

## **THE SIZE OF THE PUBLIC SECTOR – CASE OF ALBANIA**

The government is one of the key players in the economic area of each country. Its impact is evident in all areas, such as political, economic and socio-cultural ones. This impact is measured by an indicator which economists call “the size of the public sector”. As government’s influence is so significant a question naturally arises: Should the impact of the government be big or small? There are many arguments in favor and against this issue and it is difficult to come to a consensus on the extent of government’s intervention in the economy. That is why the purpose of this paper is to present a picture of this intervention in the economic life of our country by connecting this indicator with the budget deficit.

First, we will elaborate the progress of the size of the public sector in Albania and its measurement by various indicators. Secondly, we will compare the size of the public sector in Albanian with the sizes of the public sector of other countries in the region. Finally, we will present the results of a study on the optimal size of the public sector in the economy of a country being analyzed and in terms of our country.

**Key words:** Albania, Budget deficit, public sector, size

### **1. Introduction**

Throughout his life several times every man faces governmental activities in one way or another, ranging from registration in the register of citizens recording, public school attendance, payment of taxes, employment in the public sector, use of public services as highways, electricity, drinking water, garbage collection, environment, pollution and safety improvement, etc. (Stiglitz, 2000). On the basis of the importance that these activities have in the economic development of a country, they have always been the subject of study by different economists. The public sector has changed over time, by being adapted to the trajectory of economic development.

Historically referring to the government intervention there have been two opposing views belonging to the two main schools of economics. Each side

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supports the positive aspects of a large or small intervention in the economy (Rosen, 2002). Modern theories of public finance do not focus on the fact whether the government should intervene or not, but on the fact that this intervention must be more efficient and serve the economic growth.

The object of many studies in this field have been the reforms for the restructuring of the public sector in order to: reduce inefficiency in the delivery of public goods and services, address the appropriate cost in priority and productive sectors, increase the efficiency of the tax system in terms of structure and tax rates, change the relation between public sector and private sector by facilitating high levels of deficit and public debt, increase the quality of institutions and governance, etc. (Milova, 2012).

The impact of the public sector in the economy of the countries in transition is of particular interest. In these countries the government plays a two-fold role: on the one hand it is the subject of reforms to be adapted to the new structure of the economy and on the other hand it affects the creation of a positive climate for the implementation of economic reforms and other comprehensive reforms in order to accelerate the process of transition.

## 2. The public sector size in Albania and its measurement

The size of the public sector represents expenses related to institutional integrity of public entities which produce goods or services for individual or collective consumption and make the redistribution of wealth and income to meet the political and economic role and responsibilities of regulation (SNA, 1993).

The size of the public sector can be measured by means of various methods, which do not always give the same result. One method that can be used is the method based on the number of employees in the public administration. This measurement method appears too problematic because the same number of employees does not necessarily mean the same value added in the economy. This is due to the fact that the technologies used in different countries are not the same. The most accurate method for measuring the size of public sector is the method that calculates how much of the added value in the economy during a year is produced by the public sector. This method uses as an indicator the G/GDP which represents the total percentage of public sector expenditure (G) in relation to the gross domestic product (GDP). As according to the expenditure method, GDP is calculated as  $C+I+G+N_x$ , it makes sense to measure the public sector contribution to total economic output by total expenditures made by this sector (Rosen, 2002).

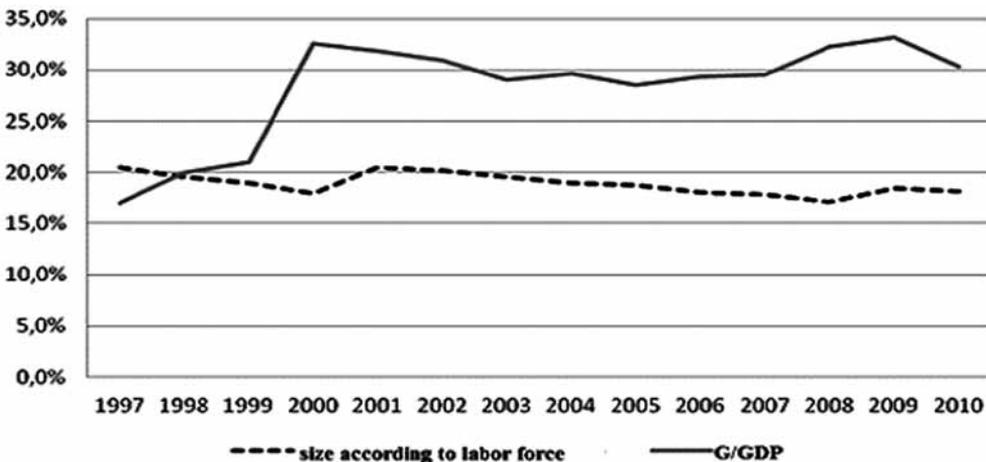
In calculating the size of government by G/GDP method, government expenditure (G) consists of:

- Acquisition (consumption) of goods and services by public administration
- Transfers of income for people, businesses or other governments
- Payment of debt interest

The chart below shows the indicators mentioned above for measuring the size of the public sector, the number of public sector employees in relation to total employees and the most used indicator of government size G/GDP.

In the below chart it is displayed the time series from 1997 to 2010. The interrupted line, show the size of the public sector, measured by the number of employees working in public administration in relation to total employees. It seems clear from the below chart that the level of public sector employees has been stable over the last decade. Only in 1998 the size of the public sector is the same under both methods used to measure it. After this year the differences between these indicators have deepened. The reason of this difference can be explained by the change in the productivity of employees in public administration compared to the private sector. Another reason has to do with the quantity that the wages of public servants constitutes within the total costs. For a country like Albania, where the share of wages in total costs is relatively high, the difference in the number of employees in the public sector, changes in the same direction G/GDP, while the rest of the conditions remain unchanged. This connection is also confirmed from the below chart.

Figure 1: The government size INSTAT, 2013; (MoF, 2013)



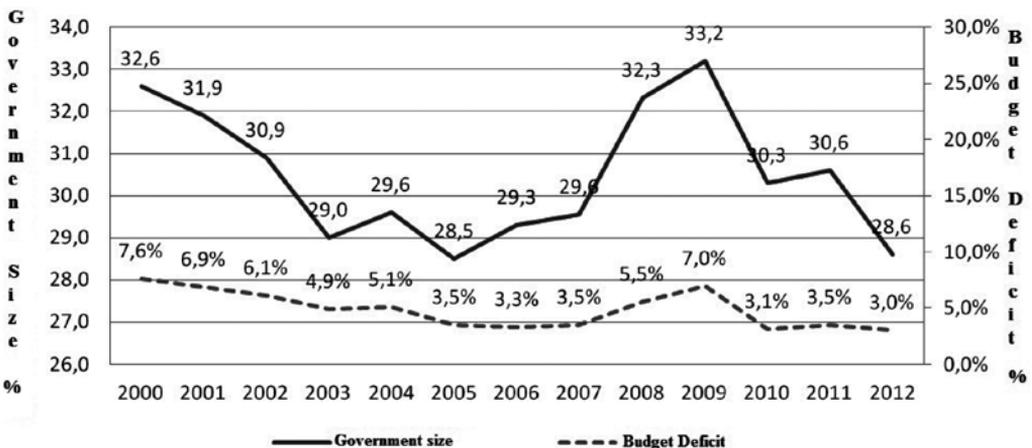
Budget deficit expresses the extent to which the expenditures exceed the revenues. This deficit can be financed by taking loans from the domestic market, which constitutes domestic financing as well as from the foreign market,

which constitutes the external financing of the deficit. Usually, budget deficit is expressed as a percentage in relation to GDP. Below we analyze the size of the public sector and budget deficit for Albania.

The link between the size of the public sector and budget deficit level is evident. If the government decides to increase expenditures at a time when income growth is impossible, the gap between expenditures and revenues will increase, which implies an increasing of the budget deficit. Therefore there is a proper relation between the size of the public sector and budget deficit. If the government increases expenditures by increasing the deficit, its intervention in the economy will grow, so this leads to the increase of the size of the public sector (Stiglitz, 2000).

In 2000 the size of the public sector was 32.6% of GDP and the deficit was at the highest value of this decade, at the level of 7.6% of GDP. After this year, it can be observed that there is a continuous decrease of G/GDP, accompanied with the decrease of the budget deficit until 2003, specifically at the level of 29% and 4.9%. Until 2007, the situation was characterized by the same trend, with the exception of the years 2005 and 2006 where the size of the public sector growth occurred without any increase of the budget deficit. This can be explained by the fact that the growth of the state expenditures was not financed by means of the budget deficit growth but by income growth of the state budget (an increase of about 12% in 2006). After this period, the two indicators have followed the normal trend.

**Figure 2:** *The government size and the budget deficit, (MoF, 2013)*



It should be emphasized that the year 2009 marked the highest level of government size as well as a high level of budget deficit, specifically at a level of 33.2% and 7%. This is due to the international financial crisis of 2008 that affected Albania too. Borrowing costs increased by increasing government spending

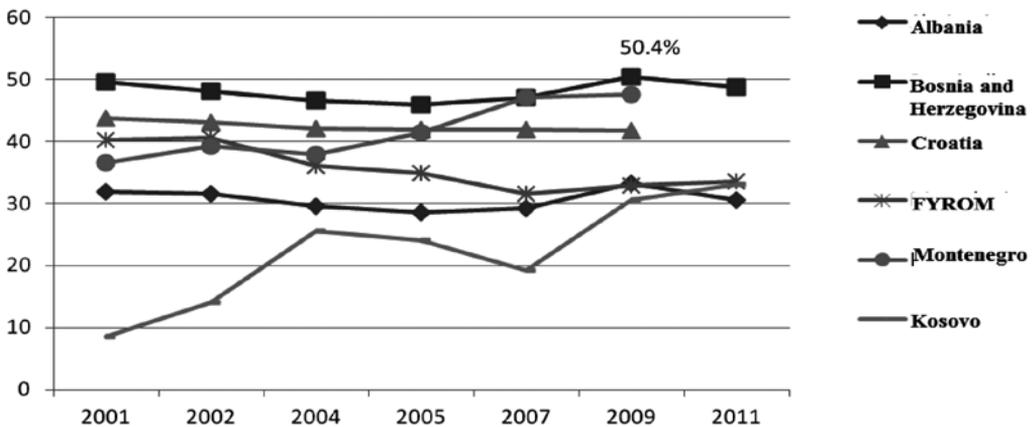
to cover the interests. The major factor contributing to the growth of the budget deficit during this year were high costs for the “Durrës-Kukës” highway. This period also coincides with the highest level of public debt in the past nine years. After the year 2009 there was a downward trend mainly on the size of the public sector and budget deficit levels.

### 3. The government size of other countries in the region

To better understand the importance of the public sector in the economy it is necessary to make a comparison of this sector to the public sectors of other countries, mainly of the region where Albania is part. The past communist period of most countries in the region has resulted in to high government expenditures in relation to GDP. The following chart shows the trend of government size for six Balkan countries: Albania, Bosnia and Herzegovina, Croatia, Macedonia, Montenegro and Kosovo.

It is obvious that the tendency of the change of public sector sizes in the region is more or less the same. Among the countries of the region, Bosnia and Herzegovina is the one with the highest level of government expenditures in relation to GDP, which come up to the level of 50% of GDP. This country is followed by Montenegro which has continuously increased the size of the public sector, in the last decade, reaching the level of 47%. As one of the most stable economies in the region, that of Croatia has had a steady size of public sector at about 41%. Macedonia, Kosovo and Albania have been characterized by a relatively low level of government expenditure. As a result of continuing consolidation of its institutions Kosovo has steadily grown its impact on the economy by making the government expenditures constitute about 32% of GDP in 2011.

**Figure 3:** The percentage of public sector expenditure (G) in relation to gross domestic product (GDP), G/GDP% (MoF, 2013)



#### 4. The optimal government size

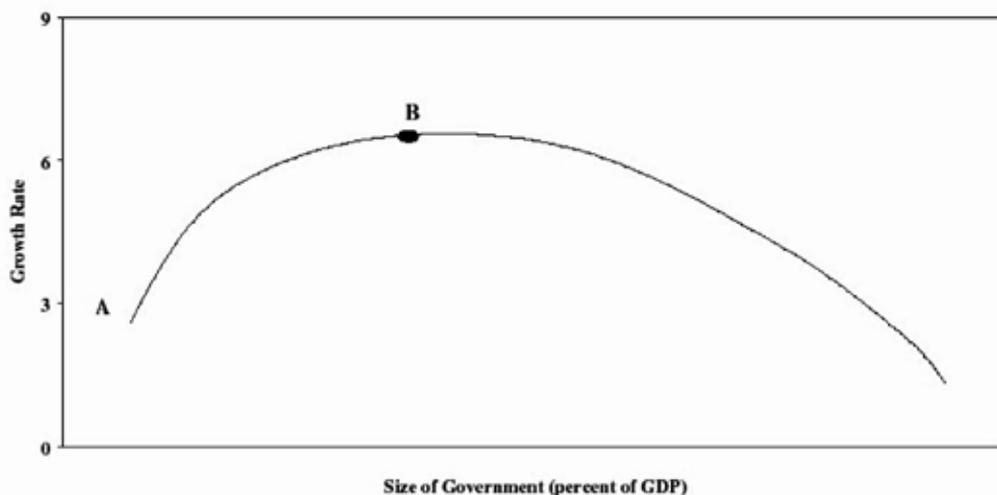
Adam Smith has always preached in favor of a small government intrusion in the economy. According to him, the invisible hand of the market would regulate it whereas in many cases the government intervention would only distort the market performance. The Great Depression of the 30's urged economists to consider the government as a regulator of markets and preventer of economic crises. Since then the government intervention in the economy has increased significantly.

Different societies have different sizes of public sector. A question can be raised: Is there an optimal size of government in the economy?

Not all economists support the idea of an optimal size of the government in the economy. Some believe that great government intervention in the economy is inefficient and in some cases causes distortions of competition in the markets. Also high public investments may shrink a private investment by "crowding-out" effect. Other economists think that bigger government can accelerate economic growth by providing public goods and correcting market failures. Apart from that, according to these views, the growth of government consumption by means of multiplier's effects increases aggregate demand in the economy.

In many studies, economists have accepted the size which provides a higher economic growth as the optimal size of government intervention (Chobanov and Mladenova, 2009). The model which gives us an overview of this optimal size is presented in the chart below.

In the chart 4, the horizontal axis represents the size of government and the vertical one represents the economic growth. At the point A, the intervention of the state sector in the economy is near zero and the economic growth it produces is also near zero. So each level near this point is inappropriate for any country. Initially the increase of the government size is accompanied with the increase of the latter's contribution to economic growth. So the larger the government, the higher is the economic growth. If the economy is at point B the government size is optimal and there is no reason to change the level of government expenditure in the economy. At this point the economic growth has reached its maximum. Beyond this point if the government size grows, its impact in the economy will be inefficient and the economic growth will be lower. Point B is exactly the one where all the countries should aim at.

**Figure 4:** *Size of Government (Gwartney, Lawson and Holcombe, 1998).*

Scully (1998; 2003) developed a model that estimates the amount of government expenditures that maximize economic growth. Government expenditures comprise one of the production factors which affects the production function of an economy. Having estimated the model with data from more than 30 different countries he came to the conclusion that the government size that maximizes economic growth is at the level of 25% of GDP. This does not mean that all countries must have exactly this size of the public sector. Different countries have different optimums of the government size, due to the fact that governments do not have the same efficiency. For this reason, other studies have shown that the size should range from 20%-30% of GDP.

In Albania, the size of the public sector is about 30.6% of GDP (MoF, 2012). This level is not too far from optimal level shown above. This size is justified by the fact that the tax revenues collected by the Albanian government are relatively low and this leads to lower government expenditures. Another reason is also the existence of high budget deficits. The reduction of the budget deficit is certainly accompanied by a decrease in expenditures.

## 5. Conclusions

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Over the past decade, Albania has experienced a proper relation between the size of the public sector and budget deficit. There are different views regarding the size of the public sector that should have an economy. However, that size that maximizes economic growth accepted as the optimal size of government. This indicator should be in the range 20-30% of GDP. Albania has consistently been one of the countries with the lowest government size in the region. This is explained by the relatively low income that the Albanian government collects and the incentives that the government has to reduce the budget deficit and public debt.

### Literature

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## VELIČINA JAVNOG SEKTORA – SLUČAJ ALBANIJE

### S a ž e t a k

Vlada je jedan od ključnih igrača u ekonomskoj oblasti svake zemlje. Njen uticaj je očigledan u svim oblastima, političkim, ekonomskim i društveno kulturnim. Ovaj uticaj se meri indikatorom koji ekonomisti nazivaju “veličina javnog sektora”. Kako je vladin uticaj od tolikog značaja postavlja se pitanje: da li uticaj vlade treba biti mali ili veliki? Postoje mnogi argumenti za i protiv ovog pitanja i teško se može doći do konsenzusa o obimu vladinih intervencija u ekonomiji. Zato je svrha ovog rada da predstavimo sliku ove intervencije u ekonomskom životu ove zemlje povezujući ovaj indikator sa budžetskim deficitom.

U radu je detaljno elaboriran napredak veličine javnog sektora u Albaniji kao i merenja od strane različitih pokazatelja. Drugo, upoređena je veličina javnog sektora Albanije s javnim sektorima drugih zemalja u regionu. Konačno, predstavljeni su rezultati jedne studije koja se bazira na optimalnoj veličini javnog sektora vezano za ekonomiju zemlje koja se analizira, u odnosu na Albaniju.

**Ključne reči:** Albanija, budžetski deficit, javni sektor, veličina