Functioning of the Market and Regulatory Measures Taken by the Government[1]

By Peter Gonda

„Unlike the private property market, the model concerning only public goods and services does not contain any of the features leading to effectiveness. The costs related to any agreement or transaction are much higher because there is a higher number of people who must be involved in business or exchange.“

J. M. Buchanan

A high living standard and as high as possible extent of personal freedom and responsibility of citizens presumes a functioning market i.e. an unlimited voluntary exchange of goods and services among those who sell and those who buy. Another requirement to be met in order to achieve this is to have a government whose purposeful functioning will solve the problems that cannot by solved by the market. [2] Therefore every government should create and observe the rules related to the rights and obligations of players on the market and in society, but it should not directly regulate the market alone.[3]

A qualitative change after 1990 has not brought any significantly faster movement towards this desirable situation.[4]

The most absurd features of "real socialism", especially central planning and government regulated personal economic decisions, do not exist any more. The basic preconditions for market oriented relations have already been created – private

[1] The term „government“ is in this chapter used as a synonym for „general governement“or for „public finance administration“. In Slovak terms it involves budgetary organisations funded from the state budget, allowance organisations also linked to the state budget, special-purpose state funds (that are gradually being eradicated and blended into the state budget), privatisation funds (the National Property Fund and the Slovak Land Fund), Slovenská konsolidačná a.s., social security funds (the Social Insurance Company, the National Labour Bureau and health insurance companies), regional and municipal governments and public universities. At present these are the institutions and organisations most often hidden under the term „state“.

[2] More than 200 years ago Adam Smith defined these governmental tasks. He outlined three governmental functions: its duty to protect the public from violence and invasion of hostile societies (by means of the army and the police), the duty to protect all of society´s member from injustice and oppression, which in other words means stipulation of precise ways of justice enforcement (by means of judiciary and laws clearly defining „game rules “ on the market) and the duty to establish and maintain certain public institutions that can never be an object of interest of any individual or small group of individuals, because yields of these instutions will never sufficiently cover expenses of an individual or a small group although they are beneficial to society as a whole.
M.Friedman defined the fourth task of the government: the duty to protect those society members who cannot be considered to be sui iuris including children. (See Friedman – Friedman, 1992).

[3] An important governmental task is to guarantee rules and preconditions for property protection and protection of funadmental human rights and freedoms. This chapter does not focus on the issues related to protection of human rights and freedom in detail.

[4] Of course, no country is in a perfect situation having an ideally functioning market and government that regulates economic and social processes only there where it is supposed to do so. One example of such a country close to this ideal was Hong Kong when under the administration of Great Britain. (See Friedman – Friedman, 1992).

property prevails, prices reflect quality and value of services rendered, and consumers have the option.[5]

But these systemic changes do not suffice. Various forms of regulation and restriction deforming competitive environment last. Not all the prices on the market have been freed up, although the elections in October 2002 meant a notable improvement.

The goods and services market and partially also some other markets remain deformed by subsidies and other selective measures taken in favour of certain enterprises.

Interventions of the National Bank of Slovakia greatly modify financial markets, but mainly the foreign currency market.[6] Regulations and barriers on the labour market including centrally regulated wages have a negative impact on overall performance and the competitive ability of Slovak economic subjects.[7]

The high level of regulation on respective markets and restriction of a competitive environment in Slovakia result from undue activity and involvement of the government in the economy. Not only does the government still administrate a great volume of funds, but they also carry out direct intervention into the entrepreneurial environment by use of public finance. [8]

This fact is evidenced by a high share of public spending on the economy (in 2002 it reached almost 13 %) on general government consolidated spending (Diagram No. 1)

[5] Which is at variance with the period 1948-1989 where the economy featured only state companies, prices were deformed to a great extent (e.g subsidized prices of food) and a shortage (or limited availability) of low quality goods and services were a common case.

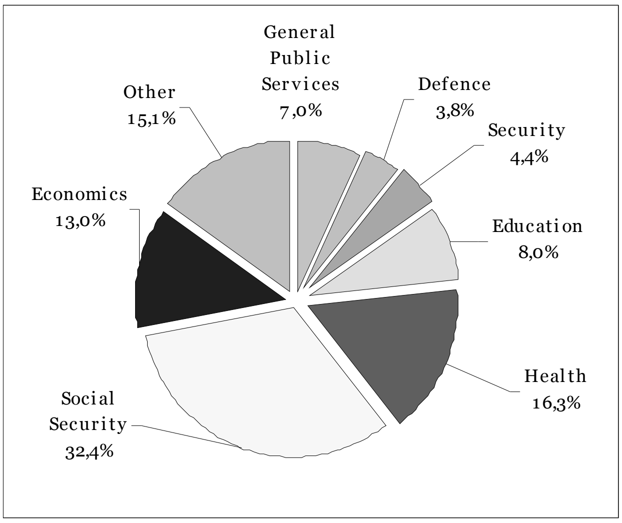
[6] Moreover, in Slovakia, the exchange rate (as currency price) was directly modulated by use of fixed determination until October 1998.

[7] You will find more details in the chapter Labor market, employment availability and employment rate.

[8] Permanent non-market failures that occur have many more negative impacts on the economy than the market failures because these have natural correcting and balancing mechanisms.

Diagram No. 1: Structure of general government consolidated expenditures in 2002

– breakdown by purpose



Note: The total share of respective types of expenditure are based on data provided by the Ministry of Finance of the SR and comply with the IMF methodology.

Source: Ministry of Finance of the SR, authors´ calculations.

A higher proportion of public spending on market activities (especially on subsidies to agriculture and transport) as well as on basic government functions (e.g. external defence and public security combined) give evidence of an excessive government intervention on the market. On the other hand, these facts prove that the government does not pay necessary attention to the administration of public possessions.

Citizens continue relying on the government´s decisions and power, they have a distorted view of its tasks within the economy and society, they do not trust individual (economic) freedom and enterprise. Apart from that, they do not believe that it is possible to succeed in the market by the observance of moral values. The system of a relative "social comfort" does not create any pressure for the pursuance of personal responsibility. Moreover, lasting "soft financial restrictions" imposed on companies,[9] result in „the survival of sick areas".

What Slovakia lacks the most at present is a systemic solution to key problems – starting with the non-existence of any market oriented government strategy for economic development, through extensive and inefficient general government to non-transparent and diverse game rules in business.

The consequences are fatal: mutually interconnected economic and social reforms are not being implemented. The scope and extent of government interventions on the market are chosen intuitively (ad hoc) and usually hard to substantiate in the medium-term. There has not been any serious debate on specific tasks which the

[9] „Soft financial restrictions" are characterized by a missing direct relation between obtaining resources and their effective use, in the period of „real socialism" this was partially replaced by party supervision. After the removal of communist management control in 1989, the softening of financial restrictions started showing up in the increasingly immoral behaviour e.g. in so called „tunneling" of companies.

government has to (and is able to) fulfil and to what extent it should guarantee social solidarity.

Excessive, centralised and inefficient general government and its regulatory actions therefore remain a key problem for the Slovak economy. It is a result of the following "sub-problems":

- too high level of redistribution (through public spending) and notable governmental (general government) interventions on the market
- high level of public finance management centralization
- significant tax and contribution burden imposed on entrepreneurial subjects,[10]
- year-on-year deficit in public finance followed by growth of public debt.

Every year general government disburses almost one half of the sources created in the economy of Slovakia and thus limits and substitutes other economic subjects. The redistribution of centrally administrated finance contributes to citizens´ extensive reliance on the government. A high level of public finance management centralization keeps citizens well away from public finance control. This significantly prolongs "the acceptance of a citizens reliance on outside sources".[11] In Slovakia, the general government interferes in the entrepreneurial environment substantially and negatively. The market conditions change also due to a high volume of subsidies provided to the agricultural sector every year. Subsidies selectively favouring some subjects demotivate other – mostly prosperous – subjects. They deform the competitive environment, deaden entrepreneurial activities and put subjects´ decision making under pressure making it thus ineffective.

Relatively high taxes and especially excessively high social security contributions are a consequence of the need to finance high volume public spending and they are to be born by economic subjects causing an increase in their expenses. [12] Particularly income tax is one of the tools by the use of which general government pumps out potentially free financial resources from firms and citizens. It means an indirect hindering of the increase in private savings, investments and thereby also a suppression of productivity of the labour market dynamics.

Issues related to a lack of finance available in the entrepreneurial sphere and for citizens are deepened by a considerable need to finance a year-on-year increasing deficit of general government. An increase in public debt followed by an increase in interest rates and other problems related to general government management (a need to cover a substantial amount of deficit in general government funding) represents direct consequences. Respective governments therefore "pass" current problems in public finance to the future. They submit "an unsettled bill" that will be made even higher by the interest to future tax payers.

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[10] High taxation, not only in Slovakia but in other candidate countries too, is considered to be one of the major economic problems (Robert Mundell, holder of the Nobel Prize). Problems of the candidate countries result from over regulation – small space for market change - low motivation for investment and job creation. It calls for a version of „supply side" revolution in the U.S.A. started by president Ronald Reagan (Mundell, 2001)

[11] More in the chapter: Character of the state and general government.

[12] First of all, social security contribution rates (in Slovakia they include rates of old age pension, health insurance, sickness insurance and unemployment insurance contributions) reach 50,8 % of the computation base and are excessively high, the highest among the OECD countries (year 2002).

Another substantial problem of the Slovak economy is hidden in the ambiguous and unequal rules of market competition (as regards entering the market, conduct of business and leaving the market). Various forms of imperfect competition (e.g. telecommunication and cable TV) and insufficient ensuring of control are great barriers to entering the market.

New subjects, in order to enter the market, have to tackle a low motivated entrepreneurial environment. The process of establishing a new subject is protracted and administratively demanding. It is a hindrance especially for small and medium enterprises as well as for foreign subjects. Long land register registration periods for foreign subjects (caused by registration procrastination, frequent changes of ownership and right of use of respective estates), multi-ownership very often accompanied by unsettled ownership rights are substantial obstacles to enterprise in Slovakia.

Despite positive changes in the Commercial law provisions, the conditions for establishing firms, especially small ones, remain complicated. First of all, there are still too many lengthy procedures which must be completed before registration with the trade register.

Tightened requirements as regards licence, permission to conduct business, compulsory certification and other administrative barriers represent major obstacles to entering the market. Also sole traders have to face certain limitation when trying to open a business despite slight improvements introduced by the latest amendment to the Trade Act.

But the trade rules do not affect everybody the same way. This situation is a result of legal opportunities to grant dispensations and enforcement of several selective tools (subsidies, tax relief and tax holiday, and provision of governmental guarantees or special benefits for some investors). The unbalanced support for big companies preserves a long running inequality of opportunity for market players.

Favouritism by the government controlled financial and non-financial companies, or other subjects linked with the political sphere (the drastic case of Devín Bank) used to be and still is a specific issue. On the other hand, smaller companies representing a perspective, dynamic and flexible part of the economy are penalised to certain extent e.g. by limited access to resources and an excessive contribution burden.

Insufficient protection of minority shareholders preventing further development of the capital market poses one more problem. The negative impacts of inequality of opportunity, and the obligation to withdraw from the market in the case of failure, are furthermore strengthened by the supervising authorities (supervision over the capital market and banks).

But the critical problem affecting mainly small and medium enterprises to a great extent is the very low law enforceability– i.e. a malfunctioning legal system of claims and contractual obligation enforcement.

The problem is made even worse by enormous delays in court proceedings, non adherence to legal schedules in some offices and corruption in the judiciary. Bankruptcy process takes several months and often might take years, during which period the defaulter's property either gets depreciated or looted. Very often the rights of creditors suffer. Extrajudicial compensations do not work to the extent needed when it comes to enforcement of own rights and contractual obligations in a friendly way and/or extrajudicial settlement of disputes. An insufficient implementation and non-functioning of right of lien represents also a serious problem.

From problems to a prognosis

Economic development will be markedly influenced by a willingness and ability of respective relevant subjects (the government, enterprise and others) to adopt a long term market oriented strategy of qualitative change in the economy and society.

A definition and respect towards competencies and responsibilities of both the government and the market (a "market-state" mix) and their affiliation to a civic society ("market – state – civic society mix) will play a substantial role.

A change leading to a clearly defined division of responsibilities and tasks among respective subjects within society will have an impact on the future economic development as well. [13]

The character of this unambiguous strategy will represent an important framework for economic and social reforms. At the same time the strategy will determine a scale of getting closer to a market with transparent rules, ownership rights (based on contracts) and equal chances, it will decide the extent of the influence Slovakia might have on potential systemic changes in the EU.

The most likely to happen scenario assumes that in the near future political parties, civic associations and other subjects will submit various strategies of Slovakia's orientation but an outline idea of similar market strategy will not be generally accepted. The resistance of several interest groups e.g. the unions (although they will partially lose influence when compared to their position today) will certainly be the reason for it. Also some political parties and many citizens will not be able to identify themselves with the idea of necessity to restrict the government's role in the economy and society.

It will not be Slovakia who will present more reforming proposals to the European Union and what is more, the European Union will experience deepening of "euro-tendencies', centralization, regulatory measures and bureaucracy. These tendencies will be slowed down by growing back-pressure from "inside" (the Conservatives and the Liberals) and "outside" competition.

Slovak governments will probably fail to reduce the excessive weight of public finance in the economy. Despite that, a lower share of general government spending on GDP is expected in the medium-term period compared to the present situation. It might be a consequence of the partial decrease in subsidies and of a certain decrease in public spending in the social sphere. Some subsidies, e.g. to agriculture, will be preserved which will comply with an ineffective agricultural subsidy policy (although partially reduced) in the EU.

A reduction in general government spending in the social sphere and better addressed distribution will not economically suffice in the following years (not even in further ahead).

A low level of social reform penetration will probably be connected with a low level of the government's willingness to lower the scale of redistribution through public spending and to reduce the degree of compulsory social solidarity.

[13] One of the key changes in the economy could be brought by the abolishment of tripartity.

Despite that, gaps between work related incomes and social help benefits for citizens will get markedly bigger, and this will help to decrease the number of socially trapped people.

A further shifting of legal limits in the social sphere (e.g. subsistence minimum) – caused also by pressure posed by EU standards – will certainly hinder reforms in the social help system.

The creation of conditions for private old age saving will be knotty also thanks to resistance by several groups (e.g. the unions) and distrust of citizens. The integration of Slovakia to the European Union that will bring negative real interest rates and devaluation of savings in the long run will only contribute to it.

Financial flows in the school and health systems will become more transparent and effective, at least partially, after putting more importance on direct payments from citizens (compared to current payments through public spending redistribution mechanisms).

A certain reduction in public spending will be followed by a reduction in total tax and the contributory burden of economic subjects especially thanks to a further income tax decrease.

The expected improved economy of general government might lead to gradual cuts in deficit, but a balanced budget is beyond sight in the distance. The transfer of part of the public finance management onto municipal and regional governments will occur as a result of lengthy and problematic negotiations reflecting politically different opinions, although it will not reach the extent needed.

We expect a more consistent solution to the problem of unclear and varying game rules in enterprise. The legislative barriers to entering the market on equal terms will be reduced due to the application of rules valid in the European Union. But we cannot assume that the influence of various forms of imperfect competition will be minimized more significantly despite a higher number of bigger foreign companies entering the Slovak market. Various forms of regulation of the market and selective "support" for entrepreneurial subjects will probably be partially removed and standard protection of minority shareholders will reach a higher level.

The capital market, even in the long run, will not develop to an adequate extent and will fall not only behind western capital markets but also behind Hungarian and Polish markets for instance, and thus limit further development of entrepreneurial activities. Also insufficient law enforceability will remain a problem and persistent corruption in the judiciary will be linked with a continuous wide acceptance of poor judgment.[14]

But the scenario of unfavourable development might become a reality if domestic subjects remain passive expecting outside solutions to their problems and if, at the same time, unification, centralism and bureaucracy in the EU prevail.

In case of such developments the government will not implement unpopular but needed economic reforms.

Passivity, rebuttal for carrying on business and assuming risks on one hand and dependency on social benefits on the other hand will deepen. Corruption and protectionism will continue to spread. Many economic subjects will passively wait for help from the European Union. The European Union is expected to harmonize tax

[14] More details in the chapter Overall economic performance and competitiveness.

systems including respective tax rates within two decades. This will cause averaging and the elimination of competition for new investments among governments and even an increase in subjects' tax burden. There is a real risk of the establishment of a European federal state and this could result in national and social commotion as well as in the EU countries' falling behind (including Slovakia) other countries outside the Union.

Meeting many demanding criteria could, on the contrary, lead to the creation of systemic preconditions for a functioning market and effective government actions in Slovakia within approximately two decades.[15] It will be possible to significantly decrease the extent of redistribution through public finance. The share of public finance on GDP will be notably lower than it is today. Expenditures related to the government's meeting of its fundamental tasks will prevail in the share structure. Subsidies and loan guarantees provided by the state will go down, though it is not probable that they will be eliminated totally. General government spending will be cut too because several institutions administering public finance will be closed and others contoured economically which also means a decrease in the numbers of their employees. Public spending on social transfers will be cut. But any more significant development will be limited by foreseen compensation (especially as regards pensions, health and school system reforms), although all these reforms will feature dominant private pillars and principles of personal responsibility.

Tax and contribution burden for economic subjects will decrease substantially and, at the same time, public finance management will become balanced. The market principles will be less deformed by various regulations and market liberalisation will step forward also due to the European Union's conditions. But we can hardly expect any more fundamental elimination of imperfect competition impacts and practical problems related to law enforceability in the near future.

A significant improvement in general government administration, a decrease in the extent of its interventions to the "real" economy and the creation of transparent market rules will be major preconditions for a sustainable economic performance in Slovakia.

A substantial decrease in the importance of general government in the economy followed by significant cuts in tax and contribution burden will allow a major part of the economy created resources in the private sphere to remain.

The growth of available financial means will lead to a rise in private savings, investments and the creation of new jobs. The transfer of a substantial portion of the financial funds from the economic centre to private hands will support the extension of economic freedom and personal responsibility.

A limited role of the government in the economy, reduction in restrictions on the market and more transparent enterprise rules may lead to corruption diminution. But we do not anticipate any more fundamental solutions to the problems related to corruption and generally low morals.[16]

A long-term, market orientation and a consistently implemented strategy for the economy and social direction represents the foundations for this desirable development. Specific measures should be targeted at the following key goals:

[15] Being realistic, the authors do not consider this scenario to be likely.

[16] You will find more details in the chapter Aggregate economic performance and competitive ability

A notable limitation of the government's (general government) role and extent of redistribution in the economy will be accompanied by rationalisation and decentralisation.

Significant cuts in the "size" of general government should be in compliance with target principles regarding the fulfilment of the general government's main tasks in the market economy.

The general government should be substantially more economical and decentralised. Simultaneously, it should be more effective and stronger when it comes to the activities that it is supposed to be dealing with (e.g. judiciary).

Reduction in the extent of the general government's activities and a limitation to its interventions in the economy will require as high a possible share of private property. To provide this, the state should sell its remaining shares in companies and other economic subjects.

At the same time, it will be important to take measures on both spending and revenues as well as on public finance administration and economy. As regards spending it will be necessary:

- to diminish, to a maximum extent, the government's interventions into the entrepreneurial environment and, first of all, cancel subsidies (and try to achieve the same as on the European Union level) [17] as well as stop providing loan guarantees;
- to lower and economize spending on general government's consumption, i.e. labour costs – decrease in the amount of wages and in the number of employees, cuts on costs for purchase of goods and services;
- to reduce costs of social transfers by their more precise addressing and by putting more weight on private pillars (within the framework of social reform).

With respect to taxes and contributions it will be necessary:

- to reduce tax and the contributions burden especially for legal entities and natural persons as well as social security contributions;
- to shorten depreciation periods and increase depreciation rates;
- to simplify the tax system and make it more transparent while paying special attention to its selective tools – in the 2003 tax reform concept the government pledges to promote it on a large scale.

In order to achieve economic public finance administration it will be necessary:

- to make efforts to reach a balanced public finance budget (a deficit may occur only if there are unforeseen outside impacts, e.g. pension system reform related expenditures)
- to stop growth of public debt and start its reduction (primarily with respect to GDP);
- to decentralize general government (including transfer of tax revenues to local governments).

[17] It is not likely that the EU will succeed in the total elimination of subsidies to agriculture within two decades (see the most likely scenario).

A definition and liability for cohesive and transparent game rules on the market (e.g. the cancellation of subsidies, loan guarantees and licensing to a maximum extent) will directly improve market conditions as well as the conditions for conducting business. But this will not suffice alone. Transparency and cohesiveness of set legislated game rules and equality of opportunities on the market require:

- simple, unified and clear criteria for entering the market;
- minimisation of various forms of imperfect competition (monopolies, oligopoly and other dominant players);
- marked limitation of regulation scale (regulations, measures, etc.) as regards the market and especially the labour market;
- elaboration of legislation which will ensure law enforceability including effectively functioning judiciary and right of lien on movable assets
- provision of unquestionable protection of rights of investors, creditors and minority shareholders;
- strengthening of unambiguous criteria for leaving the market if a subject fails.

This might arouse aversion in a considerable number of citizens particularly in those who are not able to adjust to competitive pressure on the labour market. An unemployment increase and in the number of people who face difficulties finding a job threaten radicalism and a spread of social unrest. Also some other groups of people will not want to give up their social security. So, the risk that voters will elect a government with less consistent but more popular attitudes is quite high. The European Union may as well put great pressure on the correction of the above measures, especially when it comes to a more remarkable decrease in taxes which is exactly the case of Ireland at present. The European Union efforts to integrate the countries of “the old continent” not only with respect to currency but taxes too, might strengthen regulatory activities of more centralised institutions and, at the same time, cause an increase in tax and contribution burdens for citizens.

Therefore the promotion of consistent stances in the environment of “the stronger” will call for co-ordination with pro-reform “feeling” member states (e.g. Ireland, Great Britain, Finland and partially also Portugal) and some candidate countries (e.g. Estonia and Hungary)

But this will not be enough. It will be necessary to persuade citizens in the countries with more deeply embedded social state pseudo traditions. The scale of possible influence targeted at “non-socialisation” and “non-bureaucratic” will depend not only on the formulation and respect towards similar strategies, economic reforms and an ability to implement them but also on a willingness of other countries (particularly Germany and France) to implement parallel reforms. Several constitutional guarantees should serve the purpose and help to secure a desirable long-term development.

The Slovak constitution, which might be amended after the completion of a major part of the structural reforms, should therefore contain safety measures allowing for the maintenance of balanced public finance administration, (the only exceptions are unforeseen reform impacts, particularly pension reform), a limitation of year-on-year growth of public spending and a limitation of tax rate increases.

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