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Lessons in Fiscal Consolidation for the Successor States of the Soviet Union*

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Abstract

This paper reviews lessons in fiscal consolidation for the former Soviet Union that emerge from the experience of Central and Eastern European economies in transition. A central lesson is the need to support the macroeconomic stabilization with a front-loaded fiscal adjustment. Consistent with this adjustment path, structural reform in the tax and expenditure areas should be aimed at allocative efficiency and fairness, and its sequencing be predicated largely on administrative constraints. In the face of the uncertainty of fiscal projections, formulation of contingency measures is necessary. In addition, elimination of submerged fiscal imbalances, stemming from quasi-fiscal activities of state-owned nonfinancial enterprises and financial institutions, is just as important as correcting the measured budget deficit.

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Contents

Summary

The recent experience of Central and Eastern Europe provides a number of useful lessons in fiscal consolidation for the new independent states of the former Soviet Union during their transformation to a market economy. The relevance of these lessons is largely determined by the macroeconomic, structural, and institutional context in which fiscal policy is conducted. In general, the new independent states seem to suffer greater macroeconomic disequilibria and microeconomic distortions than do the economies of Central and Eastern Europe. Compared with most of these economies, the new states have experienced more severe initial imbalances, are relatively less open, have a far more concentrated industrial structure yet less integrated commodity and factor markets, are less equipped to formulate and implement macroeconomic policies and to build market-based institutions, and, for the most part, are more vulnerable to centrifugal forces toward fiscal decentralization.

The lessons that seem particularly relevant for the new independent states can be grouped in five areas. First, a front-loaded fiscal adjustment should be implemented, eliminating or narrowing significantly budget deficits financed by the domestic banking system. Second, consistent with this adjustment and with criteria of allocative efficiency and fairness, tax reform should aim at broadening bases and lowering marginal rates and should be sequenced largely in accordance with administrative constraints. Third, in line with the same criteria, deep cuts in consumer and producer subsidies and in transfers to loss-making enterprises should be accompanied by the creation of targeted transfers to deserving households. In addition, there are medium-term reform tasks in the areas of social security, infrastructure investment, and public expenditure management. Fourth, revenue shortfalls or expenditure overruns, owing in part to an unanticipated fall in output and to administrative weaknesses, should be met with contingency measures ranging from nondistortionary indirect tax increases to cash rationing of outlays. Finally, elimination of submerged fiscal imbalances, stemming from quasi-fiscal activities conducted mainly by state-owned nonfinancial enterprises and commercial banks, is just as important as correcting the measured budget deficit.

I. Introduction

By now it is almost commonplace to state that fiscal consolidation lies at the heart of macroeconomic adjustment programs undertaken during the market-oriented transition from central planning. Equally, it is recognized that the correction of fiscal imbalances is intimately connected with structural reform in taxation, expenditure policy, extrabudgetary operations, public debt, as well as less visible quasi-fiscal activities of state-owned enterprises and financial institutions.

This paper reviews the major, albeit tentative, lessons that can be drawn from the experience in fiscal consolidation in Central and Eastern Europe (CEE) for the new independent states of the former Soviet Union (FSU). Given the recent nature of this experience and incomplete information about both regions, this is to be regarded as a progress report rather than a conclusive assessment. Before examining the lessons, it is necessary to ascertain their possible relevance for the FSU. Thus, the paper begins with an overview of the macroeconomic and structural setting in each region and an identification of features that may limit the transferability of the 1990-92 experience of CEE to the FSU. Subsequent sections are devoted to a discussion of lessons in three broad areas: the speed and magnitude of fiscal adjustment, the mix and sequence of structural fiscal measures during the transition, and the treatment of quasi-fiscal activities. The concluding section summarizes the main lessons.

II. The Setting

The overall macroeconomic, structural, and institutional setting is critical to fiscal consolidation in the economies in transition. This stands in sharp contrast to market-oriented economies, where ordinarily the institutional framework need not be altered in order to accomplish a successful fiscal adjustment. It is, therefore, essential to examine the context in which fiscal policy is being formulated and implemented during the transformation process.

At the very outset, most economies in transition were confronted by a large monetary overhang accumulated through credit expansion in combination with price controls and ensuing shortages, particularly involving merit goods and services. It was largely the subsidization of these goods and services that led to mounting budget deficits. Following the initial rounds of relative price adjustments and given the inability of state-owned enterprises (SOEs) to respond to price signals with changes in output supply and input use, including employment, partly because of an insufficient hardening of budget constraints, wage-price pressures remained strong.

As the transition got under way, these economies suffered an unprecedented contraction stemming from the decline in effective market demand for SOE output (previously produced under plan directives) and from increasing bottlenecks in critical inputs. The implosion of output was exacerbated by the collapse of the Council for Mutual Economic Assistance, followed by the breakdown of trade and payments arrangements within the FSU. In each economy, the fall in output was accompanied by the rapid accumulation of arrears among SOEs, given the absence of an integrated banking system and lack of bankruptcy risk and other market-imposed penalties. Macroeconomic imbalances, together with microeconomic distortions, were reflected primarily in strong inflationary pressures. It was less likely that the combination of supply rigidities and domestic demand growth would translate into external current account imbalances, given the external payments difficulties faced by most of these countries.

Virtually all the economies in transition continue to experience to a greater or lesser extent the above conditions. However, the macroeconomic disequilibria and allocative distortions seem considerably greater in the FSU than in CEE as a whole. There are significant differences between the two regions, which may limit the relevance of fiscal policy pursued in CEE for the FSU. 1/ These differences involve the extent of the initial macroeconomic imbalance, economic openness, industrial concentration, market segmentation, the level of institutional development, and cultural attitudes.

At the beginning of the 1990s, the FSU faced a more severe macroeconomic imbalance than had been experienced by most CEE economies (with the possible exception of Albania and Bulgaria) when they embarked on the transition. 2/ Moreover, from the outset, CEE economies took major steps toward external liberalization. Except for a few states, notably Estonia and Latvia, which have completely liberalized both the current and capital accounts, the new independent states have not only maintained some restrictions toward the rest of the world, but also erected trade barriers vis-à-vis each other. In all, the case for macroeconomic stabilization, and in particular fiscal adjustment, seems stronger for containing inflation in the FSU--with little likelihood of external spillovers--especially in states that have introduced their own currencies.

Industrial concentration and segmentation of commodity and factor markets are distinctive features of socialist central planning, and especially in the FSU. Prior to the breakup of the Union, around one third of nonagricultural output was produced by single-enterprise industries and another third by two-enterprise industries. 3/ Large horizontally- or vertically-integrated monopolistic SOEs operated in a captive internal

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1/ Nevertheless, there are instances of sharp differences among certain countries within each region. For example, arguably, there are greater similarities between the Czech Republic, Hungary, and Poland on the one hand, and the Baltic states on the other, than between any one of the former and, say, Albania.

2/ For a discussion of the monetary overhang and commodity shortages in the USSR, see International Monetary Fund and others (1991).

3/ See Hewett (1988).

market, spanning across many subnational jurisdictions. These enterprises were closely linked under the plan, but effectively were engaged in negotiated transactions. Ironically, with tight barriers on the mobility of labor, uneven supply of commodities and inputs and a centralized allocation of financial resources, the FSU was more of an integrated production process than an integrated economic space.

Perhaps the most important--though least amenable to analysis--differences are institutional and cultural. Unlike the former socialist countries in CEE, which (despite their previous colonial status vis-à-vis the FSU) had always maintained a separate national administrative and policymaking apparatus, the union republics were administratively centralized. Under a monolithic unitary system of intergovernmental relations, each subnational jurisdiction was totally dependent from the next higher level of government. Notwithstanding increasing local autonomy and open negotiation between different levels of government, ultimate jurisdiction over all budgetary and taxing decisions remained with the central government. Therefore, since late 1991, following independence, the new states, other than the Russian Federation, were unprepared--in terms of human resources as well as organizational and legal arrangements--to exercise macroeconomic control in the fiscal and monetary areas. Equally, they were handicapped in introducing market-based tax systems and expenditure management. The conduct of fiscal and monetary policies and the structural reform process were constrained by the largely undefined locus of policymaking responsibility in many of the new states. In some states (especially in Central Asia), fiscal policy has been assumed fully by the executive branch, and specifically by the ministry of economy (that is, the successor to the former Gosplan), which still regards fiscal policy as a planning instrument, rather than by the ministry of finance. In other states, considerable ambiguity remains as to the extent of involvement of the legislative branch--comprised of representatives of established interest groups rather than of openly elected officials--in fiscal policy. 1/ An additional source of institutional weakness is the evolution of administrative market relations, customary laws, and spontaneous deregulation during perestroika, which undermined the vertical hierarchical links needed to implement macroeconomic policies. 2/

Culturally, most new independent states are at a disadvantage in formulating and executing fiscal consolidation programs because of a long period of isolation and of dependency on central planning. Complicating the task are powerful centrifugal forces which have emerged partly as a reaction against excessive centralization in the past and partly fueled by ethnic

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1/ This ambiguity has been particularly strong as regards monetary policy, especially in Russia, where the legislative branch has assumed a very active role in this area. For a discussion of institutional impediments to macroeconomic policymaking in postsocialist economies, see Kopits (1993).

2/ See Naishul (1993).

diversity and differing regional demographic and resource endowment. These forces seem much stronger in the FSU than they were in CEE, with the exception of former Czechoslovakia and, obviously, Yugoslavia. Finally, individual attitudes have been conditioned to depend on explicit or implicit social entitlements, rather than on market remuneration for work effort and saving; such conditioning seems to have been far stronger in the FSU than in CEE. These features have, of course, implications for the reform of intergovernmental fiscal relations and of social security systems in the new independent states.

III. The Adjustment Path

The consequences of large and persistent fiscal imbalances were recognized early in the postsocialist economies of CEE. In the short run, if monetized, budget deficits contribute to a rising inflation tax, which, beyond a certain rate, yields declining revenue. Alternatively, financing by the nonbank public may squeeze out enterprise investment, in particular investment by the fledgling private sector which is most in need for support during the transition. If, instead, the deficits are financed from abroad, these countries' already high external debt service burden is compounded. Over the medium to long run, all three alternatives tend to undermine economic growth. 1/

In practice, with the possible exception of Czechoslovakia and Hungary, economies in transition do not face a choice among these sources of deficit financing. With undeveloped financial markets, relatively low private saving propensities, and limited access to external financing, they have been compelled to monetize budget deficits. In the event, it has been necessary to narrow or avoid fiscal imbalances as well as to limit bank credit to SOEs, and thus facilitate a monetary policy stance sufficiently cautious to cool inflationary pressures. Broadly speaking, the required speed and magnitude of the fiscal adjustment depends on the initial monetary overhang, prevailing inflation expectations, and external indebtedness. For example, in late 1989, high inflation, as well as external payments difficulties, prompted Poland to close fully the budget gap. In addition, the monetary stance was anchored to a fixed nominal exchange rate and supported by a tax-based incomes policy--an approach that came to be known as "big bang." By contrast, in the context of less pronounced disequilibria, Czechoslovakia and Hungary could choose to adopt a more gradual adjustment path.

1/ However, to the extent domestic or external indebtedness is used to finance highly productive projects, the deficit can contribute to growth.

Early success with fiscal adjustment in most of CEE gave way, however, to a somewhat precarious budgetary performance. 1/ By 1992, throughout the entire region the fiscal position had worsened, with deficits ranging from 4 1/2 to 8 percent of GDP (Chart 1), excluding Albania. 2/ Following the initial gains from a phaseout of price subsidies and various revenue enhancing measures, the deterioration resulted mainly from output contraction, mounting interenterprise arrears and weak tax administration, on the revenue side, and increased social spending and lack of adequate control, on the expenditure side. In addition, in some countries, widening budget deficits reflected the shift of the cost of some quasi-fiscal operations (discussed below) to the budget. The fiscal deterioration contributed to a rebound in inflation, in the wake of the initial one-off relative price corrections. A notable exception has been the experience of Hungary--in many ways the most advanced economy in transition--where inflation continued to decelerate despite the sharply widening deficit in 1992, a plausible explanation being the rise in the domestic private saving rate. There, however, nonbank financing of the deficit risks crowding out some private investment.

A rather straightforward lesson from the CEE experience points to the need for a front-loaded stabilization effort supported by a marked reduction in the budget deficit. This lesson is all the more relevant for the FSU given powerful inflationary pressures and a strong tendency for budget deficits to widen. These developments are attributable largely to a rapid buildup of interenterprise arrears, substantial subsidies and bank credit extended to SOEs, and increasing social transfers--even without the rise in unemployment experienced in CEE. 3/

Whereas some of the contraction suffered by the economies in transition was inevitable, it can also be argued that the implosion was perhaps larger than warranted on structural grounds. 4/ Extending this argument, the apparent contractionary fiscal stance was seen as having aggravated the fall in output; as a corollary, a budgetary injection could have mitigated the contraction. Even if this argument was valid, under the circumstances neither the magnitude of the fiscal stimulus nor its quality could be fine-tuned to ensure beneficial effects on employment and growth. But more important, the case for fiscal expansion in the FSU remains very weak in

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1/ The recorded budget balance (surplus or deficit) cannot, of course, be interpreted as either contractionary or expansionary, which would require determination of the extent these economies are operating at capacity.

2/ Facing probably the most severe distortions throughout CEE, Albania embarked on an adjustment program in the first half of 1992, reducing the budget deficit to around 20 percent of GDP in 1992 from more than twice that amount the previous year.

3/ For a discussion of the adverse effect of interenterprise arrears on tax revenue, see Ickes and Ryterman (1992).

4/ See, for example, Nuti (1992), Borensztein and others (1993), and Calvo and Coricelli (1993).

view of its immediate inflationary consequences. Furthermore, the trade-off between inflation and output seems mild at most.

A pertinent question is whether the new independent states have the discipline and the capacity for fiscal adjustment, given the unstable institutional arrangements discussed earlier. The fiscal position of most states deteriorated markedly since 1991; by 1992, Russia and Ukraine, the largest states, had incurred deficits in the 20-30 percent of GDP range (Chart 2). 1/ By contrast, in 1992, the Baltic states launched successful stabilization programs that included a virtually balanced budget or a surplus. In both Estonia and Latvia, inflation rates decelerated to about 3 percent a month by the end of the year, without necessarily resulting in a deeper contraction than experienced by states that were approaching hyperinflation. On the strength of the initial stabilization gains, the Baltic states should be in a better position to undertake structural measures--including a more transparent treatment of quasi-fiscal operations--that over the medium run might contribute to a temporary widening in the budget deficit. At that time, however, nonbank and external financing should be available more readily than at present.

IV. Structural Reform: Composition and Sequence

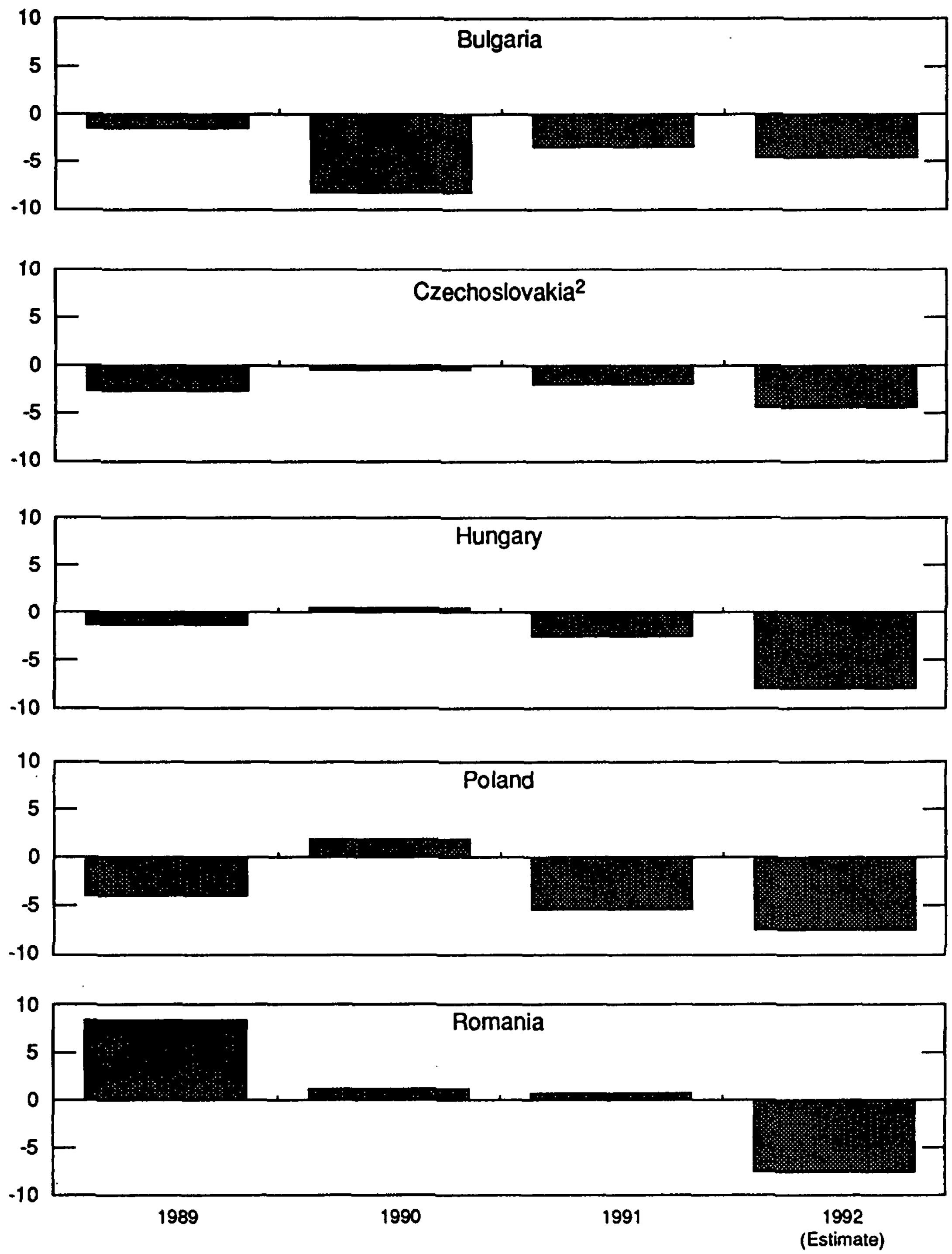
The pace and extent of adjustment cannot be separated from the sequence and composition of fiscal reform measures adopted during the transformation. The sequencing of structural measures helps determine the speed and magnitude of adjustment over time. A particular combination of measures may not necessarily be compatible with the desired degree of adjustment at a given time. Furthermore, the experience in CEE suggests that while certain measures can be taken at the very outset of the transition, others require a relatively longer gestation period. 2/ There are differences among various measures in terms of the burden they impose on the adjustment. Whereas some measures facilitate the adjustment, others hinder it in the near term, in spite of their beneficial allocative effects.

In the first stage, governments in CEE took steps both to correct the most serious distortions and to cut the budget deficit. On the revenue side, these measures included a reduction in the number of turnover tax rates, unification of the enterprise income tax rate, introduction of a single progressive personal income tax, and conversion of a wide range of nontariff barriers into ad valorem import duties. A major structural innovation was the substitution of parametric (fixed) tax rates--initially with a heavy reliance on withholding--for the previous variable rates (especially on turnover) and for the confiscation of income and profits.

1/ For a discussion of fiscal developments in each former union republic in 1991, see Aleksashenko (1992).

2/ For a survey of fiscal reform issues in economies in transition, see Kopits (1991) and the papers in Tanzi (1992).

Chart 1
Central and Eastern Europe
General Government Balance, 1989-92[1]
(In percent of GDP)



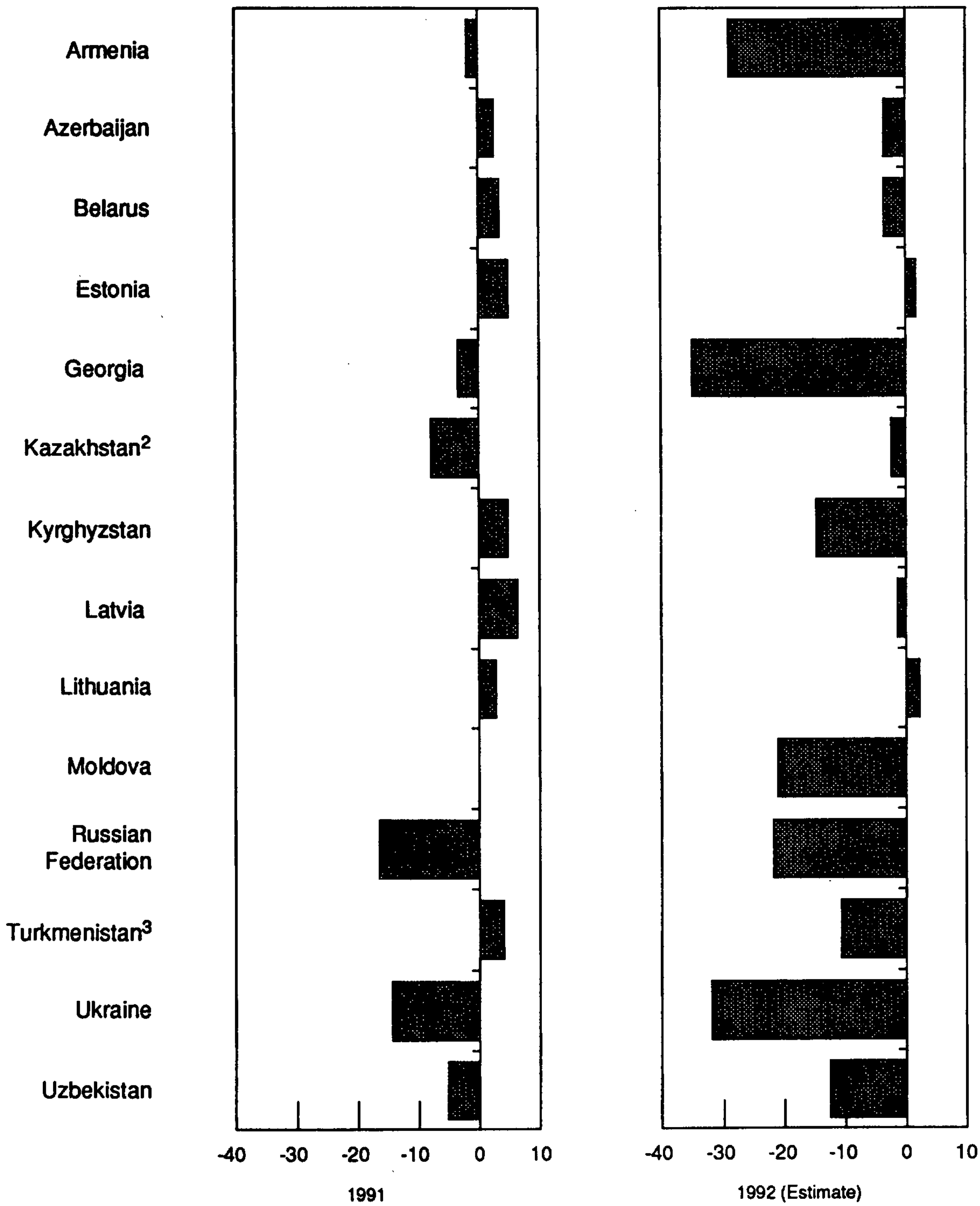
Sources: International Monetary Fund (1992), national authorities, and IMF staff estimates.
[1]Overall balance on cash basis: surplus (+) or deficit (-).
[2]Excluding stock adjustments.

Chart 2

Former Soviet Union

General Government Balance, 1991-92[1]

(In percent of GDP)



Sources: National authorities; and IMF staff estimates.

[1]Tajikistan is excluded because of lack of information. Overall balance on cash basis: surplus(+) or deficit(-). Data are not strictly comparable due to differences in definition and coverage.

[2]Excludes Social Security Fund and Road Fund.

[3]Excludes Foreign Exchange Fund.

Payroll tax rates were unified and earmarked for social security funds which had been moved off budget. By 1991, these measures were introduced in most CEE economies, following Hungary which had launched them in the second half of the 1980s. For revenue purposes, Czechoslovakia and Poland introduced a uniform import duty; in addition, these countries, as well as Romania, set a tax on windfall gains from inventory revaluation associated with price liberalization. In an attempt to capture a nondistortionary return on government property, both Hungary and Poland had imposed a uniform dividend payout requirement on SOEs, as a fixed proportion of profits and equity, respectively.

On the expenditure side, all countries proceeded to dismantle consumer price subsidies, producer subsidies (especially in connection with CMEA-related trade) and transfers to loss-making SOEs. While Bulgaria and Czechoslovakia succeeded in slashing drastically most subsidies within one year, Hungary and Poland phased them out more gradually; Albania and Romania have barely begun the phaseout. Significant cuts took place in capital expenditure projects and, to a lesser extent, in military outlays. In the meantime, the demand for social benefits began to mount, particularly for unemployment compensation and indexation of social benefits, with relatively little regard for targeting to those in real need.

After having implemented the initial stage with various degrees of success--except Albania, the last country to emerge from a long period of isolation--all CEE economies are currently involved in a complex institution-building stage. This second stage is in many ways far less predictable in terms of duration and outcome; indeed, no country has yet completed it. Hungary has probably progressed the most toward the adoption of a market-based tax system, consisting, by 1989, of a value-added tax (VAT), selective excises, a progressive personal income tax--applied mostly to wages and salaries, supplemented with a flat tax on capital income--and a unified enterprise profit tax; furthermore, recently, it began to lower statutory rates while broadening the bases of some taxes. By 1992, most other countries had also introduced taxes on income and profits and in the course of 1993 are expected to substitute VATs and excises for turnover taxation. A key element in the tax reform is the establishment of a tax and customs administration suitable for a market economy.

All CEE economies have moved rather slowly in streamlining expenditures, beyond the measures taken in the first stage of the transition. Some progress has taken place in improving the budget process--from preparation through expenditure control and reporting--in integrating a number of extrabudgetary funds into the budget and in establishing treasury operations. However, much remains to be done toward shedding excess work force and central budgetary institutions inherited from socialist central planning, undertaking efficient infrastructure investment, and starting an environmental cleanup program. Pressures for additional social assistance, active labor market programs--including manpower training--and subsidies for enterprise restructuring have been on the rise, while governments have found it difficult both politically and technically to engage in cost-effective reform of social security schemes. Only the Czech Republic, Hungary, and Poland have begun to tighten the eligibility for, and the amounts of, benefits for old-age pensions, health-care services, and particularly, unemployment compensation, while improving the delivery of social assistance.

Among the lessons that can be derived from the foregoing experience, the major one underscores the importance of an appropriate sequence and mix of reform measures (Table 1). Consistent with the need for a front-loaded adjustment path and for a minimum preparatory period for introducing certain measures, it is advisable first to simplify the existing tax structure and to cut price subsidies and investment, and leave until a subsequent stage (say, two years later) the adoption of radically new systems that are subject to considerable administrative requirements, such as a VAT. 1/ In this respect, the decision by FSU governments to introduce a VAT by January 1992, as a successor to the short-lived sales tax, can be viewed as having been premature. 2/

Another important lesson regarding taxation is that every effort should be made to set statutory tax rates as low as possible and define tax bases as broadly, yet realistically, as possible. Instead, for revenue reasons, in all CEEs marginal tax rates on income, profits, or payroll have been imposed at 50 percent or above, while the standard VAT rates were set, or scheduled to be set, above 20 percent. In the FSU, before being lowered to 20 percent effective January 1993, the standard VAT rate was 28 percent. 3/ Given the fragile administrative resources and the need for incentives to private activity during the transition, such high standard rates are clearly counterproductive in that they promote evasion and deepen allocative distortions--through the combination of high standard rates and the concomitant proliferation of tax preferences. Furthermore, administrative improvements in accounting, registration, audit, collection, and enforcement are indispensable, especially for a tax system based on voluntary compliance.

With regard to expenditure policy, the CEE experience suggests the need for a rapid phaseout of subsidies, except if clearly warranted by favorable externalities (e.g., mass transport), and for minimizing all spending that

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1/ The introduction of a comprehensive personal income tax, being far more administration-intensive, should not be attempted, if at all, in the foreseeable future by any economy in transition.

2/ By contrast, the authorities were reluctant to adopt immediately means-testing for cash benefits, as part of the social safety net, because of a lack of sufficient administrative capacity

3/ The record was set in Ukraine with an aggregate 86 percent statutory payroll tax rate earmarked for social benefits, including compensation for the Chernobyl accident, effective in the first two months of 1992. Subsequently, the tax rate was reduced to 52 percent, still high by international standards.

Table 1. Outline of Fiscal Reform During the Transition

Major Reform Areas	Transition		End System
	Short Term	Medium Term	Long Term
Tax policy			
Domestic indirect taxes	Turnover tax at fixed rates	Value-added tax, excises	Value-added tax, excises
Enterprise income tax	Uniform fixed rate; tax on gains from inventory revaluation	Redefinition and broadening of base and rate cuts	Profit tax
Personal income tax	Simple progressive rate structure; flat rate on financial income	Broadening of base and rate cuts	Comprehensive income tax with schedular elements
Foreign trade taxes	Replace nontariff barriers with uniform ad valorem import duty	Moderate tariff rates based on effective protection criteria	Tariff rates determined by membership in trading arrangements, and concessions under GATT
Payroll taxation (for SS financing only)	Uniform fixed rate and broadening of base	Rate reduction as permitted by expenditure cuts	Further rate reduction
Expenditure policy			
Subsidies	Elimination of most subsidies	Subsidies for SOE restructuring	Expenditure level and structure depend on desired role of state (e.g., public vs. private education, market-based determination of public sector wages)
Investment	Cuts in investment	Infrastructure investment per social return criteria	
Military	Cuts in military expenditure	Conversion of military to civilian expenditure	
Other	Cuts in excess work force	Integration of extrabudgetary expenditures; incorporation of quasi-fiscal activities; and elimination of nonessential government functions	
Social security			
Old-age, survivorship	Indexation of benefits	Phasein of redefined pension base	Tightening of eligibility for benefits (increased retirement age, etc.) and creation of small contingency reserve
Disability, sick pay	Tightening of eligibility for benefits	Elimination of sick pay	
Unemployment relief	Introduction of unemployment compensation	Active labor market programs	Active labor market programs
Social assistance	Categorical benefits	Means-tested cash benefits (budget financed)	Means-tested cash benefits (budget financed)
Health care	Tightening of eligibility for benefits	Cost accounting and control (moderator fees, etc.)	Further rationalization
Intergovernmental relations			
Tax assignment/sharing	)	Assignment by tax categories	System depends on desired level of centralization (ranging between unitary and loose federal structure). Reliance on objective redistribution rules
Expenditures	) Subject to negotiation and bargaining	Subsidiarity principle	
Transfers	)	Experimentation with objective rules	
Public debt	Mainly held by central bank and external creditors	Issuance of debt to nonbank public	Most debt held by domestic nonbank public
Quasi-fiscal activities			
Nonfinancial state-owned enterprises	Uniform dividend requirement Tax on excess wage-bill increases Cuts in excess work force Containment of interenterprise arrears Budget subsidy for below-cost prices	Privatization, restructuring Enforcement of bankruptcy Rationalization of nonwage social benefits Budget subsidy for below-cost prices and restructuring	Options ranging from large state enterprise sector (subject to competition and to efficiency guidelines) to very limited sector (e.g., restricted to public utilities)
Banking system	Credit allocation according risk and return Phasein of capital adequacy ratios Enforcement of loan contracts	Cleanup of nonperforming portfolios Budget subsidy for preferential credits	Privatization of commercial banks Market-based monetary instruments

is wasteful and provides disincentives to work--especially sick pay, early retirement benefits and partial disability payments, which in essence are granted as hidden forms of unemployment compensation--or can be undertaken more efficiently by the private sector (e.g., central budgetary institutions involved in commercial activities). These steps must be accompanied by reform of the budget process, including the development of appropriate accounting practices and treasury operations. By the same token, over the medium term, it is imperative to review all expenditure programs, taking into account new spending needs--such as for environmental cleanup--and to engage in a comprehensive social security reform. This endeavor should, of course, be guided by a well-defined role for the public sector in the economy, formulated from a long-run perspective that has yet to evolve in most economies in transition. For the FSU, the views regarding the desirable size of, and intervention by, government range from a renewed dominant role to a virtual withering away of the state--a process that has been already under way. 1/

In the short run, in view of considerable uncertainties regarding the macroeconomic outlook and the response of decision makers at the micro-economic level, the authorities must be ready to step in with contingency measures that can be quickly implemented to support the fiscal adjustment in the event of an unanticipated revenue shortfall or expenditure overrun during the program period. In the revenue area, such measures would preferably include nondistortionary indirect tax hikes, for instance, in excises or in a uniform ad valorem import duty. Expenditure cuts would have to be applied to nonessential programs, other than interest payments and certain social entitlements. If necessary, these measures would have to be accompanied by cash rationing of expenditures, whereby cash outlays are limited by monthly revenue performance--canceling insofar as possible unutilized appropriations, so as to contain a buildup of arrears. Such an approach has been used with considerable success at various times since 1990 in Bulgaria, Czechoslovakia, and Poland, and seems most relevant for short-run expenditure control in the new independent states. Clearly, cash rationing cannot be relied upon for a prolonged period, as it may become increasingly difficult to prevent the accumulation of payment arrears followed by a surge in outlays--partly to finance the arrears. More fundamentally, to the extent that it camouflages a structural fiscal imbalance, cash rationing beyond the near term could add uncertainty to economic decision making and possibly hamper private investment.

An area where the lessons from CEE are probably of rather limited usefulness for the FSU involves intergovernmental relations. Czechoslovakia has gone through an orderly split, while Hungary and Poland are in the process of developing federal systems incorporating some horizontal equity features. Such a system involves a clearer assignment of revenue sources and of expenditure responsibilities at various levels of government, supported by intergovernmental transfers based on quantitative criteria of

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1/ See Naishul (1992).

regional need and revenue capacity. Throughout the FSU, centrifugal forces seem to be stronger than in CEE; in fact, the strength of these forces continues unabated in the new states covering a large territorial space. In the Russian Federation, regional disparities between densely populated industrial regions and sparsely populated resource-rich regions, with differences in ethnic configuration, pose a far greater challenge to a durable federal system and to the maintenance of overall fiscal balance than anything experienced in CEE--with the obvious exception of the former Yugoslavia. 1/

V. Quasi-Fiscal Activities

In socialist economies, government operations--whether through the budget or extrabudgetary funds--accounted for only a portion of all fiscal activities. In fact, a considerable range of fiscal activities was, and still is, conducted outside the government sphere in most former centrally-planned economies. Such quasi-fiscal activities, carried out largely in the nonfinancial state enterprise sector and in the banking system, tend to understate both the size of fiscal operations and the size of the fiscal imbalance as measured in the accounts of the general government.

Traditionally, SOEs operated under an ill-defined objective function where social welfare, in terms of satisfaction of merit wants--as specified in the central plan--and of the well-being of managers and employees, was much more prominent than profitability which was incidental to performance. Equally, SOEs were not subject to bankruptcy risk. Under the circumstances, the role of enterprises became indistinguishable from that of public employment agencies, social security institutions, and suppliers of subsidized consumer goods and services. However, as budgetary transfers were pared down, the SOEs had to finance increasingly these quasi-fiscal activities from their own resources, bank credits, or simply accumulation of interenterprise arrears--all such financing being made available implicitly, if not explicitly, under government guarantee. Following the initial price liberalization, the SOEs still retained some of their role as providers of income maintenance--which can be regarded as a quasi-fiscal activity--for their own employees, as reflected in excessive wage awards unrelated to labor productivity. In some countries, these wage pressures were exacerbated by organized labor represented in the management of SOEs.

Along similar lines, commercial banks, spun off from the central bank during the initial phase of the banking reform, inherited a large portfolio of nonperforming assets. The latter consists of bad debts of SOEs, some of which have been accumulated since the beginning of the transition. In addition, some specialized banks have also held low-interest long-term mortgages and other preferential credits extended to households and enterprises, respectively.

1/ See Kopits and Mihaljek (1993).

An additional quasi-fiscal operation, found also in some market economies, especially developing ones, involves the extension of low-interest or interest-free central bank credits to the government and refinancing credits to commercial banks. In addition, central banks often play a quasi-fiscal role in connection with a distorted exchange rate system. Another, perhaps less obvious, form of off-budget subsidization consists of credit and exchange rate guarantees that become a contingent liability of the public sector. Central bank losses resulting from such lending and exchange rate subsidies have macroeconomic implications that are similar to those of monetized budget deficits.

The costs of quasi-fiscal operations are manifest in numerous and widespread distortions in the allocation of real and financial resources. Above-market wage payments by SOEs and central bank losses are not reflected directly in the budget, but have typically been financed through credit creation and contributed to inflation. The costs of bad loans or preferential credits are often cross-subsidized with deposit rates and with nonpreferential lending rates. In this case, the burden of quasi-fiscal operations is incorporated in interest rate spreads, thereby repressing bank intermediation--a heavy cost particularly in the absence of developed financial markets.

While the merits or drawbacks of some quasi-fiscal operations may be subject to debate, there are three lessons that can be derived from the experience of CEE. First, there is a case for sharing the costs of such operations among all taxpayers instead of financing them through cross-subsidies from only a group of taxpayers (for instance, depositors). This can be accomplished in part through the replacement of nonperforming bank portfolios with interest-yielding government paper, as well as the cancellation of interenterprise arrears. 1/ As illustrated by ongoing initiatives in CEE, such steps cannot be taken in haste as they require a clear change in the rules of the game, supported by effective institutional arrangements--including bankruptcy legislation--to harden budget constraints on the SOEs and the banking system. 2/ As regards the quasi-fiscal activities of central banks, the adoption of a realistic unified exchange rate and the phaseout of below-market interest rates and of other preferential lending terms contribute to the reduction in central bank losses and should be taken early in the transition.

The second lesson, of crucial importance to support short-run macro-economic stabilization, given insufficient market discipline on SOEs, points

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1/ These measures are obviated under high inflation, as it occurred for example in the late 1980s in Poland, given the erosion of the value of unindexed outstanding loans.

2/ In some instances, such as in the case of low-interest long-term mortgages in Czechoslovakia and Hungary, the incorporation of the interest subsidy in the budget (or in an extrabudgetary fund) and the discontinuation of such mortgages was technically straightforward.

to the need for containing the quasi-fiscal component of wage increases. To this end, a number of countries, especially Czechoslovakia and Poland, have resorted successfully to a highly progressive tax on excess wage-bill increases in SOEs. Although, as defined, this tax allows for productivity-based wage increases at the enterprise level if accompanied by layoffs, it can lead to economy-wide distortions over time and thus should be used only as a temporary device. However, its usefulness in the FSU at this stage cannot be overemphasized; such a tax has contributed to a sharp deceleration of wage inflation in the Baltic states, while its adoption was resisted elsewhere in the FSU. 1/

Third, there is broad agreement on the need to make transparent the costs of quasi-fiscal operations by incorporating in the budget those operations that cannot be eliminated. Despite the initiatives taken in some CEE economies in this direction, considerable work still lies ahead for the medium term. In principle, the shift of these costs to the government budget, in the form of increased social spending borne previously by SOEs and of interest expenses previously internalized by commercial banks, constitutes a legitimate addition to the budget deficit insofar as it entails an equivalent reduction in credit expansion to the nongovernment sector. The scarcity of reliable and comparable estimates of the costs of quasi-fiscal activities precludes an assessment of the submerged fiscal imbalance due to such activities, not captured by the measured budget deficit. Accordingly, a rise in the budget deficit may reflect in part the shift of some quasi-fiscal operations into the budget. This explains part of the recent increase in the budget deficit in some countries, notably Hungary. In this regard, however, it is worth noting that the cleanup of bank portfolios need not result in an increase in the budget deficit and the public debt to the extent they are--as they should be--offset with receipts from privatization of SOEs, as done for example in Czechoslovakia in 1991. More generally, while transparency in the fiscal accounts is most desirable, it cannot be achieved overnight particularly in the new independent states.

1/ The effectiveness of the tax on excess wage increases (the so-called Abalkin tax), introduced in 1989 in the USSR, was eroded by widespread preferences granted on an industry-by-industry basis and was repealed two years later by the successor states partly as a show of independence. Instead, some states, including Ukraine, moved in the opposite direction by introducing wage indexation, which aggravated the wage-price spiral. To contain the surge in wages, and to generate revenue, the new states experimented in the course of 1992 with an enterprise tax levied on a base consisting of enterprise profits plus the wage bill, intended to serve both as a revenue-raising device as well as a wage regulator. More recently, the tax base has been redefined to allow deductibility of wage costs up to four times the minimum wage. However, neither the earlier definition nor this innovation has been effective as an incomes policy.

VI. Concluding Remarks

The lessons derived from the initial experience of CEE in fiscal reform and adjustment that seem particularly relevant for the new independent states of the FSU can be grouped into five areas.

1. Successful macroeconomic stabilization during the transformation requires implementation of a front-loaded fiscal adjustment, narrowing as much as possible the budget deficit financed by the domestic banking system. Apart from the direct contribution to stabilization, such an adjustment path can be useful as a signaling device to cool inflation expectations. Once the initial stabilization is achieved and inflation begins to decelerate, then noninflationary deficit financing could be obtained from nonbank sources. Admittedly, even if the initial adjustment effort is successful, it becomes increasingly difficult to ensure balance in the fiscal accounts. Nevertheless, budget deficits should be contained as excessive recourse to nonbank financing tends to crowd out much-needed private investment.

2. Tax reform should be consistent with the above adjustment path and contribute to allocative efficiency and equity. Because of inherent administrative weaknesses, it is necessary to proceed from a rather simple design at the outset of the transition to a more sophisticated system at a later stage. As part of this approach, tax bases should be broadened sufficiently so as to permit moderate marginal statutory rates. Whereas initially tax collection is to take place largely on a withholding basis (through commercial banks and SOEs), over time presumptive rules should be used to reach hard-to-tax groups. Progress toward a truly comprehensive system of commodity and income taxation will depend on administrative improvements.

3. At the start of the transformation, major budgetary savings are to be realized through deep cuts in consumer and producer subsidies, investment expenditures, and transfers to loss-making SOEs. Besides supporting the adjustment effort, these measures confer early allocative gains. However, the phaseout of consumer price subsidies must be accompanied by the creation of a system of delivering targeted assistance. For administrative ease, at the beginning such subsidies may have to take the form of categorical transfers to well-identified groups of households, to be followed by the introduction of means-tested transfers. Over time, it is necessary to engage in a cost-effective reform of the social security system and to prune the budget of activities that could be performed far more efficiently in the private sector. The ensuing savings could be used to finance infrastructure investment projects, including those associated with environmental cleanup. This sequence of policy measures needs to be supported by the adoption of effective expenditure control techniques from the formulation to the execution stage of the budget process.

4. The experience of CEE illustrates the uncertainty associated with fiscal projections during the transformation. To meet this uncertainty, it is imperative to formulate a set of specific contingency measures that

can be readily activated in the event of revenue shortfalls or expenditure overruns or both. These measures range from nondistortionary indirect tax increases to cash rationing of expenditures. Recourse to such measures, in particular cash rationing, can only be temporary and should not be viewed as a substitute for durable and structurally sound reform measures.

5. Elimination of submerged fiscal imbalances, which stem from a wide variety of quasi-fiscal activities conducted mainly by state-owned nonfinancial enterprises and commercial banks, is just as important as the correction of the apparent fiscal imbalance. In the first stage, quasi-fiscal operations, in the form of wage increases by enterprises and bank lending to enterprises not warranted by market considerations, can be contained through a tax on excess wage-bill increases and credit limits, respectively. In the medium term, these temporary measures must be replaced by market-oriented restructuring, including liquidation and privatization, of the state-owned enterprise sector. The cost of all remaining quasi-fiscal activities should be fully incorporated in the fiscal accounts. The associated accumulation of actual and contingent government liabilities is to be partly offset with the proceeds from privatization.

Clearly, these lessons are tentative and cannot possibly be applied evenly across the FSU. All new independent states have begun to reform their tax systems and expenditure policies, although the sequence outlined above has not always been observed. While the Baltic states seem to have been successful in launching the initial stage of the adjustment, most other states have yet to secure a minimal political consensus and to establish the institutional preconditions for fiscal control.

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