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Fiscal Developments and Issues in Selected Centrally Planned Economies 1/

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I. Introduction

The purpose of this paper is to provide a basis for assessment of the role of fiscal policy in the economic management of centrally planned economies (CPEs), including its possible role in causing or curing external adjustment difficulties. Although fiscal and other financial policies and the international adjustment process, and their mutual interrelationships, have been extensively studied for market economies, these topics have, until recently, received relatively little attention in the context of the economic analysis of central planning. In large part, this was no doubt a consequence of the limited extent of trade and financial integration of most CPEs with the rest of the world; as a group, such countries enjoyed a relatively high degree of self-sufficiency in essential raw materials, and financial links with the West were of no great significance. In contrast, in the last ten years or so, following the implementation of policies of detente in major industrial countries, there has been a dramatic growth of trade and financial links between East and West. 1/ As a result, the economic policies pursued by governments of CPEs not only influence the welfare of their own citizens, but now have a significantly increased impact on economic and financial developments in the rest of the world. In particular, following the rapid expansion of foreign borrowing by East European countries in the 1970s, Western financial institutions and governments have a very direct interest in the results of adjustment policies adopted by those CPEs that have recently experienced severe external payments difficulties.

Serious balance of payments problems in CPEs, as in any other country, will eventually require measures aimed at restoring external financial stability. Such measures may be initiated by the authorities of the country concerned when the seriousness of the situation comes to their attention, or may instead be required by external creditors as preconditions for rescheduling debt and granting new credits. In either situation, the question arises whether the measures typically undertaken by market economies in programs designed to achieve external adjustment will adequately perform the same functions for CPEs. In particular, external imbalances in market economies are frequently a consequence of inappropriate fiscal policies, so that corrective fiscal measures are indicated; 2/ an assessment of whether such measures would also be appropriate for a CPE experiencing external payments

1/ For discussion of the growth of East-West trade and credit during the 1970s, see Wolf (1977) and Marer (1981).

2/ Beveridge and Kelly (1980) outline the increasing role of fiscal performance clauses in Fund programs during the 1970s. Kelly (1982) finds that external imbalances in years prior to program years have tended to be associated with large fiscal imbalances, and that reductions in external deficits in program years are generally accompanied by reductions in fiscal deficits.

problems requires, first of all, an understanding of the nature of fiscal operations and instruments in such economies and their relation with other tools of economic management, notably the Plan.

The classical analysis of the functions of fiscal policy (Musgrave (1959)), identifies three distinct "branches":

(1) Allocation--the satisfaction of social and merit wants by raising taxes to finance public expenditures on goods and services.

(2) Distribution--the adjustment of the distribution of income and wealth by tax and transfer payment policies.

(3) Stabilization--the attainment of macroeconomic demand/supply equilibrium through appropriate budget surpluses/deficits and associated financing policies.

Musgrave (1969) argues that in a traditional CPE the budget would be expected to be large in relation to the size of the economy, mainly on account of the paramount role of the allocation branch of fiscal policy. In the absence of a capital market, the budget in a CPE provides the principal medium through which resources are allocated, especially to finance investment; the budget is the instrument through which the allocation of resources directed by the Plan is put into effect. In principle, the distribution branch should have a smaller role to play than in a market economy: in a CPE there is no need to correct undesirable imbalances in income distribution generated by the free operation of market forces and, with capital owned by the state rather than by private individuals, there should be no concern about the consequences of large private holdings of wealth. According to Musgrave, the stabilization branch of fiscal policy has no role to play in a traditional CPE, as the Keynesian demand management problem--possible insufficiency of aggregate demand owing to the instability of private investment--is lacking in a system where all investment is under central control. 1/ Where reform measures lead to greater decentralization of decision making and financial autonomy, the relative size of the budget may well decline (as the role of the allocation branch diminishes), but the importance of the budget as a stabilization tool to regulate the macroeconomic impact of autonomous decisions will be expected to increase.

These observations, especially in relation to the allocation and stabilization branches, serve as a background for the discussion in the main body of this paper. Prior to that, Section II describes the

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1/ "Socialist planning must merely see to it that the level of expenditure grows with potential output, which is a simple task. The socialist trauma, corresponding to aggregate demand instability in the capitalist system, is that of imbalance between industrial sectors," (Musgrave (1969)).

salient features of CPEs, based on stylized assumptions intended to encapsulate the typical characteristics of such economies. This expository device is common in the literature on the economics of central planning but, while valuable in highlighting issues for economists more familiar with the operations of market economies, it does suffer some shortcomings. For example, CPEs do not all share the same institutional characteristics (concerning, for example, the extent of permitted private economic activity or the organization of foreign trade), nor are they all at similar stages in their economic development. Partly as a result of these differences, there is not yet a consensus on the best approach to the formal modeling of the economic behavior of CPEs. In view of these considerations, in Section III and in the Appendix this paper adopts the approach of reviewing recent fiscal developments in a relatively diverse group of Fund member CPEs in the context of their overall economic management including, where relevant, efforts at external adjustment. 1/ While such a procedure does not itself lead to definitive conclusions, it serves to highlight some important issues in the analysis of fiscal developments and policies in CPEs, including major similarities and contrasts with fiscal issues in market economies, and the fiscal ramifications of economic reform measures.

II. Features of Central Planning 2/

1. Traditional system

The logical starting point for discussions of central planning as a mode of economic management has been the "traditional" Soviet system, which was in place in the U.S.S.R. by the beginning of World War II. This was the role model for central planning systems subsequently introduced in a considerable number of countries, and it also provides the most clear-cut contrast to the Western economic model of the capitalist free market economy. Its descriptive relevance has diminished somewhat during the last two decades, as the U.S.S.R. and many other CPEs have attempted reforms that entail varying degrees of economic liberalization in an effort to improve performance. Moreover, many of the countries that currently espouse central planning are markedly more dependent on external economic influences than was the U.S.S.R. under the traditional system. While this paper does not aim at providing a comprehensive analysis of the differences between pre-reform and post-reform CPEs, it will be seen that these are significant for the analysis of fiscal developments and policies.

1/ For a comprehensive discussion of external adjustment issues in CPEs, see Allen (1982).

2/ See Brown and Neuberger (1968) for a fuller discussion of the main distinguishing features of CPEs.

Key features of traditional centrally planned economies are the collective ownership of the means of production, distribution, and exchange and the transmission of economic information via administrative planning procedures rather than through price signals provided by the market mechanism. Thus, the state typically monopolizes virtually all industrial, commercial, and financial activity, including banking and foreign trade and exchange. These activities are generally carried out by state-owned enterprises and banks. State ownership is less prevalent in the agricultural sector, where cooperatives or collectives (i.e., enterprises jointly owned by their members but using state-owned land) play a major role. The scope for legal private production and trade is usually strictly limited; the most common form of private activity is the free market sale of farm output in excess of plan quotas, while in some countries individual households are permitted to sell produce obtained from tending small private plots. In addition, illegal and semilegal private commercial activity apparently flourishes in the presence of widespread price/quantity distortions in official distributional channels for consumer goods and services and key raw materials. 1/

In the traditional planning system prices and markets play virtually no role in guiding decisions on production and investment. Instead, producing enterprises and cooperatives are provided by the central planning authorities with quantitative output targets, whose achievement is encouraged by a varying blend of material incentives and moral suasion. Within the framework of Five-Year Plans that define general medium-term economic development objectives, successive annual Plans specify in considerable detail (often down to enterprise level) the production targets for major commodities. In principle, the system of planning through "material balances" is designed to match sources of commodities (production, imports, and initial stocks) with uses (consumption, productive use, exports, and final stocks), although in practice plan production targets often turn out to be overambitious or inconsistent, and shortages and bottlenecks develop. Similarly, the implementation of investment plans has often been impeded by resource constraints. The domestic price structure at all levels is typically rigid, often reflecting historical factors or sociopolitical objectives rather than prevailing opportunity costs, and a variety of devices (often of a fiscal character) have been employed in order to insulate domestic prices from fluctuations in relative world market prices and exchange rates. Although in the traditional system prices have little or no relevance for enterprise decision making, consumer prices have typically had a substantial impact on household decisions. Notwithstanding original long-term objectives to abolish money and prices and distribute consumer goods and services exclusively according to need as judged by the central authorities, most consumer markets are still unrestricted on the demand side; that is, consumers may spend or save their income as they wish, subject to

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1/ Katsenelinboigen (1977) classifies the various shades of these so-called colored market activities.

the controlled supplies and prices of consumer goods and services available through the state distribution system. In some instances, however, basic consumer goods are allocated by administrative rationing; for example, in the Lao People's Democratic Republic and Viet Nam, essential commodities are rationed to public employees at subsidized prices.

Financial policies in the traditional system are first and foremost a reflection of the Plan. The budget implements the financial flows between the government and other sectors consistent with the Plan's quantitative output and investment objectives, valued at prevailing official prices, and the state bank prepares cash and credit plans designed to provide sufficient liquidity for successful Plan implementation. 1/ Although fiscal and monetary instruments are not used to guide real economic activity of enterprises independently of the Plan, they have an important role in its monitoring and implementation: with a high proportion of value added subject to redistribution through the budget, and with all banking activity monopolized by the state banking system, financial transactions are potentially subject to close scrutiny to check their conformity with the Plan. This monitoring is facilitated by tight restrictions on the use of different types of money. Enterprise transactions in excess of small amounts payable in currency are settled exclusively through deposit accounts at the state bank, with the exception of payments in cash to workers; trade credit between enterprises is generally forbidden. To limit financial autonomy of enterprises, their permitted holdings of currency for working purposes are set at low levels, and the use of bank deposits is restricted, in principle, to transactions authorized by the Plan. Consequently, enterprise deposit balances have limited liquidity. Aside from enterprise wage payments, other sources of cash to the household sector are wages and transfers received from the government, payments for agricultural procurement, and withdrawal of previously accumulated household savings held on deposit with the banking system. Conventional checking deposits are a rarity, and household purchases are generally made entirely with cash. With households having greater financial autonomy than enterprises, demand management in traditional CPEs has focused on efforts to avert inflationary conditions in the household sector by means of control over the volume of currency in circulation. Instruments available for this purpose include regulation of wage payments, promotion of household savings, restriction of budgetary payments leading to the injection of cash into the household sector, and control over the flow of consumer goods through the state distribution system.

Reflecting the emphasis on central control, in most CPEs the state budget consolidates the operations of the central government with those of regional, provincial, and local governments; however, enterprises usually maintain separate accounts, so that their financial

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1/ The role of financial policies in traditional CPEs is described in detail in Garvy (1966, 1977) and Holzman (1955).

operations are not formally integrated in the budget. The budget plays a major role in the redistribution of resources, especially within the state sector (i.e., government and enterprises); a high proportion of budgetary revenue is derived from gross profit margins of enterprises as turnover taxes or profit remittances, with direct taxes on the population and nonstate entities (such as agricultural cooperatives) usually of relatively minor importance. On the expenditure side, a high proportion of outlays is absorbed by "financing the national economy"--funds channeled back to enterprises to meet fixed investment and working capital requirements in accordance with the targets of the Plan and with prevailing policies on enterprise finance. Also included in this expenditure category are subsidies, to compensate those industrial and commercial enterprises whose Plan-mandated activities generate losses at prevailing official prices, or to protect real incomes of particular groups of consumers.

Foreign trade and payments are a state monopoly, with quantitative plans for imports and exports drawn up in a foreign trade plan consistent with the net real resource requirements of the overall Plan, and with due regard, in principle, to the economy's capacity to finance any resulting balance of payments deficits and to service the consequent accumulation of external debt.

Domestic prices of tradable goods are insulated from world prices by a system of price equalization: under this system, foreign trade corporations trade in export and import goods with domestic enterprises at prices established by the planners--prices that do not reflect movements in foreign prices and exchange rates. As a result, the exchange rate in the traditional CPE has primarily an accounting role and does not affect domestic production or consumption decisions. The price equalization system may, however, have a significant impact on the budget: trade in a commodity whose domestic price is lower than the world price converted at the official exchange rate will generate revenues if it is exported and expenditures if imported. Depending on the particular administrative arrangements for foreign trade, these flows affect the budget either directly or through the financial position of a foreign trade corporation whose net profits or losses on trading operations are ultimately absorbed by the government. 1/

2. Modifications

A convenient, but confining assumption in the analysis of planned economies is that Plan-mandated activities and transactions actually take effect without error or modification. With this approach, behavior

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1/ For a detailed account of the operation of price equalization systems, see Wiles (1969), Chapter VI.

of enterprises can be taken as given, and analysis can then focus on those sectors, notably households, whose behavior is influenced by the Plan only in part. 1/ Such a framework is perhaps unduly deferential to the efficacy of the Plan implementation process even in the traditional system, and becomes still more restrictive when account is taken of numerous recent reforms. Such reforms, instances of which are evident in the country examples of this paper, include use of profit-linked incentive schemes; substitution of retained profits and loan finance for budget transfers in financing working capital and fixed investment; explicit authorization of non-Plan activity as long as Plan targets are met; partial replacement of binding quantitative output targets by financial goals such as value of sales, profit, or value added; legitimization of horizontal financial relationships between enterprises; limited flexibility for price determination; and measures to establish links between world price developments and the domestic price structure. As will be apparent below, many of these measures have fiscal implications.

The broad objective of these reforms has been to improve economic performance by decentralization of decision making and financial autonomy to the enterprise level. A particular contributing factor behind the East European reform initiatives of the 1960s may also have been the inherent unsuitability of the traditional Soviet model for the economies in which it was implanted following World War II. 2/ Whereas the U.S.S.R., when central planning was adopted, was virtually self-sufficient in key raw materials, the East European CPEs were much smaller, with only limited availability of domestic raw material supplies and hence a far greater dependence on foreign trade. As a result, the rigid traditional planning system could not deal adequately with the need to adapt to rapidly changing economic conditions in the rest of the world, and pressures for reform intensified. When attempting to understand the system of economic management in a given CPE, some consideration therefore needs to be given to the country's extent of economic development and its dependence on foreign trade. CPEs are hardly unique in this respect, as the same factors must also be taken into account in the analysis of more market-oriented economies. More generally, it is useful to recall that, while CPEs compared with other countries may have a different system of economic management and may profess a different mix of economic and social priorities, they face the same fundamental economic challenge of how to make the best use of scarce resources.

1/ This approach is followed in Fetherston (1981), which analyzes the impact of price, wage, and tax policies on consumption demand and labor supply.

2/ This point is developed in Bornstein (1977).

III. Fiscal Issues in Selected CPEs

This section draws on the recent experience of five countries as a background for discussion of some general issues in the fiscal analysis of CPEs. The countries discussed comprise two from Eastern Europe (Romania and Hungary) in which the traditional central planning system adopted in the late 1940s has since undergone varying degrees of modification; one fairly large economy (China), which since 1949 has pursued various different paths of its own but has recently emphasized modernization and greater openness; and two small low-income economies (Viet Nam and the Lao People's Democratic Republic), where more recently instituted central planning systems have faced serious resource limitations. While these countries span a considerable range of incomes, degrees of openness, and other structural features, their own particular versions of CPE economic management still share many common features. All five countries have experienced macroeconomic difficulties of varying degrees in recent years, and have made use of the Fund's resources in support of programs of stabilization and adjustment. Background information on each country's general structure and fiscal developments is provided in the Appendix.

1. General aspects

An overview of the relative size of the budget in each of the five countries is provided in Table 1, which presents average ratios to gross domestic product (GDP) of major budgetary aggregates during the period 1978-81. While statistical limitations inhibit precise inferences, 1/ there is considerable variation among the group regarding the magnitudes of the major aggregates. A priori, the importance in CPEs of the allocation branch of fiscal policy, resulting from the absence of capital markets and the key role of the budget in redirecting resources between sectors, should make the budget relatively large. This appears to be true of the two European countries, for which the observed expenditure/GDP ratios of 50-60 per cent exceed those of most

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1/ To the extent possible, fiscal data are presented on a comparable basis according to the classification described in International Monetary Fund (1974). Identified divergences from this standard are noted in the Appendix; among them is the inclusion above the line in some cases of certain financing items. Revenue and expenditure aggregates are influenced by different treatments of corresponding gross and net flows, such as those concerning foreign trade subsidies and taxes. In addition, most CPEs construct national accounts data on the basis of the net material product system, which excludes most services. GDP estimates and ratios based on them are, therefore, rather tentative.

Table 1: Operations of the State Budget in Selected Centrally Planned Economies

(In per cent of GDP; 1978-81 averages)

	Romania	Hungary	China	Viet Nam	Lao People's Democratic Republic
Revenue	50.8	59.4	27.3	28.5	10.9
From state enterprises					
(Taxes and transfers)	36.6	37.5	24.0	22.3	7.4
Other taxes and transfers	14.2	21.9	3.3	6.2	3.5
Expenditure	50.3	60.1	29.2	39.0	28.3
Current expenditure	...	49.7	...	27.9	16.9
Capital expenditure	...	10.4	...	11.1	11.4
Overall surplus or deficit (-)	0.5	-0.7	-1.9	-10.5	-17.4
Financing	-0.5	0.7	1.9	10.5	17.4
External	...	...	...	9.8	16.9
Banking system	-0.5	0.7	1.6	0.7	0.5
Other domestic	--	--	0.3	--	--
Memorandum item:					
Taxes and transfers from state enterprises (per cent of revenue)	72.2	63.6	87.5	77.7	71.0

Sources: Tables 2-6.

non-CPEs. 1/ Expenditure/GDP ratios for the three Asian CPEs, ranging between 28 and 39 per cent, are substantially lower than those for Romania and Hungary, but still above those of most of the developing economies of the region. 2/ A likely explanation of the lower ratios found for the Asian CPEs is that, being at a generally earlier stage of industrial development than the two European countries, the share of agriculture in their GDP is correspondingly higher; but budgetary expenditures in CPEs tend to be associated more with industrial and commercial activity than with subsistence agriculture. In the Lao People's Democratic Republic, for example, state enterprises monopolize industrial and large-scale trading activity, yet account for only about 10 per cent of GDP.

The dichotomy between the two CPE groups is still more marked on the revenue side, so that, whereas on average Romania experienced a modest surplus and Hungary a small deficit, the Asian countries, and especially the Lao People's Democratic Republic and Viet Nam, had sizable overall deficits. 3/ Sources of financing for budgetary deficits in CPEs include external borrowing and net credit from the state bank; as with many developing countries, in the absence of organized capital markets, nonbank sources of domestic financing are generally insignificant. One such source, again also found in other developing countries, is the placement of government securities with state enterprises on a nonmarket basis. 4/ While the large deficits of two countries in our CPE sample have been financed almost entirely from foreign sources, in all but one of the five countries recourse was made to the state bank

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1/ According to data in International Monetary Fund, Government Finance Statistics Yearbook (1982) and International Financial Statistics (various issues), the average (unweighted) government expenditure/GDP ratio for 17 non-CPE European countries during 1978-80 was 36 per cent. For 7 of these countries the ratio was in the range 20-29 per cent; 5, 30-39 per cent; 4, 40-49 per cent; and 1 was 52 per cent.

2/ For 9 non-CPE Asian developing countries, the unweighted average expenditure/GDP ratio during 1978-80 was 22 per cent. Six countries had ratios between 12 and 19 per cent; 1 of 26 per cent; and 2 between 30 and 39 per cent.

3/ To some extent this divergence is exaggerated by differences in definition; data for the Lao People's Democratic Republic and Viet Nam include foreign loans and grants as below-the-line financing items, while in China, Romania, and Hungary certain financing items are included above the line under revenue. Although these have included the proceeds of direct foreign borrowing by the state, most of the sizable foreign borrowings of the two European CPEs have been undertaken by the banking system and not passed through the budget.

4/ In some CPEs household savings deposits have been channeled to the budget, where they would usually be included above the line under revenues.

during the period. On the basis of this evidence, the traditional aim of CPEs to avoid bank financing of budget deficits has by no means been regularly achieved in recent years.

2. Allocation branch: budget and state enterprises

Because the system of enterprises operating under the directives of a central plan constitutes the most important distinguishing characteristic of economic organization in CPEs, any attempt to explain the economic role of the budget in such countries must begin with the relationship between the budget and the state enterprise sector. 1/ This is true both for traditional and modified CPEs. First, as already noted, in the traditional CPE the budget's main function is to assist with Plan implementation by acting as the chief medium, in the absence of capital markets and of legitimate horizontal financial relationships between firms, through which resources are mobilized from and channeled back to enterprises. Second, virtually all economic reforms undertaken in CPEs have involved modification of the ground rules governing enterprise activity and have, therefore, potentially changed the nature of the relationships between enterprises and the budget.

In both the traditional CPE model and the five countries examined in this paper, both revenue and expenditure from the budget are dominated by transactions with state enterprises. 2/ Financial resources mobilized from enterprises, which provide the bulk of budgetary revenue, are derived in various forms from the margin between prices and unit costs. In terms of conventional budgetary classifications, these receipts include direct taxes (taxes on profits), indirect taxes (turnover taxes specific to individual commmodities), and nontax revenues (profit remittances, depreciation charges). In the traditional system these distinctions lose much of their significance; in that system, enterprises' output quantities, selling prices, and input costs are all established by the planning authorities, and residual profits or losses are absorbed by the budget. Under these conditions, the financial surplus generated by enterprise activity is transferred to the budget in its entirety and is fixed in amount, regardless of the revenue category in which the transfer is made. Given the Plan configuration of output quantities, prices, and costs, no change in enterprise or household behavior would result from, for example, a

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1/ These relationships are not all unique to CPEs, as many other economies have large public enterprise sectors that monopolize key sectors of economic activity (Short (1983)). In this respect, many problems of public enterprise management may be common to both CPEs and non-CPEs.

2/ State enterprises in CPEs generally maintain separate accounts, so that their financial operations are not formally consolidated with the budget.

switch from high turnover taxes and low profit transfers to low turnover taxes and high profit transfers. The distinction between the types of revenue is, therefore, of accounting rather than of economic significance. 1/

The reform measures taken in many CPEs, including those examined in this paper, have changed the role of enterprises as passive agents in the Plan implementation process, and by providing greater autonomy have increased the scope for economic analysis of the instruments used to regulate their finances and provide revenue for the budget. In this respect, a key common element of the reforms is the practice of permitting enterprises to retain part of their earnings and allowing some discretion in their use of retained funds for such purposes as investment financing, wage bonuses, and social welfare payments. For example, in Hungary under the 1968 New Economic Mechanism that was reinforced by further measures taken in 1980, enterprise profits after payment of taxes are divided between reserves, payments for welfare and cultural services, a development fund to finance investments, and a sharing fund to finance wage supplements. In recent years Romania and the People's Republic of China have also implemented schemes that encourage enterprises to retain profits for financing investment, as well as for bonus and welfare payments; Viet Nam introduced a system where profits in excess of planned amounts may be retained up to specified amounts in incentive funds, although with residual profits still transferred to the budget; and the Lao People's Democratic Republic also expanded the scope for profit retention on a trial basis. These various reforms notwithstanding, the systems of budgetary contributions from profits in most CPEs are still well removed from the arrangements typical of other economies, where the size of private firms' payments to the budget as a function of profits are determined ex ante in accordance with tax laws, and where most enterprises cannot rely on an automatic subsidy to cover any losses but have broad discretion as to the disposition of posttax profits. As a result, the distinction 2/ between receipts from enterprises as tax revenue or as nontax revenue still has relatively limited significance in CPEs (and is accordingly

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1/ As a practical matter, the typically greater frequency of payment of turnover taxes as opposed to profit transfers could assist the audit function of monetary policy in monitoring enterprise liquidity.

2/ "Taxes are defined as compulsory, unrequited, nonrepayable contributions exacted by a government for public purposes." "Nontax revenue includes requited receipts--from property income . . ." (International Monetary Fund (1974), p. 127). In the latter definition, property income receipts are requited in respect of public ownership of capital. In CPEs, all capital is publicly owned, and surpluses generated by enterprises are treated as the property of the state, whether paid as taxes or profit transfers or retained by the enterprise.

not used in the tables in this paper). 1/ Instead, following the reforms, the more important factor governing enterprise behavior is the system for division of the price/cost margin between total payments to the budget and retained funds, with its implications for the structure of incentives facing managers and workers.

On the expenditure side, the budget provides resources for state enterprises in the form of fixed investment and working capital finance, and various subsidies. In the traditional system, capital finance is fully centralized, with enterprises depending on the budget or bank loans for all their investment requirements. The greater autonomy under reforms for enterprises to retain funds for various purposes has as its counterpart a reduction in the share of fixed investment and working capital that is financed by transfers from the budget, often compounded by increasing use of bank loans as an external source of enterprise capital finance. 2/ Following the reforms in Hungary, about two thirds of enterprise investment is now financed from retained profits accumulated in development funds, and bank loans for investment projects are based increasingly on profitability criteria.

Another significant category of expenditure in CPEs consists of subsidies, accounting in 1981, for example, for nearly one third of total outlays in Hungary and almost one fifth in Viet Nam. Analysis of the economic effects of subsidies in different CPEs is complicated both by statistical problems and by the confining effects of assumptions of fixed prices and limited enterprise autonomy. Fixed official prices in CPEs may be set to reflect opportunity costs, but need not necessarily do so; various other aspects of planners' preferences, such as sociopolitical objectives, may also play a prominent role. To the extent that official prices differ from opportunity costs, accounting profits and economic profits do not coincide. Likewise, the payment of direct subsidies or the absorption by the budget of enterprise losses do not necessarily imply the existence of inefficiency or misallocation of resources. In the traditional CPE, the allocation of resources is determined by the Plan instead of by prices, so that by assumption inappropriate price signals do not themselves give rise to distortions. 3/ Once enterprises

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1/ Because of the weakness of this distinction, the conventional measure of "tax effort" (the ratio of tax revenue to GDP) is less useful for CPEs than for other economies.

2/ The effective role of credit as a means of finance can be enhanced not only by increased volume but also by stricter enforcement of repayment requirements.

3/ Under these conditions actual prices have only an accounting function; what really matters for resource allocation is the set of shadow prices implicit in the formulation of the Plan.

are reoriented toward the pursuit of profit-related financial goals, instead of toward the implementation of quantitative Plan directives, then there is increased importance for setting prices that properly reflect opportunity costs, and accounting profits or losses begin to acquire greater economic meaning. Conversely, price restructuring measures 1/ in CPEs can have only a limited impact on enterprise performance, unless accompanied by greater use of profit indicators in the incentive system.

Subsidies in CPEs take a variety of different forms, ranging from those designed to protect living standards of particular groups of consumers by maintaining low prices for basic necessities, to the absorption by the budget of losses made by enterprises. For example, Hungary's expenditures on subsidies increased during the 1970s as a result of efforts to insulate consumers from the impact of producer price increases and to protect the domestic economy from the effects of increasing world prices, especially for imported raw materials. In other countries, such as Romania, foreign trade activities have generated subsidies on the export side. 2/ In addition to the subsidies that are directly reflected in the budget, CPEs also feature a variety of implicit subsidies which are partly a consequence of the lack of well-defined measures of opportunity cost that results from the absence of markets. One common example is the granting of loans on soft terms from the state banking system to enterprises. 3/

In market economies, the reduction of subsidies is often regarded as a means both for alleviating macroeconomic imbalances and improving microeconomic performance by the removal of price distortions. In CPEs the scope for improving microeconomic efficiency by fiscal measures affecting the structure of price incentives depends very much on the nature of the incentive system itself.

1/ As well as resetting administered prices, such measures have also included partial liberalization of price determination, as, for example, under Hungary's New Economic Mechanism.

2/ Romania operated a price equalization system under which a foreign trade entity generally made losses on exports which were offset against profits on imports. Under this type of system, foreign trade tax/subsidy operations only affect the budget on a net basis. Under alternative but analytically equivalent arrangements where trade flows are taxed or subsidized directly, aggregate budgetary revenue and expenditure would both be correspondingly larger.

3/ Implicit subsidies are also found in many non-CPEs; for example, Wattleworth (1983) finds substantial credit subsidies in budgetary lending in Korea.

At least in the traditional CPE, state enterprises do not respond to price signals as do enterprises in market economies, so that changes in prices unaccompanied by changes in quantitative plan instructions would not affect real activities but only the prices at which they are valued. As a result, measures to align prices more closely with opportunity costs, while improving the usefulness of profits as an economic indicator for the planners, will not by themselves necessarily improve the economic performance of enterprises. Also pertinent to this issue is the argument that inefficient performance in the enterprise sector of CPEs results, regardless of the actual incidence of subsidies, from the expectation that any losses will not lead to bankruptcy of the enterprise but will ultimately be absorbed by the budget. 1/ On this view, reforms in the price structure, as well as efforts to replace budgetary finance for working capital and fixed investment by retained funds and bank loans, will produce only limited benefits in terms of improving enterprise performance unless there exists a credible threat of liquidation for enterprises that make financial mistakes. 2/

Throughout the discussion in this section, the effects of reform measures and of official fixing of prices and wages have recurred as key determinants of the various financial flows between the budget and enterprises. This is hardly surprising, since enterprise financial performance, as we have already seen, has a direct bearing on the budget and is itself effected by price and wage decisions and by reform measures that change the rules for the formation and distribution of profits. The countries studied in this paper provide several examples of the substantial impact that reforms of enterprise finances and pricing structures can have on the budget. In Romania, for instance, budgetary revenue and expenditure both declined by about 13 percentage points relative to GDP between 1979 and 1981, largely as a result of a switch away from budgetary transfers to finance investment and of a restructuring of producer prices that smoothed a previously uneven distribution of profits and losses; in effect, these measures, as expected, 3/ significantly reduced the role of the allocation branch of budgetary policy. In this light, it is therefore initially surprising that of the countries examined in this paper, Hungary still has the highest expenditure/GDP ratio, even after the extent of decentralization reforms undertaken in the past 15 years. In this country, the impact of those measures was offset by pricing policies

1/ This view is developed at length in Kornai (1980); its implications for demand management are noted below.

2/ Similar issues are involved in the problem faced by non-CPEs of ensuring adequate performance by public enterprises protected from market forces.

3/ See Section II.

in traditional CPEs therefore stems from its role as one determinant, together with policies on wages, prices, and consumer goods supply, of this balance. 1/ Although most CPEs did manage to sustain significantly

1/ The planners' goal in this context is to match the change in liquidity implied by the difference between household disposable income and the supply of consumer goods to households' desired increase in liquid asset holdings. Household income is influenced by fiscal instruments (taxes and transfers), regulation of wage payments, and employment policies, while the supply of consumer goods is determined in real terms by the Plan and sold at prices set by the authorities. The remaining element is the forecast of household savings.

The link between the budget and the household sector can also be shown in terms of the monetary survey identity:

$$D_G + D_E + F = M_H + M_E \qquad (1)$$

where D_G is net credit to government, D_E is credit to enterprises, F is net foreign assets, M_H is household liquidity, and M_E is enterprise deposits (other, relatively insignificant, forms of credit, e.g., to households and cooperatives, are omitted).

Rewriting (1), the supply of household liquidity is given by

$$M_H^S = D_G + F + D_E - M_E \qquad (2)$$

Under the monetary control assumptions of the traditional CPE, F is set by the foreign exchange budget, and $D_E - M_E$ is controlled by monitoring enterprise financial transactions in accordance with plan purposes. Both are therefore insulated from the household sector, so that the proximate determinant of variations in household liquidity becomes net credit to government. Moreover, an increase in credit to enterprises, if not usable for extra-Plan purposes, would not necessarily increase excess demand pressures.

In the CPEs examined in this paper, definitions of money and credit employed in Fund-supported financial programs varied in their treatment of enterprise credit and deposits. In three countries, program ceilings on domestic credit were defined net of enterprise deposits, consistent with a definition of money comprising cash in circulation and household savings deposits. In a fourth, the ceiling included gross credit to enterprises with their deposits considered part of total liquidity. The fifth adopted targets for expansion of currency in circulation and growth of enterprise credit.

reduced official inflation rates in the postwar years, this could have resulted either from a genuine abatement of inflationary pressures or, instead, the repression of inflation through extensive official price controls. 1/

As fiscal and monetary policies in CPEs are, in principle, the financial reflection of the Plan and the official prices at which its transactions are valued, as long as the economy evolves in accordance with the Plan, financial policies appear to play the mainly passive role of validating other official decisions and, as seen above, of containing inflationary pressures in the household sector. In practice, however, achievement of the planners' goals is hampered by a variety of shocks, both internal and external, which require adjustment both to the Plan and the instruments by which it is put into effect. Should economic developments diverge from the Plan, financial policies would need to be correspondingly modified to prevent the emergence of potentially damaging macroeconomic imbalances. For example, a level of liquidity that would adequately support the implementation of planned output targets could prove excessive should those targets be underfulfilled, so that failure to adjust financial policies could lead to an intensification of inflationary pressures. Such situations could result from the typical preference for taut, ambitious output plans and the consequent incidence of supply constraints arising, for example, from shortages of intermediate goods.

As indicated earlier, the five CPEs examined in this paper have not all conformed in recent years to the conventional picture of fiscal conservatism, with four of the group experiencing budget deficits and having some recourse to bank finance. In addition to statistical problems in obtaining comparable definitions, 2/ the interpretation of the budgetary stance is further complicated in certain cases by factors resulting from the extent of central control over enterprise behavior. Budget targets 3/ may be achieved despite emerging shortfalls in performance during the year by forcing enterprises to increase their

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1/ Portes (1977) and Portes and Winter (1980) argue that in East European CPEs demand pressures resulting from taut planning of enterprise activities have in the main been prevented, by the management of household liquidity, from generating inflationary pressures, whether open or repressed, on consumer goods markets; shortages and queues reflect microeconomic disequilibria, resulting from inappropriate relative prices, rather than aggregate demand imbalances. Kornai (1980) argues, however, that the soft enterprise budget constraint (resulting from the expectation that losses will ultimately be absorbed by the State) generates an insatiable hunger for resources, which inevitably generates inflationary pressures in other sectors.

2/ See p. 8 above.

3/ In some countries (e.g., Romania) the budget is required by law to be in balance.

payments to the budget, providing a flexibility of adjustment generally not available in market economies. In at least one of the CPEs surveyed in this paper, industrial enterprises have made significant payments to the budget in respect of ultimately unsalable goods, which, in accordance with Plan directives, commercial enterprises are forced to take into inventory. In both these cases, budgetary revenues are higher, and net credit to government lower, than would otherwise be true, while net credit to enterprises is correspondingly increased. In such circumstances, the financial position of the public sector as a whole, including enterprises, probably provides a more meaningful picture than that of the budget alone. 1/ However, to the extent that reform measures establish stricter regulations on the formation and distribution of enterprise profits ex ante, and subject enterprises to tighter financial discipline, these difficulties in interpreting budgetary balances would be diminished.

Economic reforms have a potentially more fundamental impact, however, on the role of demand management policies than just the meaning of budgetary data. Decentralization of major expenditure decisions correspondingly increases the scope for autonomous fluctuations in aggregate demand, which can be influenced by the central authorities only by indirect instruments, such as fiscal and monetary tools, rather than by specific directives under the Plan. Reform measures, therefore, make it more difficult for the authorities to regulate enterprise expenditures and, at the same time, facilitate such expenditures by weakening the restrictions placed on uses of enterprise deposits, thereby enhancing their liquidity. For example, both in Hungary after the 1968 reforms and in China in the late 1970s, decentralization measures were followed by a boom in enterprise investment. In these cases the subsequent efforts to bring aggregate demand under control entailed some degree of recentralization and a reduction in enterprise autonomy. Maintaining the momentum of reforms without at the same time aggravating excess demand pressures therefore requires that . eater use be made of fiscal and monetary instruments for demand management purposes as deployed in non-CPEs. 2/ Ironically, the impact of reforms may be to increase the importance of fiscal policy for demand management

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1/ Perhaps reflecting these considerations, in four of the CPEs examined in this paper a fiscal subceiling was not included as a performance criterion in a Fund-supported financial program. Since state enterprises account for a very high proportion of total credit, a subceiling on credit to the public sector (i.e., including state enterprises) would be virtually equivalent to the overall ceiling on domestic credit.

2/ More active use of fiscal and monetary instruments for demand management purposes may also need to be accompanied by a general strengthening of financial discipline for enterprises, including a real threat of bankruptcy (Kornai (1980)). Otherwise, the risk of losses may not curtail excess demand.

purposes, while at the same time reducing the relative size of the budget as its role in reallocating resources is diminished. The role of fiscal instruments, narrowly defined, in demand management is also enhanced as a result of reforms that decentralize price and wage determination to enterprises, thereby eliminating instruments previously used for the direct regulation of real incomes of households and enterprises. 1/ Hungary provides a clear example of this process: under the reforms, wage determination was partially decentralized to the enterprise level, with excessive growth in wages now discouraged by various means, including a progressive tax paid by enterprises on wage increases granted in excess of centrally determined norms.

No discussion of economic policies in CPEs would be complete in the present circumstances without reference to external issues, given the serious balance of payments and external debt difficulties that several CPEs have experienced in recent years. At first glance, the role of fiscal policy in generating and adjusting external imbalances in a CPE appears minor, at least in an institutional sense; in the traditional model, external trade flows are mandated by the foreign trade plan and implemented by specialized monopoly foreign trade corporations, with all external financial transactions controlled by a unit of the state banking system (such as a foreign trade bank). Improvements in the external trade position would, therefore, entail changes in the foreign trade plan and consequent amendments of the domestic plan. However, given the major role played by the budget in implementing the Plan and allocating resources, these changes are effected to a considerable extent through fiscal measures. External current account imbalances in CPEs, as in other economies, reflect disequilibrium between domestic savings and domestic investment. However, because of the close links between the budget and state enterprises, and the limited role played by household savings in financing investment, savings and investment flows are channeled through the budget to a considerably greater extent than in market economies. Thus, efforts to promote external adjustment, i.e., to improve the balance between domestic investment and savings, are very often reflected in and implemented through the budget. Fiscal measures alone would not always be sufficient for this purpose in the traditional CPE: for example, restricting household incomes and demand through tax increases would not reduce imports in the absence of a corresponding adjustment of the foreign trade plan, although, as noted above, such actions would certainly help to avert potential domestic inflationary pressures in the consumer goods sector. Reforms may increase the scope of fiscal measures in influencing the external position by their impact on household and enterprise decisions, depending on the extent to which foreign trade flows have been liberalized, and therefore directly reflect domestic demand pressures.

1/ The equivalence of price and wage controls with conventional fiscal instruments in the traditional CPE is analyzed in Fetherston (1981).

The extent of official control over economic activity in CPEs provides considerable scope for major short-term adjustments in response to pressing macroeconomic difficulties. In countries that have pursued intensive investment programs characteristic of CPE development strategy, rapid adjustments could be effected by curtailing budget-financed investment outlays to less ambitious levels. For example, in recent years, sharp cuts in such investment spending were implemented in Romania to achieve an emergency reduction in imports prompted by external payments problems, and in China to quell domestic inflationary pressures that followed earlier moves toward decentralization of investment decisions and financing. In the Lao People's Democratic Republic, a decline in foreign budgetary assistance was countered by a sharp curtailment of expenditure, including cuts in government employment and purchases of materials, as well as in capital spending.

IV. Concluding Remarks

The context of the discussion in this paper of the role of the budget has ranged from the relatively straightforward features of the traditional model to the real-world complexity of a sample of actual CPEs, where economic management is generally in a state of some flux because of internal and external pressures for reform and adjustment. In these circumstances, sweeping conclusions are inevitably elusive, but some general observations do emerge from the above discussion and the material on individual countries presented in the Appendix. The state budget plays a key role in allocating resources in accordance with the Plan and also provides a means by which short-term adjustments can be implemented in the face of unforeseen developments. Because of the importance of the allocative function, the budget tends to be somewhat larger relative to total economic activity than in most comparable non-CPEs. In the execution of the allocative function, relations with state enterprises play a major role in the budget, so that fiscal developments are closely associated with measures affecting the financial performance of enterprises, notably price and wage policies. Reforms that decentralize economic decision making reduce the role of the budget in resource allocation and may, therefore, diminish the budget's relative size, while at the same time enhancing the potential role of fiscal policies in demand management, which must take greater account of autonomous actions by enterprises. Finally, the possible contribution of fiscal measures to the process of structural reform, for example, by improving incentives, depends on just how far CPEs are prepared to move away from directive planning and toward increased use of pricing signals and market mechanisms.

Recent Fiscal Developments in Five CPEs

Background information on economic structure and fiscal developments is provided below for the CPEs discussed in the main text--Romania, Hungary, China, the Lao People's Democratic Republic, and Viet Nam. A common format is employed for each country, with an introductory section providing information on the thrust of economic development, per capita income levels, dependence on foreign trade, and the planning system, including any significant recent changes. A brief account of the monetary system is followed by a description of the structure of public finance and recent fiscal developments, with particular reference to the impact of economic management reforms and issues of stabilization and exterral adjustment.

1. Romania

a. Background

Romania is one of the East European countries in which the traditional model of central planning was adopted shortly after World War II. In line with other countries in this group, Romania's development strategy has emphasized heavy industry and a high rate of investment: during the 1970s, investment absorbed about 35 per cent of national income, which grew at an average annual rate of over 9 per cent. According to World Bank estimates, by 1980 per capita gross national product (GNP) exceeded US$2,300. 1/ Foreign trade, in both convertible and inconvertible currencies, plays a substantial role in Romania's economy: in 1980, exports, most of which were manufactured goods and refined petroleum products, were equivalent to about 19 per cent of GDP, and imports, consisting mainly of raw materials, machinery, and equipment, were over 22 per cent. In common with other East European CPEs, the investment effort in the 1970s was financed to an increasing extent by foreign borrowing in convertible currencies. In the second half of the decade, external debt grew rapidly as Romania's current account deficit came under strain from sluggish external demand and rapid increases in raw material import prices and international interest rates. In 1981, large short-term capital outflows triggered by the impact of Poland's external debt difficulties on international financial markets gave rise to acute balance of payments pressures.

In most respects the planning system in Romania exemplifies the traditional model. The planning process focuses on the establishment of physical targets for production and expenditure, set in broad terms in Five-Year Plans and in considerable detail down to the enterprise level in the Annual Plans. The targets emerge from an iterative

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1/ Estimates of per capita GNP in terms of the U.S. dollar face a number of methodological problems, and are thus very tentative. See International Bank for Reconstruction and Development (1982), pp. 18 and 23.

exchange of information between various administrative levels and, in theory, specify a mutually consistent plan for volumes of production that will satisfy users of resources for intermediate and final needs.

Some modifications to the planning system were introduced in the 1960s during the general period of economic reform measures in Eastern Europe, including moves toward administrative decentralization by the creation of an additional layer of decision making responsibility (the "centrals") between enterprises and their supervising ministries. These measures were, however, less ambitious than others attempted elsewhere and had only limited effects, as ministries resisted any erosion of their direct influence over enterprise activities. 1/ In recent years, potentially more far-reaching reform measures have been adopted: in 1978 a new law on the generation and distribution of profits was enacted to improve incentives and raise the share of fixed investment financed by retained profits as opposed to transfers from the budget, while net (rather than gross) production became the main economic performance indicator. More recently, reform measures have focused on rationalization of prices and exchange rates. In common with other CPEs, domestic prices had remained unchanged for long periods, and were fully insulated from fluctuations in world prices by a complex price equalization system. In 1981 producer prices were adjusted for the first time in five years, mainly to eliminate enterprise losses in the mining industry, and initial steps were taken toward a reformed exchange rate system, under which domestic prices of traded goods would be more closely linked to world prices.

b. Financial system

The monetary system in Romania incorporates most of the features of the traditional model. The banking system comprises the National Bank (the central bank and principal commercial bank), four state-controlled specialized banks, and credit cooperatives for private farmers. The state banking system monitors Plan implementation by supervising the flow of funds among enterprises, households, and the state budget in accordance with cash and credit plans drawn up by the National Bank and designed to provide sufficient liquidity for the implementation of the physical plan targets. Strict separation is maintained between the cash circuit, encompassing household transactions, and the noncash circuit, involving payments among enterprises and between enterprises and the state budget; all cash receipts of enterprises (from sales to households) above specified minimum amounts must be deposited with the banking system.

The state budget, which consolidates the budgets of the republic and of local authorities, is drawn up in conjunction with the Plan. A major though diminishing role for fiscal policy is the mobilization

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1/ Bornstein (1977); Höhmann, et al. (1975).

and channeling of resources among enterprises in accordance with the Plan targets; receipts from enterprises in various forms have consistently exceeded 70 per cent of budgetary revenue (Table 2), while the bulk of expenditure comprises "financing the national economy," i.e., transfers to enterprises to finance fixed investment and working capital, as well as subsidies. Resources mobilized from enterprises comprise turnover taxes (the difference between enterprise sales and costs minus a markup), the tax on net production (payable even if profits targets are not met, but at a reduced rate if it would otherwise generate a posttax loss), residual profit remittances (after distribution to amortization and internal enterprise funds), and other taxes and revenues from socialist units. On the expenditure side, subsidy payments have consisted mainly of transfers to enterprises whose official sales prices did not cover costs (especially in mining) and absorption of net losses generated by the price equalization system for foreign trade transactions.

By law, the budget must be planned to balance; however, planned budgetary expenditure includes reserve funds (recently about 10 per cent of expenditure) to finance unforeseen expenditures or offset revenue shortfalls. In addition, taxes paid by and transfers planned for specific enterprises may be varied during the year to compensate for divergences from planned targets or to achieve other objectives. As a result, the budget outcome has typically been a small surplus. 1/

c. Recent developments

The two main features of fiscal developments in recent years have been a notable contraction of both revenue and expenditure, and an increase in the overall budget surplus. Between 1979 and 1981 budgetary revenue and expenditure declined in nominal terms, and by 13-14 percentage points as a ratio to GDP, mainly as a consequence of the reform measures affecting the finance of enterprise investment and the resetting of producer prices. Following enactment of the new profits law, the role of the budget in financing fixed investment projects diminished, as enterprises were permitted to increase profit retentions and to make greater use of bank loans. Consequently, enterprise transfers to the budget and fixed investment outlays under "financing the national economy" both declined. In addition, the resetting of producer prices caused a substantial redistribution of operating profits among enterprises, which reduced both budgetary receipts from excess profits and subsidy payments to enterprises which experience losses.

1/ The overall balance, however, at times has included some financing items above the line.

Table 2. Romania: Budgetary Operations, 1978-81

(In per cent of GDP)

	1978	1979	1980	1981
Revenue	54.5	56.7	48.1	43.6
Taxes and transfers from state enterprises 1/	38.7	42.8	34.3	30.6
Taxes on cooperatives and the population	0.7	0.6	0.7	0.7
Other 2/	15.2	13.3	13.1	12.4
Expenditure	54.2	56.4	47.9	42.3
Financing of the national economy	37.2	40.3	29.9	25.2
Fixed investment	(18.8)	(18.9)	(17.0)	(14.4)
Working capital	(0.3)	(0.3)	(0.3)	(2.5)
Other 3/	(18.1)	(21.2)	(12.6)	(8.4)
Social welfare and cultural activities	11.3	11.0	11.5	11.6
Other	5.7	5.2	6.6	5.5
Overall surplus	0.3	0.3	0.2	1.3
Financing	-0.3	-0.3	-0.2	-1.3
State Bank	-0.3	-0.3	-0.2	-1.3
Memorandum items:				
Taxes and transfers from state enterprises (per cent of revenue)	71.1	75.5	71.4	70.2
Financing of the national economy (per cent of expenditure)	68.6	71.4	62.4	59.6

Sources: Romania, 1981 and 1982; International Monetary Fund, International Financial Statistics, various issues; and data provided by the Romanian authorities.

1/ Turnover tax, tax on net production, payments from profits, and other taxes and revenues from socialist units.
2/ Includes tax on total remuneration fund and social insurance fees.
3/ Includes subsidies.

The year 1981 was marked by an increase in the overall budget balance to 1.3 per cent of GDP, compared with small surpluses recorded in earlier years. A major factor in this improvement was a reduction in import-related expenditures implemented in response to the emerging balance of payments difficulties. As the capital account position unexpectedly deteriorated with the withdrawal of new credit facilities, steps were taken to reduce the current account deficit in convertible currencies by means of sharp cuts in imports of capital goods and raw materials; these were effected promptly by revisions during the year of the Plan and the budget to reduce the authorized expenditures of ministries and enterprises. As a result, aggregate real gross fixed investment declined by 7 per cent from 1980 (compared with a planned increase of over 4 per cent) and real output growth was also less than planned. In addition, net subsidies generated by the price equalization system declined in 1981, when adjustments in exchange rates and the ratios of domestic prices to foreign prices amounted to a net effective depreciation of the Romanian currency, reducing implicit subsidies on exports and increasing revenue from imports. 1/

2. Hungary 2/

a. Background

Hungary, like Romania, belongs to the group of East European countries where central planning was adopted as the mode of economic management in the late 1940s. For nearly two decades the economic system and development strategy conformed to the traditional CPE model,

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1/ Prior to 1980, the Price Equalization Fund (PEF) of the Bank for Foreign Trade (RBFT) absorbed differences between the fixed domestic prices of exports and most raw material imports and their foreign prices converted at the official commercial exchange rate. In general, inflows to the PEF (i.e., taxes) were generated by imports, and outflows (subsidies) by exports, as most Romanian prices were higher than the domestic currency equivalent of world prices. Following the exhaustion of earlier accumulated surpluses, net losses of the PEF were directly reflected in the budget in 1979 and 1980; even in those years, payments from the budget show only the net subsidy, not distinguishing gross subsidies from gross receipts. In 1981 the PEF was abolished, but the RBFT continued to receive compensation (on a considerably reduced scale) from the budget for the average exchange rate differential between export and import transactions under the new multiple exchange rate system (involving 27 discrete exchange rates). As before, however, flows from the budget correspond to the net subsidy, with gross payments and receipts not separately identified.

1/ For a comprehensive account of the structure of the Hungarian economy and developments up to the end of 1981, see de Fontenay, et. al. (1982).

emphasizing control through central directives and priority for investment in heavy industry. As in other CPEs in Eastern Europe, pressures for reform began to develop in the 1960s, with the need to improve export performance, 1/ and in 1968 Hungary adopted the New Economic Mechanism under which a greater role was provided for market forces and foreign trade considerations in output and investment decisions. Plans were implemented at the enterprise level by indirect policy instruments rather than by direct controls, so that enterprises began to enjoy greater autonomy than previously in decisions on employment, output, and investment. The rigid system of official price determination was also partially liberalized, and domestic prices were linked more closely with foreign price developments. These reforms generally went further than those attempted in other CPEs during the same period, and also proved to be somewhat more durable, despite some subsequent recentralization, notably during the mid-1970s in the aftermath of the first oil shock, when the emphasis switched to insulation from, rather than adjustment to, external developments. Further reform measures were undertaken after 1978 as part of renewed efforts to improve external performance.

Hungary is a small, landlocked country modestly endowed with natural resources and, therefore, heavily dependent on foreign trade: in 1981 exports and imports were both equivalent to almost 40 per cent of GDP. Exports consist mainly of machinery, other manufactures, and food, while imports are predominantly manufactures and raw materials: just over half of total trade (both exports and imports) is with other CPEs. Following sustained long-term economic growth both before and after the 1968 reforms, by 1980 per capita GNP reached about US$4,200. 2/ During the mid-1970s, external policies emphasized financing rather than adjustment of payments imbalances which had arisen from a sharp decline in Hungary's terms of trade. As a result, external debt expanded rapidly between 1973 and 1978. Subsequently, the current account deficit was reduced by promoting exports and restraining domestic demand, but external debt remained large. Hungary began to experience liquidity problems late in 1981 when the climate in international capital markets became significantly less favorable for East European countries with substantial foreign indebtedness.

While being less centralized than the traditional CPE, following successive phases of reform, Hungary's economy remains predominantly based on state or collective ownership. Most industrial enterprises are state owned, while the bulk of agricultural activity is performed by cooperatives. Only about 6 per cent of recorded GDP is generated

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1/ Bornstein (1977).

2/ International Bank for Reconstruction and Development (1982), p. 18. Also cited therein, however, is an estimate of only US$2,060 based on alternative methodology, including a different exchange rate conversion procedure.

in the private sector (including household plots cultivated by employees), although the so-called second economy accounts, in addition, for a number of unofficial and unrecorded activities, especially those providing personal services. Economic planning is still based on a framework of aggregative Five-Year Plans, but as a result of the reforms the extent of central control over economic decisions in the context of Annual Plans is considerably less than in the traditional model. About half of total investment is decided by enterprises and partly financed by enterprises' own funds, with most decisions on large investment projects still made centrally.

The reforms introduced after 1978 were geared toward resuming the decentralization process and strengthening export performance. Domestic producer and consumer prices for industrial goods were raised and linked more closely to world market prices, from whose fluctuations the domestic economy had been largely insulated during the mid-1970s by an increasingly complex system of subsidies and taxes. In addition, in 1981 Hungary's commercial and noncommercial exchange rates were unified. Other reform measures, aimed at increasing the role of profitability in enterprise decision making, included some decentralization of wage determination and investment financing and changes in the formulas governing profit distributions and tax payments of enterprises. Steps were taken to enhance the role of competition by reducing the high degree of industrial concentration, promoting the development of smaller enterprises and reducing restrictions on private sector activity.

b. Financial system

The structure of Hungary's financial system conforms closely to the traditional CPE model, although the role of monetary and credit policies within that framework has been modified to some extent by the various economic management reforms. The banking system comprises the National Bank (the central bank and principal commercial bank) and various specialized institutions, all state owned, engaging in development finance, savings, foreign trade, and trust and insurance activities. The available financial instruments, and the rules governing their use, still reflect several characteristics of the traditional CPE system, including the virtual separation of cash and noncash payment circuits, the absence of capital markets, and the prominent role in banking operations for the audit function, facilited by the high degree of centralization of financial transactions at the National Bank. However, the greater financial autonomy permitted to enterprises under the reforms has increased both the scope and the need for a monetary policy that goes beyond the usual concerns of formulating and implementing cash and credit plans, which are merely the financial reflection of the detailed physical output plan. Since the 1968 reforms, the state budget, 1/ formulated in conjunction with the Annual Plan, has

1/ The state budget provides for all central government expenditures and for current and part of capital expenditures by local governments.

begun to share its former pre-eminent role in resource allocation and investment financing with credit policy operated by the National Bank. However, the size of the budget has remained large, reflecting in part the extensive recourse to subsidy payments designed to cushion the domestic economy from the impact of increasing world prices during the mid-1970s. The bulk of budget revenues are derived from various levies on state enterprises, 1/ including profits taxes, production taxes (mainly on enterprises not subject to profits tax), turnover taxes, and import duties. Included under profits taxes is a progressive levy on the sharing fund (from which wage bonuses are paid) that amounts to a tax on excessive wage increases and forms part of wage regulation policy. Direct taxes on individuals account for an insignificant portion of total revenue, as in other CPEs. The composition of expenditures reveals the importance of subsidies, which in recent years have amounted to about one third of total budget outlays, and arise both from the support of producer prices and from the subsidization of imports, notably oil. Transfer payments under the social security system, which is largely financed from the budget, also form a major component of expenditure. Given the emphasis on self-financing of enterprise investment under the reforms, capital expenditures are less prominent in the budget than in some other CPEs.

c. Recent developments

The overall balance in Hungary's state budget has generally been a modest deficit of less than 1 per cent of GDP in recent years, but in 1981 the deficit more than doubled to about 1 1/4 per cent of GDP (Table 3). Gross borrowing to finance this deficit is entirely through long-term loans from the National Bank, as the proceeds of foreign borrowing by the State are included above the line as a revenue item. 2/ Both revenue and expenditure have been close to 60 per cent of GDP, although declining slightly.

While the finance of investment has been considerably decentralized since 1968, the overall role of the budget in mobilizing and transferring resources between sectors and enterprises has remained large on account of extensive recourse to so-called income regulators--subsidies and taxes designed to provide insulation between foreign and domestic prices, and between domestic producer and consumer prices. Fiscal developments have, therefore, continued to be closely influenced

1/ "The budget revenues of the socialist state derive for the most part from taxation and other payments made by the state enterprises (and cooperatives)," Hungary (1982).

2/ On the assumption that net foreign borrowing by the State has been positive, the overall deficit on a Government Finance Statistics basis would be correspondingly higher than shown in Table 3.

Table 3. Hungary: Budgetary Operations, 1978-81

(In per cent of GDP)

	1978	1979	1980	1981
Revenue	60.9	60.4	58.9	57.2
Taxes on state enterprises 1/	34.6	35.7	38.7	40.8
Other taxes 2/	14.0	13.5	7.8	8.3
Other revenue 3/	12.3	11.3	12.3	8.1
Expenditure	61.5	61.0	59.5	58.4
Current expenditure	49.2	48.9	49.8	50.8
Subsidies	(20.1)	(19.9)	(18.3)	(18.5)
Social security	(8.5)	(9.1)	(10.8)	(11.6)
Health, education, and culture	(7.3)	(7.3)	(7.8)	(8.7)
Defense and internal security	(3.9)	(3.7)	(3.9)	(4.0)
Other	(9.3)	(8.9)	(9.0)	(8.0)
Capital expenditure	12.3	12.0	9.7	7.7
Overall deficit (-)	-0.6	-0.5	-0.6	-1.2
Financing	0.6	0.5	0.6	1.2
State Bank	0.6	0.5	0.6	1.2
Memorandum item:				
Taxes on state enterprises (per cent of revenue)	56.9	59.1	65.8	71.3

Sources: International Monetary Fund, International Financial Statistics, various issues; and de Fontenay, et. al. (1982).

1/ Profits taxes, production taxes, turnover taxes, and import taxes.
2/ Wage tax, social security contributions, and other direct taxes.
3/ Includes receipts from fees, licenses, and charges and proceeds of foreign borrowing by the State.

by changes in price and wage policies and by other factors affecting enterprise financial performance. On the revenue side, the increasing importance of taxes on state enterprises, which rose by 6 percentage points of GDP between 1978 and 1981, can be attributed in part to the impact on turnover tax receipts of price reforms in 1979 and 1980; in addition, in 1980 the authorities increased the general profits tax rate from 40 per cent to 45 per cent, and introduced a differential producers' turnover tax, designed to appropriate windfall gains accruing from the difference between world market raw material prices (on which domestic prices are based) and actual import 1/ or domestic extraction costs. Meanwhile, revenue from other taxes declined with the abolition of the wage tax in 1980.

On the expenditure side, about half the reduction in the aggregate as a percentage of GDP was on account of subsidies, which declined in relative importance following the price reforms but nevertheless remained substantial. The resumption of the decentralization process during this period also led to a reduction in the significance of capital expenditures financed from the budget. The most buoyant category of expenditure was social security, the growth of which was due to demographic trends and extension of pension benefits.

Overall developments in the fiscal area since 1978 have reflected the various measures, mostly of a structural nature, which were taken during the period to achieve external adjustment by an improved export performance. Emergency demand restraint measures, which would be effected largely through the budget, were generally not in evidence during this period. Nevertheless, use of the budget as a macroeconomic instrument to counter aggregate domestic demand fluctuations elsewhere in the economy or to provide adjustment to external shocks, carries potentially more weight than in the pre-1968 system now that enterprises have more meaningful financial autonomy.

3. China

a. Background

Since 1949, Chinese economic development has been characterized by periods of rapid growth and industrialization alternating with phases of consolidation and stabilization. In recent years, growth accelerated in the late 1970s, but moderated after 1979 as mounting pressure on resources led to the introduction of structural adjustment and stabilization measures. Despite average annual economic growth in excess of 6 per cent during the last three decades, China remains in

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1/ Raw materials are imported from other CPEs at prices sometimes below equivalent world market prices.

the low-income group of developing countries, with a per capita GNP in 1980 of less than US$300. Apart from reliance on a comprehensive system of central planning for its economic management, the Chinese economy differs from most less developed countries with its high rate of investment (the gross investment/output ratio has averaged almost 30 per cent over the last decade) and, until recently, a low degree of integration with the world economy (imports and exports reached about 8-9 per cent of GDP in 1981, an increase from 5-6 per cent as recently as 1978). The development strategy also featured almost exclusive reliance on domestic saving to finance the investment effort, strict monetary restraint and price controls, and, until recently, even in comparison with other CPEs, a preference for moral and political suasion over material incentives. When the rapid investment and growth of the late 1970s proved to be unsustainable, leading to bottlenecks in domestic supply and increasing inflationary pressures, the authorities initiated a Readjustment Program aimed at restraining demand and shifting the emphasis of growth away from high investment toward structural, technological, and managerial improvements.

Throughout the last three decades, Chinese economic management has relied on central planning within the framework of State or (in agriculture) collective ownership of the means of production. Industrial enterprises receive allocations of materials, equipment, and labor and their physical production targets from the planning authorities; until recently, prices played little part in output and investment decisions, and enterprises had very limited autonomy. Plan targets for sources and uses of goods are established through the system of material balances. To a greater extent than other CPEs, China has allocated labor by administrative means rather than by wage incentives to influence autonomous household decisions.

Reforms of the economic management system in China in recent years have concentrated on efforts to decentralize decision making to enterprises to provide greater scope for material incentives, and to supplement Plan directives by expanding the role of the market in allocating resources. 1/ Specific measures taken in these areas include the trial introduction of a profit retention system for some enterprises, greater use of bank loans in place of budgetary funds for capital finance, and experiments with previously prohibited commercial credit. In addition, under a trial system of "market adjustment," enterprises have been encouraged to produce above quota and to sell surplus production themselves, in some cases competing for sales through varying prices. Greater price flexibility has also been introduced by the introduction of "negotiated" (i.e., contract) prices of non-Plan agricultural production and some small industrial products, and "floating" prices (a permitted range around Plan prices) for a limited part of industrial output. New work incentives were introduced by

1/ The reforms are discussed in detail in Wei and Chao (1982).

linking agricultural incomes to production performance, and by providing a greater role for efficiency-related bonuses in wage payments. Whereas at one time enterprises were fully insulated from foreign price developments by the operation of the Ministry of Foreign Trade's price equalization system, a modest share of foreign trade is now carried out directly by enterprises that are outside this system and whose financial performance is, therefore, directly influenced by foreign trade prices.

b. Financial system

The Chinese monetary system conforms closely to the traditional CPE model, with all banking activity controlled by the State through the People's Bank of China and various other financial institutions. Financial planning and control emphasizes the separation between the two payment channels--cash for households and bank deposits for transactions among enterprises, official entities, and agricultural collectives. Payments made through bank deposit transfer, as well as conversion of bank deposits to cash for wage and other payments to households, are controlled by the People's Bank to ensure conformity of such transactions with the Plan. The use of currency by households is not restricted by these controls, but the amount of household currency holdings is closely monitored in order to contain inflationary pressures on consumer goods markets.

The state budget consolidates the budgets of the Central Government and the various levels of local government. In line with the usual CPE pattern, the structure of public finances is dominated by the financial relations between the budget and the state enterprise sector, with almost 90 per cent of budgetary revenue derived from price/cost margins of industrial and commercial enterprises remitted to the budget as turnover taxes, profits, or depreciation charges. Resources are channeled back to industrial and commercial enterprises through transfers for working capital and fixed investment, which, prior to the introduction of trial reform measures, financed most enterprise capital requirements, and through subsidies. Together, these items have consistently accounted for about half of total expenditure in recent years. The largest group of subsidies comprises those on agricultural commodities and agricultural inputs, designed to stimulate rural income and production while protecting urban living standards. 1/

1/ Some of these subsidy payments affect the budget on the revenue side, by reducing net profit remittances of enterprises (Wang Bingqian (1982), p. 15). Presentation of subsidies and profit remittances on a gross basis would, therefore, increase the revenue and expenditure aggregates.

In common with a number of other CPEs, China has aimed at avoiding overall deficits in the state budget so as to increase control over the growth of liquidity in the economy. In a majority of years this has been achieved, with any budgetary surpluses being used to accumulate deposits at the People's Bank.

c. Recent developments

Budgetary developments in China in recent years have featured a move into substantial deficit in 1979 (Table 4) which was then progressively reduced as the Readjustment Program came into effect. 1/ In 1979 and 1980 the deficit was financed almost exclusively through the banking system, but in 1981 the allocation of treasury bonds to enterprises reduced net outstanding bank credit to Government.

The large deficit in 1979 was in part the result of efforts to reform economic management. Efforts to cut state spending on capital construction, following very rapid growth in 1978, experienced difficulties as a result of the greater financial autonomy which had been granted to local authorities and state enterprises. Total outlays rose by about 1 percentage point of GDP, while revenue declined by almost 4 percentage points, as policy decisions restructuring wages and prices adversely affected profits of state enterprises.

Budgetary developments in 1980 and 1981 reflected intensifying efforts to reduce the expansionary impact of the budget by containing expenditure growth. Revenue declined further relative to GDP, with enterprise profits continuing to be restrained by the effects of wage and price policies, and the trial profit retention scheme also reducing gross profit remittances to the budget. At the same time, total expenditure was reduced over the two years by more than 8 percentage points of GDP. This was brought about by sharp cutbacks in spending on capital construction, which was reduced by one third in nominal terms between 1979 and 1981. In the main, this was achieved through postponement or cancellation of projects and a reversion to stricter central control over investment spending, but, in addition, an increasing share of project finance was switched from the budget to bank loans.

1/ The data in Table 4 include foreign borrowing under revenue and loan repayments under expenditure. Gross proceeds of foreign borrowing averaged about 0.9 per cent of GDP during 1978-81 (Byrd (1983)).

Table 4. China: Budgetary Operations, 1978-81

(In per cent of GDP 1/)

	1978	1979	1980	1981
Revenue and grants	32.0	28.3	25.5	23.5
Taxes and transfers from state enterprises	29.2	24.6	22.0	20.0
Other	2.8	3.7	3.5	3.5
Expenditure and net lending	31.7	32.6	28.4	24.1
Financing the national economy	...	18.7	14.5	10.9
Of which:				
Capital construction	(12.9)	(13.2)	(9.8)	(7.3)
Social services and science	3.2	3.4	3.7	3.8
Defense	4.8	5.7	4.5	3.7
Administration	1.4	1.5	1.6	1.6
Other	...	3.3	4.1	4.1
Overall surplus or deficit (-)	0.3	-4.4	-2.9	-0.6
Financing	-0.3	4.4	2.9	0.6
Banking system	-0.3	4.4	2.9	-0.5
Other domestic	—	—	—	1.1
Memorandum item:				
Taxes and transfers from state enterprises (per cent of revenue)	91.2	86.9	86.3	85.1

Sources: Byrd (1983), pp. 147-50; International Monetary Fund, International Financial Statistics, various issues; and Economist Intelligence Unit (1982).

1/ Estimates in dollar terms cited in Economist Intelligence Unit (1982) converted back to domestic currency at average yuan/dollar exchange rates reported in International Financial Statistics.

4. Viet Nam

a. Background

Viet Nam has a low-income, agriculture-based economy with a per capita GDP of about US$250 in 1980. Economic development has faced considerable obstacles in recent years, most notably a variety of resource constraints resulting from crop failures, reductions in foreign aid, and a series of wars. Following the unification of the country in 1975, economic management was further complicated by the task of integrating the economy of the south, where a considerable proportion of economic activity is still conducted on a free-market basis, into the north's system of central planning. Foreign trade provides significant resources for the economy, with imports (covering all major product categories) equivalent in 1981 to about 13 per cent of GDP, and exports (mainly handicrafts, light industrial goods, and agricultural and mineral products) only 4 per cent. Acute pressures on the balance of payments and foreign exchange reserves developed in 1981, when an already weak external position deteriorated further because of rising imports and declines in exports and foreign aid receipts.

In line with the traditional CPE model, a comprehensive economic plan establishes quantitative objectives for output, investment, and consumption. Goods are produced and distributed through the administrative supply system according to instructions from the central planning authority. Prices are set by markups on average cost norms and applicable taxes, but once established are often left unchanged for long periods and are allowed only a limited role in the allocation of resources. Essential commodities are distributed to consumers under a ration system; ration purchases by public sector employees are heavily subsidized, but other consumers, most of whom benefit from higher salaries, pay prices based on costs. Prices paid by foreign trade corporations to export producers, and domestic prices of imported goods, are fixed by the authorities and have borne no systematic relation to world prices converted at the official exchange rate.

Since 1979, a number of measures have been taken to improve production incentives, remove supply bottlenecks, and rationalize prices. A pay-according-to-work system was introduced for wage determination in most enterprises and cooperatives, cooperatives were permitted to sell above-quota production at non-Plan prices, and a small number of enterprises were permitted to engage in free-market purchases and sales; most transactions in the economy are nevertheless still conducted at Plan prices set by the authorities. In 1981, the Vietnamese currency was devalued by 70 per cent, and agricultural procurement prices were raised by amounts ranging from 400 per cent to 600 per cent, with the full effect passed on to selling prices of intermediate and consumer goods, other than ration goods distributed to public employees.

b. Financial system

Banking activity is monopolized by the State; the central bank--the State Bank of Viet Nam--each year prepares a credit and cash plan that are the financial counterparts of the physical Plan targets. Use of bank deposits of enterprises and cooperatives is restricted to officially approved transactions, but personal savings deposits are freely convertible into cash.

The state budget consolidates the operations of the Central Government, provincial governments, and local authorities. The bulk of budgetary revenue (more than three fourths--see Table 5) is derived from state enterprises in the form of turnover taxes, profits, and depreciation allowances. Turnover taxes are levied at specific or ad valorem rates on enterprise production or sales, with collections varying with actual production developments. Profit remittances are paid monthly, computed in advance on the basis of average cost norms and a fixed profit margin. Refunds are paid to enterprises with profits less than the norm, while enterprises with excess profits may retain specified maximum amounts in various incentive funds, with residual excess profits transferred to the budget. The subsidies shown under current expenditures in Table 5 comprise cash subsidies arising from the distribution of essential commodities to public employees at below-cost prices. 1/ Capital expenditures finance the bulk of fixed investment by state enterprises and part of their working capital requirements.

c. Recent developments

In recent years, Viet Nam has experienced large fiscal deficits, for which the bulk of financing was obtained from external sources in the form of loans and grants 2/ and the remainder from the State Bank. Revenue and expenditure were relatively stable in relation to GDP during the period. In 1981, efforts to reduce the overall deficit as part of a first credit tranche stabilization program met with only limited success, as revenue improvements were offset by higher subsidies on ration goods. The overall deficit as a percentage of GDP declined slightly, but remained over 10 per cent, and financing by the State Bank doubled to 1 per cent of GDP. Although the expansion of credit to Government contributed to rapid monetary growth during the year, as

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1/ Data on enterprise transfers in Table 5 are net of subsidies implied by the absorption of enterprise losses in the budget; according to the Government Finance Statistics format, however, subsidies to enterprises having losses should in principle be included as part of expenditure, with revenue defined to include enterprise profit transfers on a gross basis.

2/ Inclusion of grants in receipts above the line would imply smaller overall deficits on a Government Finance Statistics basis.

Table 5. Viet Nam: Budgetary Operations, 1978-81

(In per cent of GDP)

	1978	1979	1980	1981
Revenue	29.4	28.2	28.5	27.9
Taxes and transfers from state enterprises 1/	23.8	22.7	22.1	20.8
Taxes on cooperatives and the private sector	5.6	5.5	6.4	7.1
Expenditure	38.9	39.8	39.3	38.0
Current expenditures	27.0	28.1	28.4	28.1
Wages and salaries	(5.5)	(5.7)	(5.8)	(6.2)
Consumer subsidies	(2.0)	(2.6)	(3.1)	(7.0)
Other 2/	(19.5)	(19.8)	(19.5)	(14.9)
Capital expenditures	11.9	11.7	10.9	9.9
Overall deficit (-)	-9.5	-11.6	-10.8	-10.1
Financing	9.5	11.6	10.8	10.1
External 3/	8.9	11.0	10.3	9.1
State Bank	0.6	0.6	0.5	1.0
Memorandum item:				
Taxes and transfers from state enterprises (per cent of revenue) 1/	80.8	80.5	77.6	74.6

Source: Fund staff estimates.

1/ Comprises net profit transfers and turnover taxes, depreciation allowances and other transfers; includes repayment of working capital advances.
2/ Includes debt servicing.
3/ Includes grants.

cash in circulation increased by 40 per cent and total liquidity (including enterprise deposits) by 110 per cent, the most important factor in the latter was expansion of credit from the State Bank to enterprises and cooperatives to finance increased working capital needs occasioned by the official price adjustments.

Devaluation and price adjustments were the predominant influences on developments in 1981, when revenue and expenditure, while slightly lower relative to GDP, rose sharply in nominal terms (66 per cent and 64 per cent, respectively). With enterprise profit markups fixed as a proportion of costs, budgetary receipts from profit remittances and ad valorem taxes rose sharply in line with the increased value of turnover, and tax collections on the nonstate sector also showed strong gains. On the expenditure side, the main feature was an increase in consumer subsidies equivalent to almost 4 percentage points of GDP, as prices of essential goods distributed to public employees were left unchanged despite the sharp increases in procurement prices. With a doubling of civil service salaries, the wage and salary bill also increased somewhat relative to GDP.

5. Lao People's Democratic Republic

a. Background

The Lao People's Democratic Republic is one of the world's least developed countries, with a per capita GNP in 1980 of less than US$100. In common with other countries in the region, economic development has been considerably hampered by resource constraints and political tensions, compounded in the Lao People's Democratic Republic by its landlocked geographic situation. With the limited availability of domestic resources, the Lao People's Democractic Republic depends considerably on foreign trade: imports in 1980, dominated by machinery, raw materials, and foodstuffs, were equivalent to about 18 per cent of GDP and exports (mostly agricultural products and hydroelectricity) 3 per cent. Balance of payments pressures have persisted for some years, with foreign exchange shortages constraining imports of capital and intermediate goods and limiting the growth of the domestic production base.

Central direction of economic activity in the Lao People's Democratic Republic covers most nonagricultural activities other than small trade and handicrafts; however, reflecting the low level of economic development and the importance of subsistence agriculture, state enterprises account for only about 10 per cent of total output. Although all land is owned by the State, most of the cultivated area is still operated privately. The state trading enterprise distributes basic commodities through a ration system, purchases and sells industrial inputs and outputs of state enterprises, handles agricultural procurement, and engages in foreign trade, where it maintains a monopoly over export and import of key commodities. Official imports through this enterprise are resold to domestic enterprises at the local currency equivalent of world prices, but procurement prices for export goods are not automatically adjusted in line with world price developments. Most state domestic transactions take place at fixed official prices, but domestic products and imports not subject to state monopoly are traded privately on a free market where prices are determined by the forces of supply and demand.

During recent years a number of reform measures have been introduced to remove bottlenecks to growth and to increase domestic resource mobilization, including efforts to improve the performance of state enterprises and further liberalization of private trading activities. During 1979 and 1980, official procurement and sales prices were raised to near free market levels; the exchange rate was devalued; and half of the working capital requirements of state enterprises began to be met by interest-bearing loans from the banking system rather than by interest-free transfers from the budget. Official prices were again adjusted early in 1982, when there was a further devaluation of the official exchange rate.

b. Financial system

The monetary system comprises two state-controlled institutions, the State Bank, which handles all domestic banking activity, and its subsidiary, the Foreign Trade Bank, which deals with all international financial transactions. Annual cash and credit plans are formulated in line with the production and sales plans of enterprises. Monetary management has focused on controlling the growth of currency in circulation--the predominant determinant of private sector liquidity and, hence, of price developments on the free market.

The budget comprises the financial transactions of the Central Government, including grants to provincial administrations and transfers to and from enterprises. Although in principle, as in other CPEs, the budget is the financial reflection of the Plan, in the the Lao People's Democratic Republic the link between the two has been relatively loose, as the Plan has included neither current expenditures nor part of budgeted capital outlays. Public finances are dominated by the state enterprises, which also account for about 95 per cent of bank credit, mostly to the state trading enterprise. Transfers from state enterprises--turnover taxes, taxes on international trade, net operating surpluses, and depreciation allowances--provide about three fourths of total budgetary revenue. Until 1979, enterprise profits were fully transferred to the budget; beginning in 1980, however, enterprises were authorized to retain part of their earnings for incentive purposes, as well as for maintenance of equipment, and more recently increased profit retention shares were granted to some enterprises on a trial basis.

Enterprise losses, which in some instances were substantial prior to the price reform at the end of 1979, are absorbed by budgetary allocations at the end of the year; in the budgetary data, these losses are netted against transfers of enterprise profits on the revenue side.

c. Recent developments

The overall fiscal deficit has ranged between 22 per cent and 13 per cent of GDP in recent years (Table 6), with financing almost exclusively from external sources, mainly in the form of concessional loans and grants. Revenue and expenditure have exhibited sharp fluctuations in relation to GDP, mainly as a result of official adjustments to prices, wages, and the exchange rate. Recourse to credit from the State Bank, the only source of domestic financing, was reduced in 1979 and avoided altogether in 1980 and 1981.

Budgetary revenue in nominal terms increased sevenfold between 1978 and 1980, and more than doubled as a ratio of GDP. This was mainly on account of increased transfers from the state enterprise sector, whose net profits rose sharply after major price adjustments early in 1980. Tax receipts also benefited from higher economic activity following liberalization of private trading and improved agricultural incentives associated with increases in official procurement prices. Expenditure also rose sharply in 1980, as the devaluation raised the domestic currency cost of imported materials and capital equipment, and public sector wages were more than doubled in January 1980 to compensate for the consumer price increases.

In 1981 a decline in foreign assistance forced a marked reduction, equivalent to 7 percentage points of GDP, in the size of the overall deficit that could be sustained without recourse to bank finance. This was achieved entirely through curtailment of expenditure, by means of a cut in government employment, postponement of a planned public wage increase, cuts in expenditure on materials and supplies, and a sharp reduction in planned capital spending in infrastructure and social services, which was, in part, a direct consequence of the reduction in foreign project assistance.

Table 6. Lao People's Democratic Republic: Budgetary Operations, 1978-81

(In per cent of GDP)

	1978	1979	1980	1981
Revenue	5.0	10.7	14.4	13.2
Taxes and transfers from state enterprises	1.6	7.4	10.9	9.5
Taxes on private sector	2.6	1.9	1.9	2.7
Other	0.8	1.4	1.6	1.0
Expenditure	27.3	25.4	34.2	26.1
Current expenditure	18.3	15.8	19.8	13.7
Wages and salaries	(5.0)	(4.6)	(5.2)	(2.7)
Subsidies and other transfers	(8.0)	(6.6)	(1.3)	(0.8)
Other	(5.3)	(4.6)	(13.3)	(10.2)
Capital expenditure	9.0	9.7	14.4	12.4
Overall deficit (-)	-22.2	-14.7	-19.8	-12.9
Financing	22.2	14.7	19.8	12.9
External 1/	20.5	14.2	19.9	12.9
State Bank	1.7	0.6	-0.1	--
Memorandum item:				
Taxes and transfers from state enterprises (per cent of revenue)	30.9	68.7	75.9	71.6

Source: Fund staff estimates.

1/ Includes grants.

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