private goods. This process is also taking place through a reduction of tax burdens, especially direct taxes. Other developments include changes in social insurance, the health service and the education system.

III

Does all this mean that public sector expenditure will rapidly decrease, accompanied by a reduced range of public goods? Most probably, such a scenario is premature. Instead, a specific regrouping of spending from some public goods in favor of others is inevitable, in my opinion.

Over the past decade or so, economic globalization has led to a situation in which a new group of public goods has emerged: Global Public Goods. Of course, this involves a certain problem with the definition, in addition to a practical problem. How are global public goods supposed to differ from national (general) public goods and local public goods? Will some goods be exclusively transferred to the global economy level or a part of the global economy? Or does the issue involve some other public goods? The theoretical dispute in this area is only beginning. On the one hand, a division has been proposed into pure and impure global public goods, and on the other hand, a classification into final and intermediate global public goods has been offered. A detailed analysis of the problem exceeds the framework of this study. Relevant analyses are available in other studies (including Inge Kaul, Isabelle Grunberg, Marc A. Stern, *Global Public Goods*, New York, Oxford University Press 1999).

While it may be less important in this context what specific areas will be covered by global public goods, one thing is certain: Some of the funds (expenses) originally earmarked for general public goods and local public goods with a national character will be moved to global public goods. This shows that an excessive limitation in the share of global public expenditure in GDP is unlikely.

This does not alter the fact that some of the expenditure on public goods in the national economy is subject to reduction. This is chiefly due to administrative and parliamentarian mechanisms based on economic factors such as limits on moving funds from the private to the public sectors, an excessive debt of the state, reduced economic effectiveness of the public sector, and social resistance in the face of excessive taxation, especially indirect taxes.

IV

So far, the discussion focused on various general issues involving public goods, viewed against the background of developed economies. The basic question in this context is just to what extent the above discussion holds true for transition economies, including Poland. Two different answers—in some respects mutually complementary, but in others quite divergent—can be offered in this area.

The first, general, answer is that the above remarks hold true if the main targets for transition economies are a market economy, democracy and civic society. This is in keeping with the old rule that the developed country model is the ultimate model for the less developed economies.

The other answer is more complicated because, just as society and the entire economy are subject to transition from communism to capitalism, mutual relations between public and market goods are bound to undergo deep changes. It seems that this process is especially complicated because the relationship between public and private goods under transition is burdened with historic factors harking back to communism. Transforming this historic legacy, at least with regard to public goods, is a much more difficult thing to do than creating new, private economy rules from a scratch.

The following discussion will consequently focus on the latter answer, especially as the public vs. private goods model in economically developed countries with democratic systems is subject to the influence of globalization processes. At the same time, it is not really known what model transition economies should actually follow.

V

I would like to begin with a brief presentation of the relationship between public and private goods under communism.

1. The predominant part of the communist economy was in the hands of the state. Characteristically, state-owned enterprises were not businesses in the strict sense of the word, but performed many social functions. In a market economy, such functions normally belong to other institutions governed by different rules of the game. First of all, the distinction between the economic and social spheres was unclear. Second, enterprises were equally responsible for the economic and the social spheres. Third, as a result of an unclear division of ownership powers between the state and the enterprise itself, the state and even party apparatus could force SOEs to handle various tasks that "normal" businesses never performed. Fourth, even though they provided goods and services, SOEs were exempt from normal economic calculations. Most these features of state-owned enterprises also applied to the cooperative sector.
2. With households, there was no real distinction between private goods, which means goods acquired by representatives of households on the quasi-market, for quasi-money, and public or social goods. This was due to several reasons. First, the market was shallow, and consequently the choice was limited, with many goods either rationed (in some countries, this applied to food) or available only for holders of special coupons issued on the basis of arbitrary decisions (examples included cars, television sets, refrigerators and washing machines). On the other hand, many goods were available for free. These included services obtained in kindergartens, company cafeterias, health centers and educational institutions at all levels. Old-age and disability pensions were another example. Even if some separate institutions were available to deal with these matters, they were all controlled by the state and did not perform any independent functions according to clearly defined rules.
3. Many public and social goods enjoyed by the population under communism were in fact a specific compensation for low pay. These goods accounted for about 25 percent of the market value of wages in Poland.
4. The previous political and economic system was actually a contradiction of a full-fledged democracy. Through their representatives, people had no influence on the character and supply of public and social goods, and the same was true of the effective use of funds set aside for this purpose.

The transformation of the public vs. private goods model is bound to bring about a revolution. In the initial phases, this revolution may involve not so much reduced spending on the relevant areas, but a major reshuffling of expenditure. At the same time, in what may be one of the prime factors hampering the entire process, all this is taking place under a specific "transformation crisis." The crisis is characterized by three types of trends. The first trend involves a drop in production, in some countries limited, in others substantial. And contrary to what is frequently argued, the decline does not exclusively apply to "unnecessary production"[1]. The second trend is inflation on a greater or smaller scale. Finally, unemployment follows.

The transformation crisis is a negative consequence of market transition. However, positive processes include the introduction of market rules and the transformation of SOEs into full-fledged businesses. Among other developments, this leads to a situation in which companies begin to get rid of their social functions, liquidating kindergartens, nurseries, vacation centers, schools, health centers and cafeterias. They do so due to their unsatisfactory financial condition, and also because most these social functions were previously imposed on them by the state. Once they secure some measure of independence and begin to follow normal market rules based on economic calculations, they tend to eliminate everything that is not an indispensable attribute of the enterprise. To a large extent, the determination of individual enterprises in this process depends on the strength of the trade unions.

Finally, in an especially important development, a general public finance crisis develops[2]. On the one hand, the possibilities for siphoning funds out of SOEs are limited. On the other hand, a modern tax system does not yet exist or remains inefficient. At the same time, an unregistered, tax-evading segment of the economy begins to grow, at least in the preliminary stage of transition.

The state and its institutions are forced to limit public spending on many areas fitting into the category of public goods, both general and local. These include both goods classified as pure public goods and those which were (are) defined as social goods but which functioned as public goods.

Initially, the strategy of reducing public expenditure is characterized by cutting expenses wherever possible without major public resistance. Spending is usually limited in areas where social and professional groups are less well organized and put up less resistance. As a result, if the overall image of the market economy, with all the limitations of the transition period, is fairly clear (despite the ubiquitous problem of choosing a specific model for it), the supply of public goods features a lack of clarity and conceptual mess, both

[1] This is actually one of the most disputable points: Just what kind of production was unnecessary? At the same time, the assessment system normally followed in market economies may not be applicable in this case.

[2] Admittedly, the public finance crisis was in part provoked by the liquidation of the state's monopoly on some products such as spirits.

quantitatively and qualitatively. This is due to the still-low GDP level, the continued absence of a consolidated market economy and conflicting market economy visions displayed by leading political parties. An important external factor is that societies in transition usually try to copy some developed-country model, when it comes to both market rules and mutual relations between the private and public economies. Naturally, this also applies to the quantitative and qualitative supply of public goods. However, societies in transition often overlook the fact that the model they seek to copy applies to a country with a much higher per capita GDP level (sometimes two and even three times higher). At the same time, the initial stage of transition does not lead to the substitution of limited public goods by increased wages.

VI

Let's take a brief look at the developments in Poland. I would like to highlight three issues in this context: first, the share of public spending in GDP; second, a clear expenditure model, or actually its absence (for public and social goods) from the perspective of its compatibility with the economic model; and third, the policy pursued by public authorities vis-à-vis public and social goods, accompanied by people's attitude to the supply of public and social goods.

1. Public finance sector expenditure in Poland remains high in relation to GDP, with a slight downward trend recently. In 1995, public finance sector expenditure accounted for 46 percent of the country's GDP. By 1999, it shrank to 44.3 percent. However, the figure does not seem to cover items such as designated funds and the expenditure of various non-profit public institutions participating in the "production" of public and social goods. Consequently, for a more precise comparison, I would like to use slightly different measures. The first such measure is the expenditure of the consolidated central sector, without central and local governments and other relevant institutions, in relation to per capita GDP.

   In 1998, the average per capita GDP in the European Union stood at $22,755, while in Poland the figure was $4,023.90, accounting for 17.6 percent of the EU average. On the other hand, the share of consolidated central sector expenditure in the EU stood at 41.24 percent, while Poland reported 38.07 percent. The difference was not substantial considering the gap between the per capita GDP levels. With per capita GDP calculated according to purchasing power parity, Poland accounted for 37–38 percent of the EU average. Among individual EU members in 1999, Poland accounted for 57 percent of the level displayed by Greece, the least developed EU country, and for only 32.4 percent of the figure reported by Denmark, the most developed member state, not including Luxembourg. At the same time, in Greece, the share of consolidated central sector expenditure was only 29.65 percent. Consequently, the absolute consolidated central sector expenditure in Poland stood at 73.3 percent in per capita terms, which means it was more than 16-percent higher than in the case of the per capita GDP level calculated according to purchasing power parity. With this calculation method, spending in Poland was greater than in both the Czech Republic and Hungary.

To a large extent, the above discussion was designed to prove that the relative per capita expenditure of the consolidated budget in Poland is much higher than in both the EU and other Central European economies such as the Czech Republic and Hungary, considering Poland's economic development level measured with per capita GDP.

The above arguments invite two important conclusions. The first conclusion is that the distribution of funds as part of the consolidated central budget leaves much to be desired. For example, education in Poland claims less than in the EU and also less than in countries such as the Czech Republic, Estonia, Hungary and Slovakia. This also applies to spending on the health service, which claims less than in the EU, and only slightly more than in Hungary. On the other hand, wages and salaries in Poland claim only slightly less than in the EU: 4.91 percent for Poland, compared to 5.28 percent for the EU. In the Czech Republic and Hungary, the level is much lower. The second conclusion is that spending is insufficient from the perspective of the supply and quality of public and social goods, and what's more important, these goods fail to reach the most sensitive areas from the perspective of the population's needs and the requirements of development.

2. In the new market economy conditions, the supply of public and social goods must meet the requirements of the nascent democratic system and civic society. The previous command-and-quota system has become anachronistic. Poland has consequently moved away from the old model for spending funds on various public and social purposes. A closer look at the process yields a number of interesting conclusions.

One conclusion is that the preliminary economic reform program, known as the Balcerowicz Plan, was fairly consistent. It ushered in the most essential changes in the economy including liberalization and business freedom. Moreover, the reforms were quite efficient and did not take long to implement, despite criticism from both liberals and various "socially sensitive" circles. However, the Balcerowicz Plan failed to provide a consistent concept for the future social model, especially with regard to public and social goods and the relationship between the public and private goods sectors.

Clearly, such a model could not be offered in the initial stage of transition, or none of the chief architects of transition considered this problem seriously enough. This explanation is not intended as an accusation, yet I would like to point to two key outcomes of this situation.

First, efforts to adapt both social policy and the supply and quality of public goods took place on an ad hoc basis, under the influence of various social threats and the state's financial limitations. Under the inconsistent public and social goods system, pressure from some social and professional groups provoked a spontaneous transfer of funds from one area to another. At the same time, these shifts were not carried out from the perspective of the optimal use of funds held by the state and its agencies with a view to spur development, but took into account the strength and efficiency of the strongest pressure groups, institutions and large SOEs.

Second, political parties with varying political and social preferences have been in power in Poland over the past 11 years. Their operations in the public and social spheres have been influenced by various challenges, day-to-day threats and pressure groups. In connection with this, no internally consistent model has emerged to regulate mutual relations between the public and private spheres. This has provoked many dangerous social tensions with varying intensity.

Consequently, no clear and precise model is available that could be considered the ultimate model. Some experts call for a social market economy, others favor a liberal model. However, neither option enjoys a sufficient substantive or theoretical background. The principle of subsidiarity, so important for modern market economies, has been lost along the way.

3. No major revolution has occurred at the level of general expenditure on public and social goods. However, the structure of social spending has displayed profound changes.

   First, the share of social expenditure in the overall public sector spending increased from 25.2 percent of GDP in 1990 to 31.2 percent in 1998. Second, far-reaching changes have occurred in the structure of expenditure. Money transfers and social services, especially those involving old-age and disability pensions, have increased. In 1990, they accounted for 8.6 percent of GDP, while in 1998 the figure was 14.1 percent. Third, in the education system and the health service, the two important areas offering both public and private goods provided by the state, the share of spending remained at a fairly stable level over the nine years: In 1990, its share in GDP stood at 10.6 percent, and in 1998 it accounted for 9.9 percent of GDP. Fourth, in several areas, the share of social expenditure increased and decreased alternately. These included family policy, the labor market and social welfare. Of course, there were also areas in which public spending decreased continually. One example was science.

   Just as the very process of transition, the new public and social goods model has been subject to major fluctuations. This is due to several important factors. First, the public sphere took time to institutionalize, and, as I have said, no single model enjoyed the unanimous approval of leading political forces. Second, trade unions have played a special role in the institutionalization of social dialogue. In Poland, trade unions play a vital political role, which is hardly conducive to the speedy emergence of a viable public goods model meeting the state's financial capabilities.

Still, as it develops, the new model involves the constant transformation of public and social goods into private goods. This is especially evident in two important areas: education, especially at university level, and the health service.

Unfortunately, these changes have had an unfavorable social effect after more than a decade of transition. Many people are critical of the new rules, and many others do not fully accept them. This is due to several factors.

First of all, the changes have been too fast, considering society's adaptability. Evidently, market-oriented adaptation in the social sphere takes longer than in the economy. Changes in public awareness are slower than transformations in the economy.

The progressive diversification of Polish society is another factor hampering the crystallization of the new division into public-and-social and private goods. Regardless of whether the division into the winners and losers of transition is theoretically justified, the economic status of a large section of society has deteriorated as a result of economic reforms. People's access to basic public and social goods has been restricted considerably. Deep regional differences compound these problems.

Finally, as the economy opens itself to the world and democracy develops, Polish businesses and institutions seek to follow EU models, inspired by the wide coverage of Poland's membership aspirations in the media.

VII

To summarize the above discussion, let me recapitulate its basic points.

1. Poland is still at a preliminary stage in its efforts to develop a consistent model for public-and-social and private goods. This also applies to theoretical solutions in the area. Admittedly, some experts doubt if an internally consistent model is possible in this area at all.
2. The adopted orientation of transition, at least judging by the latest reforms, calls for a wide-ranging transformation of public-and-social goods into private goods. This is taking place in a situation in which quasi-communist mentality remains relatively strong in Poland, and the majority of the population displays unsatisfactory financial status.
3. Poland's strategic goal to secure membership in the EU calls for efforts to adopt the EU model for public and private goods. However, a simple transfer of the EU model to Poland is impossible for at least two reasons. First, the EU model, which actually varies from one member country to the next, took decades to develop in much better economic conditions. Second, the model is increasingly criticized, and the direction of its future evolution remains unclear. Moreover, individual EU countries continue to display considerable differences. Consequently, any shared solutions in this area may only be possible after these countries develop a common or at least similar economic model.