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The Role of the State in the Modern Economic System

As a number of scholars have pointed out, the transition to a new paradigm of economic science requires rethinking many concepts that have been affirmed in economic science.[1] We would like to focus attention on such an important sphere of research as the economic activity of the state,[2] even though its functions have been studied rather closely in different areas of research.

According to the commonly accepted view, the state's activity is not an internal component of the market economy, but supplements it; in other words, the state is "destined" to address economic problems that the market cannot resolve, as a result of which the economic activity of the state is a forced supplement to it. Such an approach in objective measure inheres in both principal modern economic currents—the neo-classical and neo-Keynesian schools,[3] whose views differ from one another by virtue of their attitude toward the level, forms, and methods of state intervention in the economy.

The goal of the proposed article is to substantiate the fact that the state's economic activity in reality is an internal, immanent part of the market. Based on such a formulation of the question, we can take a fundamentally different approach to the problem of forms and methods of state economic activity, in which for all practical purposes they do not differ in any way from the forms and methods of activity of other economic agents. This in turn requires rethinking the commonly ac-

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cepted view of the market and the role of the state in the market system.

The commonly accepted view of the market, and the state and the results of the functioning of the state sector

Theory makes a distinction between two types of market: a free market and a real (or operational) market.

Generalizing that which is contained in modern world economic literature, the characteristics of a free market can be formulated in concentrated form as follows:[4]

—the absolutely free access of buyers and sellers to the market and the same freedom to withdraw from the market, which is the equivalent of an unlimited number of competitors;

—the absolute mobility of all types of resources (labor, material, financial, etc.);

—the availability of the full amount of market information (on supply and demand, on prices, etc.) to every competitor;

—the absolute homogeneity and indistinguishability of same-name products (the absence of trademarks and any individual quality features of a product);

—the impossibility of any competitor influencing decisions made by other participants.

The fundamental principle in the above economic system is "laissez-faire" ("let it be"), as a result of which interrelations between entrepreneurs, between entrepreneurs and customers, and the movement of private and social interests are controlled by Adam Smith's "invisible hand."

As we know, such a "sterile" economy, with these features, has never existed anywhere in the world and in principle could not exist; the free market, as an absolute competitive space, is an abstraction, a theoretical construct necessary for the scientific study of market regularities as such. At best, the free market can only be a fragment of the real market.

But even if we assume that a market with such features exists somewhere, not all economic problems can be resolved by the "invisible hand." There are in particular three: the elimination of external effects, the production of public (and also many quasi-public) goods, and providing the economy with the necessary amount of money.[5]

It is the task of the state sector to resolve all three economic problems.

Since the free market is only a theoretical construct, in addition to these problems, the state sector will be compelled to eliminate barriers to free competition. These include the elimination of internalities (asymmetrical information) and the elimination of the advantages of individual competitors that are a barrier to the free transfer of capital.[6] The state's basic task here is to create a legal base and social atmosphere for maintaining and facilitating the functioning of the market system, to redistribute income and wealth, and to stabilize the economy.[7]

Problems addressed by the state sector also include a number of others in addition to those enumerated above, in particular: preventing the propagation of undesirable effects through the chain of interrelationships of different economic units and sectors of the economy; regulating economic interrelations with different countries in order to stabilize long-term development; resolving economic contradictions among groups of people, groups of firms, and various social formations; and directly managing the economy in emergency situations (during wartime, for example).[8] Special programs are created to solve these problems; a special place among these programs is occupied by programs for the development of the entire national economy that unifies all its sectors.[9] Adam Smith's "invisible hand" is thus replaced by the "visible hand."[10] Personal and corporate taxes also become a basic instrument here (this issue will be examined below).

The inability of the market to solve these problems qualifies as a "market fiasco." The state's desire to help the market does not always attain its goal: as the scale of the state sector grows, it begins to develop its own internal decision-making logic[11] (social selection theory studies these problems). The internal logic of state behavior (expressed, for example, in lobbying or logrolling) unfortunately leads not so much to the elimination of a "market fiasco" as to the intensification of the latter, which qualifies as a "government fiasco"[12] (more precisely "state fiasco").

Here, to all appearances, it is appropriate to return to the examination of the terminological question that was posed at the beginning of this work: the question of the legitimacy of using the term "state" instead of the term "government" that is often used in Western economic literature. It is easy to see that almost all the problems that the state sector must address go beyond the jurisdiction of the executive branch, requiring the participation of the legislative and, in some cases, the judiciary branches as well. For example, other things being equal, it is impossible to attain the legal base and social atmosphere needed for one market to function effectively without the intervention of the judicial branch.

Consequently, the government as an executive branch is not capable of "personally" resolving in full measure all the questions posed by the market system. It can therefore be considered more correct to say "state" instead of "government" when discussing the system's functioning.

In the analysis of commonly accepted views of the economic role of the state, the state sector's production of public and quasi-public goods was noted as being one of the principal tasks. It is evidently easy to show that the solution of any problem connected with ensuring the functioning of the market system is in turn also the production of public and quasi-public goods by the state sector. Let us examine this question in greater detail.

Economic goods are classified in two groups according to the nature of consumption. The first includes goods that are consumed individually.

These are divisible to such a degree that they can be accessible to individual consumers. The most important point is that these goods are subordinate to the action of the so-called exclusion principle, according to which another [second] consumer may not enjoy the given goods free of charge. Moreover, these goods are competitive because the marginal production costs of a larger volume of goods are positive. These goods form a group under the name of private goods or individual consumer goods.[13] As a counterweight to private goods, there are goods that are noncompetitive and nonexclusive, that is, public goods.[14]

The reason that public goods are noncompetitive is that at any set level of production, marginal costs for an additional consumer equal zero. They are nonexclusive because people cannot be excluded from the sphere in which a given good is consumed. Public goods are by their nature indivisible.

In addition to private and public goods, there are goods that by their nature cannot directly belong to either group in the strict sense; they are intermediate between private and public goods. For instance, such goods will be either exclusive but noncompetitive or nonexclusive but competitive.

Notwithstanding the rigor of R. Pindyck's and D. Rubinfeld's definition of public goods as noncompetitive and nonexclusive, public goods can be either competitive or exclusive, or both at the same time.[15] It would be more correct to call the last private goods. But among them, there are the kinds of goods (unlike other private goods) that the private sector cannot produce in the proper volume. This is connected with the presence of side or outside (external) effects. Among these goods, we can name, for example, education, municipal economy, highways, the police, fire department, libraries, museums, medical care, and so forth; even though they are not public goods, because of the existence of significant outside effects, their production cannot be secured in proper volume by the private sector; it is therefore necessary for the state sector to produce (or finance) the shortfall of these goods.

Economic goods that are not by their nature public goods, but in the production (or financing) of which the state sector takes an active part, belong to the group of quasi-public (quasi-state) goods. This group of goods should evidently also include those goods (private by their nature) in whose production the effect of scale is important, where the lowest costs per unit of output and the lowest prices are attained with large-scale activity (natural monopoly). As a result, production of such goods can become virtually the total prerogative of the state sector. These goods are produced by public utilities, as exemplified by electric, water, and gas supplies, the telephone service, and so forth.

Following the cited definitions of public and quasi-public goods, we can easily become convinced that the result of state economic activity, which aims to smooth over shortcomings in the market system, is the production of these very goods and nothing more.

Social protection grants [*posobiia sotsial'noi zashchity*] created through the redistribution of incomes and wealth require special scrutiny. This is because the literature refers to transfer payments for this purpose as unproductive transactions.[16]

A market mechanism (just as a nonmarket mechanism, as M. and R. Friedman have properly noted)[17] can generate a great inequality in property, which is the result of the income distribution mechanism: owners of large capital and land; workers who are highly paid (because of the rarity of their labor); and people who have large inheritances and a high income level. However, society also includes people (the aged, the unemployed, etc.) whose incomes within the framework of the market system are either very small or altogether nonexistent. The state pays grants to everyone in need of social protection through transfer payments based on taxes.

The above-mentioned actions of the state under conditions of the market system are by no means motivated by the necessity of attaining equality of incomes (which is the essence of the egalitarianism concept)[18] or of realizing other socialist goals (the bankruptcy of the socialist conception has been proven not only theoretically), but by the striving to secure social tranquility by reducing unequal incomes.

The social tranquility that is achieved from supporting low-income population strata can be called an egalitarian good. It is based on the development of social insurance and social security, unemployment benefits and benefits for war veterans, a state program for free medical care, state housing construction, and the like.

Since an egalitarian good is created with the aid of transfer payments, it is natural to recognize their productive character.

It must also be emphasized that in addition to producing public and quasi-public goods, the state sector in many countries of the world also includes the kinds of enterprises that (along with the private sector) produce private goods. Unlike public and quasi-public goods, the nature of production of private goods (undertaken by the state or private sector) does not change. Therefore when we speak of the results of the functioning of the state sector, the production of public and quasi-public goods (which the private sector cannot produce at all or cannot produce in sufficient quantity) will be the exclusive focus of our study.

Factors of production and the state's economic ability

Movement toward a new paradigm of economic science also requires rethinking the traditional factors of production.

Economists of all schools (with the exception of the Marxists) today agree that income from the realization of a good breaks down into the four factors that create this income. They are generally recognized to be the following (they are also called economic resources): land, capital, labor, and entrepreneurial ability. The first two are included in material resources and the second two are included in human resources. Each factor of production brings income to its owner, which is broken down into income from the realization of the product: rent, interest, wages, and entrepreneurial profit.

In addition to the enumerated factor incomes, earnings from the realization of a good carry with it depreciation and indirect business taxes (general sales tax, excise taxes, property taxes, license payments, and customs duties). The literature calls the latter unearned state income,[19] and this in turn partly calls into question the integrity of the theory of factors of production, which divides the price of a good into income-producing factors: there arises a type of income (indirect business taxes) that does not have an economic basis. In order to overcome this contradiction, we must answer the question: have all factors of production and the corresponding incomes been taken into account?

To all appearances, the answer to this question would be in the affirmative, if all interrelations among economic agents were determined on the basis of the "laissez-faire" principle, characteristic of the free market and of pure competition, and in the absence of state economic activity. In reality, however, this is how matters stand.

If an entrepreneur undertakes the initiative to include land, capital, and labor in the unified production of a good or [performance of a] service, the state undertakes the initiative of regulating the given entrepreneurial activity within the framework of the national economy. If an entrepreneur organizes the production of a certain good or service, then the state organizes the production of the entire mass of goods and services within the framework of the national economy. If an entrepreneur makes decisions (uses innovations, assumes risks in the process of running his own business), the state makes decisions on the main avenues of developing the entire national economy, uses innovations, and assumes risks in its own economic policy.

Much in the development of the modern economy and business depends on which political forces are in power within the state. For example, the assumption of power by conservatives in the United States and Great Britain in the late 1970s and early 1980s promoted the growth of economic activity in those countries, while seventy years of communist rule in the former USSR doomed the market to a predominantly underground existence and brought the country to a state of deepest crisis.

It can thus be concluded that the economic ability of the state is the fifth factor of production.

Notwithstanding the cited parallels, the similarity between entrepreneurial ability and the economic ability of the state is purely external; but internally there is a fundamental difference between them.

The entrepreneur deals both with material resources (land, capital) and with human (labor) resources, which he unites in a single production process; the state, however, primarily unites human resources—entrepreneurs—within the framework of the entire national economy.

By making basic decisions in the conduct of his business, the entrepreneur determines the course of activity of a specific firm. The decisions made by the state influence the strategy of development of all firms making up the national economy.

As an innovator, the entrepreneur develops the production of new products and introduces new technologies and new forms and methods of business organization. The state as an economic innovator, on the other hand, primarily introduces new forms and methods of financial-credit and tax policy, forms new institutional structures, and so forth.

In the process of operating his business, the entrepreneur assumes risk and, depending on how justifiable the risk is, receives an appropriate "reward"; bankruptcy may be the most "lamentable" variant of the development of events. The state, which guides the economy, also assumes risk, but of a somewhat different nature; the state does not have the right to such "bankruptcy," when it is subject to self-destruction (although history contains a few examples even of this). And the receipt of as much economic profit as possible is the most significant reward to the entrepreneur for uninsured risk, whereas the reward for persons exercising state power is victory in elections in order to retain power for the next term.

Thus, if the state's economic ability acts as a factor of production, it should bring in a certain amount of revenue. This revenue is what is currently called indirect business taxes. As we know, these taxes raise the price of a product—a price which includes incomes based on factors of production: land, labor, and entrepreneurial activity. Accordingly, we treat this price increase as revenue of the state, that is, as the fifth factor of production. Recognition of the state's economic ability as a factor of production in turn makes it possible to give the status of *state profit* (by analogy with entrepreneurial profit) to indirect business taxes.

In qualifying indirect business taxes as factor income, a question may arise about the state's receiving direct taxes, in addition, in exchange for its economic ability. In reality, direct taxes are part of other factor incomes and are subtracted from them after they are collected by the state. Unlike direct taxes, indirect business taxes are placed at the disposal of the state directly in exchange for the services reviewed above; indirect business taxes, like other factor incomes, are primary, while direct taxes are derivative incomes.

We note that the level of state profits, that is, revenue from indirect taxation, is determined by the level of corresponding tax rates; they influence the growth of state profits depending on the degree to which they stimulate or inhibit legal business activity.

On the concept of "dominant" factors of production

The factors of production theory has a long history and it has changed a great deal since the time of A. Smith and J.B. Say. The concept of "dominant" factors of production is one of its modern versions.[20]

According to this concept, even though all factors of production are used in the production of each concrete good, one of them will become the "dominant" source of increase in the efficiency of production. Based on the "dominance" of factors, authors of the concept distinguish among three types of production: "capital-dominant," "material-dominant," and "labor-dominant."

According to this approach, production processes in which production workers control and secure the functioning of machines and other basic equipment and secure the technological process are "capital-dominant" (or "machine-dominant," as they are also called). "Material-dominant" processes are production processes in which the production potential depends on raw materials and supplies, land and other natural resources, while labor, buildings, machinery, and equipment simply promote the realization of existing production potential. "Labor-dominant" processes are production processes in which manual labor and the skill level of workers are of paramount importance, hence machine tools, equipment, and all other elements of fixed capital perform an auxiliary function for these works.

Authors of this conception list, for example, electric power plants, cement plants, and blast furnaces as "capital-dominant" types of production. They classify agriculture and fisheries as "material-dominant," and define bricklaying, made-to-order clothing, and carpentry as "labor-dominant."

Citing examples of production in which one or another set of factors is "dominant," the authors acknowledge that because reality is so varied, extreme variants with a clearly pronounced "dominance" of a given factor of production comprise a limited number of modern production processes. Nevertheless, this kind of classification of the latter has great significance for the goals of applied analysis.

Obviously, as an example, one could even consider a case in which the "dominance" of factors changes during the production process. Specific examples of such a case are air shipments in which the production process during takeoffs and landings is "labor-dominant" but becomes "capital-dominant" when the plane gains altitude (particularly when the automatic pilot is engaged).

Having briefly characterized the conception of "dominant" factors of production, it is possible to make certain generalizations with regard to other factors of production—entrepreneurial ability and the economic ability of the state.

"Entrepreneur-dominant" production processes should include those in which paramount importance is attached to innovations, the realization of which is, as we know, connected with the entrepreneur's initiative, while other factors of production perform an auxiliary function *vis-à-vis* the innovative activity of the entrepreneur. A competitive environment promotes the diffusion of a given concrete type of innovation, as a result of which its newness levels off and, in the absence of other significant innovations, the corresponding production process ceases to be "entrepreneur-dominant"; the "dominant" status of entrepreneurial activity is replaced by the "dominant" status of some other factor of production.

Production processes in which economic ability will be dominant can be identified by analogy with other factors of production. A production process in which the economic ability of the state is of decisive importance and all other factors of production perform a subordinate function is "state-dominant." The production of public and also quasi-public goods is naturally classified among "state-dominant" production processes.

The "dominance" of a given factor in some production process determines the "dominance" of income produced by a given factor compared with other factors of production. In "capital-dominant" production, in particular, interest is the "dominant" income; in "material-dominant" production, it is rent; in "labor-dominant" production, wages; in "entrepreneur-dominant" production, entrepreneurial profit; in "state-dominant" production, state profit.

On the system for selling public goods

There is a substantial difference between the sale of private and public goods. The first of these is usually acquired individually; the second, collectively. In spite of this, payment for the acquisition of public goods is also made individually, just as it is for the acquisition of private goods; payment for the acquisition of public goods in particular is in the form of direct taxes that are paid individually by physical and juridical persons.

Certain expenditures are required for the production of public goods. The revenue side of the state budget includes three major sources: tax receipts; loans in the form of interest-bearing state securities; and the emission of paper money and coins. Tax receipts predominate among these three sources in all more or less normally functioning states. Thus, on the one hand, taxes are used for the production of public (and the great majority of quasi-public) goods, while on the other hand, they are payment for their "acquisition" by consumers.

It must be emphasized that if taxes were not collected, it would be impossible to produce public goods which, as such, are needed by every individual and by all society. Hence there is every justification for considering taxes a natural payment for these goods, because the consumption of any good is impossible without payment, and the more that is consumed, the more it is necessary to pay.

The production of private goods by no means equals the consumer obtaining the useful effect provided by the goods; it is attained only after the purchase of the given goods. As a counterweight to this, it is enough to produce public goods to realize a useful effect from them; this is explained by the fact that there is no interrelationship between payment for consumption and the actual consumption of these goods. Taxpayers do not know the specific goals for which taxes are collected from them. On the other hand, the nonexclusiveness and noncompetitiveness of public goods create the real possibility of their consumption by individual economic agents without the payment of the corresponding taxes, which is most strictly combated by special inspection agencies created by state authority. As a consequence, the payment (or more precisely, collection) of taxes acquires the character of a forceful act, which has to some degree been opposed by more than one generation of well-known economists: people are forced to pay for public goods (and for a significant percentage of quasi-public goods). Consequently, calling state taxation a state racket makes a certain amount of sense.

Therefore, an ideal system would be one in which both physical and juridical persons would be interested in paying taxes, or at least more so than they would be in evading them. This requires that taxpayers realize their own economic interests when they pay their taxes. We shall call a market in which forcible taxation by the state is absent (or is at any rate reduced to a minimum) a *full market*.

It was noted above that taxes are used to produce public (and a considerable part of quasi-public) goods on the one hand and that they are payment for their "acquisition" by consumers on the other. Consequently, taxes perform two functions at the same time: the financing of expenditures on the production of public goods and payment for consumption. In order to see how appropriate it is to combine these two functions in the existing system of taxation, let us see how they are manifested with respect to the production and consumption of private goods.

Person A borrows money from person B in order to organize the production of a desired private good. Person A pays interest to person B for the use of this money. At the expiration of the term of the loan, person A returns the borrowed money to person B. If person B has a demand for a private good produced by person A, upon entering the market, he pays person A the price of this good. It must be emphasized that the given interrelationship between the two persons (producers and consumers of consumer goods) is an elementary act of the market system that is repeated many times.

In order that the state be an integral part of (and not a supplement to) the market, we should evidently adopt the given interrelationship between producers and consumers of private goods with respect to the production and consumption of public goods.

By analogy with the cited example, it is necessary to recognize as person A the state sector that produces public goods, while the entire society that consumes them must be recognized as person B.

Thus, following market principles, the state sector must borrow money from private persons and corporations instead of collecting taxes. Because the latter are at the same time consumers of public goods produced by the state sector, they must pay for their consumption, that is, act as person B does in the cited example. Taxes that are transformed into payment for the consumption of public goods, which is the consequence of the above-indicated merger of the two functions (the financing of expenditures on the production of public goods and payment for their consumption), must be the economic "price" of public goods. And then the loan taken out by the state sector in place of taxes need not be repaid even though interest will be paid on the loan.

Consequently, in a market system in which the state sector is its immanent, component part, there is no place for forcibly collected taxes (i.e., there is a full market); they are replaced by nonreturnable interest-paying state loans that together with returnable loans in the form of state securities and the emission of paper money and coins are used to finance expenditures on the production of public goods (and the part of the quasi-public goods that are not paid for by the private sector).

A different view of the state, when it does not supplement but is an immanent part of the market, requires rethinking many questions in "economics." The present work has touched upon only a few of these. It appears that a comprehensive study of the state profit-forming mechanism as factor income connected with the economic ability of the state will make it possible to reconstruct the existing system of taxation and to increase the effectiveness of the market's functioning.

Notes

1. *Voprosy ekonomiki*, 1992, no. 10, pp. 81–120; 1993, no. 1, pp. 4–65.
2. According to the existing tradition of translating Western economic literature into Russian, almost until recent times, the term "state," in contrast to the original, has frequently been used instead of the term "government." In the present work, this terminological question will be resolved by considering that "state" includes "the government" as the executive power.
3. Dzh. K. Gelbreit [J. K. Galbraith], *Ekonomicheskie teorii i tseli obshchestva* (Moscow: Progress, 1979), pp. 45–50.
4. See, for example, A.Ia. Livshits, *Vvedenie v rynochnuiu ekonomiku* (Moscow: MP TPO "Kvadrat," 1991), pp. 5–6.
5. Ibid., pp. 11–15.
6. For example, L. Shiriaeva and N. Mamedova, "Neoklassicheskaia model' gosudarstvennogo regulirovaniia rynochnykh otnoshenii," *Rossiiskii ekonomicheskii zhurnal*, 1992, no. 4, pp. 104–108.
7. K.R. Makkonnell and S.L. Briu [C. McConnell and S. Brue], *Ekonomiks*, vol. 1 (Moscow: Respublika, 1992), pp. 95–96, 101.

8. L. Iokhansen [Johansen], *Ocherki makroekonomicheskogo planirovaniia*, vol. 1 (Moscow: Progress, 1982), pp. 36–37.

9. V. Leont'ev [W. W. Leontief], *Ekonomicheskie esse* (Moscow: Politizdat, 1990), pp. 394–405.

10. G. Sirkin, *The Visible Hand: The Fundamentals of Economic Planning* (New York: McGraw-Hill, 1968).

11. K. Eklund, *Effektivnaia ekonomika: shvedskaia model'* (Moscow: Ekonomika, 1991), p. 159.

12. E. Dzh. Dolan and D.E. Lindsei [Lindsey], *Rynok: mikroekonomicheskaia model'* (St. Petersburg: Rossiisko-britanskoe SP "Avtokomp," 1992), p. 100.

13. Iokhansen, *Ocherki makroekonomicheskogo planirovaniia*, p. 202; Makkonnell and Briu, *Ekonomiks*, vol. 1, p. 99.

14. R. Pindaik [Pindyck] and D. Rubinfel'd, *Mikroekonomika* (Moscow: Delo, 1992), pp. 504–505.

15. Ibid., p. 506.

16. Makkonnell and Briu, *Ekonomiks*, vol. 1, p. 118.

17. *Fridmen i Khaiek o svobode* (Minsk: Polifakt-Referendum, 1990), p. 96.

18. Ibid., p. 87.

19. Makkonnell and Briu, *Ekonomiks*, vol. 1, p. 140.

20. S. Eilon, B. Gold, and Iu. Sezan, *Sistema pokazatelei effektivnosti proizvodstva* (Moscow: Ekonomika, 1980), pp. 64–66.