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**An Incomes Policy for Russia?**

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**Abstract**

Russian authorities have implemented penalties on excess wages which have been ineffective in restraining overall wage growth and in stimulating state enterprises to behave more efficiently. Assuming monetary and fiscal policy aimed at reducing inflation to low levels, this paper examines the conditions under which incomes policy can be useful and how incomes policy, if introduced, should be designed. Any possible incomes policy for Russia should be temporary, applicable only to state enterprises, include prohibitive penalty tax rates and tripartite bargaining, allow revision of excess wage norms, and focus directly on managerial compensation packages. However, practical considerations suggest that introducing incomes policy in Russia should be viewed with considerable caution.

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<u>Contents</u>	<u>Page</u>
1. Incomes Policy in Formerly Planned Economies	1
2. Prevailing System of Taxing Excess Wages in Russia	2
3. Institutional Factors Contributing to Rapid Wage Growth in Russia	6
4. Questions About Incomes Policy	7
5. Approaches to Incomes Policy--Experiences and Lessons	10
6. Microeconomic Costs of a TIP	18
7. Equity	18
8. Practical Considerations for Russia	19
References	21

The Russian authorities have implemented relatively weak penalties on excess wages. These penalties have been ineffective in restraining overall wage growth and in stimulating state enterprises to behave more efficiently. Assuming monetary and fiscal policy aimed at bringing down inflation to low levels, this paper investigates the conditions under which incomes policy can be useful and how incomes policy, if introduced, should be designed.

After reviewing the rationale for implementing incomes policy in formerly planned economies, describing the prevailing system of excess wage taxation in Russia, and raising some basic questions about regulating wages, three dimensions of an incomes policy are discussed: the usefulness for macroeconomic stabilization, microeconomic costs, and equity considerations. Finally, the arguments for and against introducing a tax-based incomes policy with prohibitive penalties on excess wages in Russia are presented.

#### 1. Incomes policy in formerly planned economies

In advanced industrial countries with national unions and a monetary policy that accommodates wage and price increases, incomes policy has been described as a means to improve the trade-off between inflation and unemployment. This characterization has rested on the argument that wage increases carry a negative externality in the form of inflation, which, in the presence of uncoordinated wage setting, may be neglected. For example in an economy with many industries where each is small relative to the size of the economy as a whole, an increase in the money wage of one industry has no significant impact on the general price level. <sup>1/</sup> However, if the money wages of most industries increase, this would have a noticeable impact on inflation. Incomes policy therefore generally consists of some

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<sup>1/</sup> This example is found in Soskice (1992, pp. 37-39). Soskice assumes that there is a monopoly union for each industry.

combination of coordinated wage setting or penalties designed to reflect the negative externality of wage increases.

Another argument for an incomes policy arises in the formerly planned economies during the early stages of economic transformation, when most firms are either fully state-owned or at least under state control. The state often fails to act as an effective owner--both in terms of making decisions based on a long time horizon and enforcing hard budget constraints--at a time when workers and managers are unsure of their future with the firm. <sup>1/</sup> Thus, managers and workers may well opt for larger short-term wage increases and less investment than would occur under more effective ownership. In these circumstances, incomes policy would include wage regulation for employees of state-controlled firms.

Finally, heterodox stabilization programs have often featured wage regulation because high inflation has become a chronic problem. Therefore, wage control is adopted as a means "of breaking the momentum of inflation and dampening inflationary expectations in order to mitigate the output consequences often associated with fiscal and monetary stringency... ." <sup>2/</sup>

## 2. Prevailing system of taxing excess wages in Russia

Russia has yet to implement fully a stabilization program--whether it be called heterodox or orthodox--though efforts at economic transformation have lead to considerable structural change (price and trade liberalization,

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<sup>1/</sup> A variant of this view was held in Poland in 1989-90. Enterprises were labor-managed or -dominated. In addition, there was concern that it would take time to implement hard budget constraints on enterprises. Therefore, wage controls for enterprises were introduced "to prevent wage increases from leading to inflation by weakening the fiscal balance through lower tax revenues... ." Lane (1992, p. 127).

<sup>2/</sup> Lane (1992, p. 127).

corporatization, privatization, and a new legal framework) and brief periods of improving macroeconomic performance. 1/ Inflation and nominal wage growth during Russia's transformation have usually been higher than the authorities have predicted. Yet as of end-1993 the Russian authorities had not introduced a tax-based incomes policy (TIP) with prohibitive penalties on excess wages. Rather, during 1991 and 1992, they relied on a weaker policy, which eliminated the deductibility from profit of the excess wage bill, defined as that part of the wage bill in excess of "the number of employees multiplied by four times the minimum wage." Accordingly, the excess wage bill was effectively taxed at the enterprise profit tax rate of 32 percent. In 1993, the excess wage bill was taxed progressively: any amount up to "the number of employees multiplied by four times the minimum wage" has been treated as costs and not been taxed; any amount of the wage bill ranging from "four to eight times the minimum wage multiplied by the number of employees" has been treated as profits and been taxed at 32 percent; and any amount above "the number of employees multiplied by eight times the minimum wage" has been taxed at 50 percent. 2/

The high level of tax revenue generated by the excess wage tax 3/ and steep wage inflation suggest that the tax on the excess wage bill has not been effective in restraining overall wage growth. With respect to the

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1/ IMF (1993, pp. 1-2).

2/ This system has been further complicated by regional coefficients used to widen the wage-tax brackets of relatively high cost regions (such as the Territories). For 1994, the maximum deductible wage cost was increased from four times to six times the minimum wage and agricultural entities, with at least 70 percent of their activity agricultural related, were exempted.

3/ A preliminary government forecast in October 1993 indicated that 1993 taxation of excess wages would generate revenue equal to 3 percent of GDP or to 25 percent of all profit tax collected.

latter, official statistics indicate that after the April 1991 price reform, the national average nominal wage rose by 30 percent in the third quarter of 1991 and by 64 percent in the fourth quarter--much faster than consumer prices. Although the price liberalization of January 1992 was accompanied by a two-thirds drop in the overall average statistical real wage, this wage then grew at about 10 percent per month from February through June. 1/ By mid-1992, the overall average statistical real wage recovered to its mid-1991 level, then remained roughly constant through the rest of 1992. 2/ These developments occurred amid rapid inflation, with consumer prices rising by more than 2,300 percent between end-1991 and end-1992.

Not only has the tax on the excess wage bill been ineffective, but it has not aroused widespread opposition. Five reasons stand out. First, Russian enterprises appear to have been maximizing neither profits nor "profits plus wages" per worker. 3/ Rather, Russian enterprise managers may have been hoarding labor and approving relatively high wages at the expense of investment in the belief that soft budget constraints would continue to prevail and that being a source of employment would be beneficial for society and perhaps themselves. 4/ Such behavior is consistent with the perception by managers and employees that the near

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1/ For April-June 1992, wage arrears in industry rose, indicating that the statistical real wage was less than the actually received real wage.

2/ Koen and Phillips (1993, pp. 15-18).

3/ Coricelli and Lane (1993, pp. 197-99) provide an overview of models describing the behavior of state enterprises.

4/ A model consistent with labor hoarding is found in Commander, McHale and Yemtsov (1993, pp. 24-28), who assume that Russian firms: have Leontief production functions and market power; face soft-budget constraints; maximize workers' expected utility; and are labor-controlled.

future will include labor shedding, managerial reorganization, and streamlining of activities, if not the enterprise's complete liquidation.

The fact that Russian enterprises have reacted to the large post-1990 negative output shocks by retaining much more labor than would be expected from most models of enterprise behavior is support for the labor-hoarding hypothesis. In particular, real GDP fell 13 percent in 1991, 19 percent in 1992, and 12 percent in 1993, yet the unemployment rate averaged 0.7 percent in 1991 and 1.5 percent in both 1992 and 1993. 1/ While short time work, involuntary leave, and other forms of latent unemployment may well inflate the "actual" unemployment rate to 8-11 percent for mid-1993, 2/ this increase is still low relative to the fall in national income. 3/

Second, the Government has not taken its own excess wage guidelines seriously (which is understandable given the rate of real decline in the minimum wage) as the wages in the budgetary sphere (government services, education, science, defense, and social services) have increased sharply relative to the minimum wage. 4/ Third, highly subsidized sectors, such as coal mining, have been effectively exempt because they have covered their

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1/ Unemployment relative to registered jobseekers, (Goskomstat). However, Goskomstat's January-November 1993 report indicates that end-November unemployment was 5 percent of the labor force according to the standards of the International Labour Organization.

2/ CEA (1993, p.149).

3/ Labor hoarding has occurred amid massive job turnover in which voluntary quits have been responsible for more than 60 percent of all separations while involuntary staff reductions have been responsible for less than 30 percent, Commander, McHale and Yemtsov (1993, Table 5).

4/ The ratio of the average wage in "public health/social security" to the minimum wage rose from 2.6 in January 1992 to 5.1 in January 1993 and to 5.3 in July 1993; in public education from 3.2 to 5.6 and to 4.5; in arts and culture from 2.5 to 4.7 and to 3.9; in science from 3.1 to 5.0 and to 4.6; and in public administration from 4.1 to 6.7 and to 8.2, (Goskomstat).

wage increases directly out of government subsidies. Fourth, enterprises have been adept at circumventing the spirit of the law through the creative use of fringe benefits. 1/ Finally, the Government has not taken a firm anti-inflationary position with the trade unions representing entities dependent on state subsidies for their survival. 2/

3. Institutional factors contributing to rapid wage growth in Russia

Since the late 1980s, wage increases in Russia's enterprise sector have greatly exceeded measured productivity. Two changes have contributed to this development. First, the Law on State Enterprises of July 1, 1987, allowed enterprises to retain a higher share of internally generated funds and to allocate these funds more freely among wages, the investment fund, the material incentive (bonus) fund, the fund for social-cultural measures and housing, and so forth. 3/ Before that time, the share of internally generated funds that could be used as wages was tightly controlled. Moreover, enterprises that earned higher than expected profits generally saw those profits absorbed by federal authorities, so that even abnormally high profits did not translate easily into higher wages.

Second, in the late 1980s, the formula for calculating a manager's salary became decoupled from any performance measure of the enterprise.

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1/ For example, in 1991 the annual output of one manufacturer of automobiles totaled about 700,000 units. Of this total, 300,000 were exported, 200,000 were sold on the domestic market through normal channels, and 200,000 were reportedly bartered for inputs (such as glass and tires). In turn, the manufacturers of inputs sold the cars received via barter to its workers at 10 percent of the market price, thereby avoiding the payment of the penalty for excess wages and as well as a portion of the VAT.

2/ Examples in the nonbudgetary sphere include the Coal Miners' Union and the Agricultural Workers' Union; in the budgetary sphere, the union representing air-traffic controllers and other airport personnel.

3/ A Study of the Soviet Economy (1991, vol. 1, pp. 26,28,49).



Since then, the salary of a manager of a state-controlled enterprise has been limited to a branch-specific coefficient multiplied by the average wage of the enterprise. Therefore, managers of state-controlled enterprises have had little incentive to oppose employee demands for higher wages.

#### 4. Questions about incomes policy

This section examines five questions about incomes policy: (i) Who is being constrained?; (ii) Why is incomes policy meant to be transitory?; (iii) What should be regulated?; (iv) Should the wage norm be based on past or forecasted inflation?; and (v) When is incomes policy successful?

(i) Incomes policy in formerly planned economies mostly has focused on limiting wage growth among those state firms that generate high net income per employee <sup>1/</sup>, including those with monopoly power, firms that would like to consume their own capital, and also dynamic firms. The assumption is that most state firms are not dynamic and that the source of enterprise growth is the private sector, which is not subject to wage regulation.

(ii) If incomes policy is applied only to state enterprises in the nonbudgetary sphere, incomes policy should be transitory because the private sector is expected to grow rapidly and the state is expected to become a more effective owner of any firms remaining under its control. In addition, once the remaining state entities face hard budget constraints within a competitive environment, then there is no sense in handcuffing the state

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<sup>1/</sup> Enterprise net income is the amount available to cover wages, other labor costs, and all investment expenses (revenue minus material costs minus expected taxes). If firms borrow to pay wage increases, this often is a sign of soft budget constraints rather than poorly designed incomes policy.

sector vis-à-vis the private sector with an incomes policy that may inhibit talented individuals from remaining in or joining the state sector.

(iii) Three possibilities are generally discussed when deciding what should be regulated: job-specific wage rates, each enterprise's average wage, or each enterprise's wage bill. It may be that all three will be utilized within a country at the same time. Regulation of the lower and upper bounds of job-specific wages is most often applied to government employees within the budgetary sphere.

Regulation of the average wage (enterprise wage bill divided by the number of full-time employees) has the disadvantage of encouraging state enterprises to hire superfluous low-paid employees simply to increase the average wage of the remaining employees. This is particularly problematic when overemployment is widespread. On the other hand, average-wage regulation eliminates the incentive for state enterprises to subdivide simply to avoid excess-wage penalties. In any case, regulation of the average wage has not been utilized frequently in formerly planned economies.

Regulation of the wage bill might be applied when enterprises need an additional incentive to shed workers who are paid too much relative to their productivity. However, such regulation could possibly hinder the growth of those enterprises that, based on efficiency criteria, should be expanding their labor force. Nonetheless, wage-bill regulation has been the principal focus of incomes policy in formerly planned economies, not least because of the relative ease with which it can be applied and enforced.

(iv) The decision to base the wage norm on past or forecasted inflation depends on: confidence in the Government's ability to forecast price

increases; whether an opportunity to reopen wage negotiations exists; and whether inflation is expected to rise or fall in the near term. Suppose labor believes the Government's forecast of price movements and is willing to accept an incomes policy based on forecasted inflation without having the option to renegotiate if actual inflation exceeds forecasted inflation. Under these circumstances, labor is likely to be a staunch supporter of government efforts to keep inflation from exceeding the forecasted figure. If labor has insufficient confidence in forecasted inflation, then either past inflation will be used to set the wage norm, or the wage norm will be based on forecasted inflation but wage bargaining will be reopened whenever actual inflation exceeds forecasted inflation by a certain amount. Finally, in order to limit the increase in the real wage, the Government may prefer to use past inflation and ex post renegotiation whenever inflation is expected to accelerate and to rely on forecasted inflation (assuming confidence in the forecast) whenever inflation is expected to decelerate.

(v) Deciding when incomes policy is successful is difficult because it may seem to have been redundant whenever the increase in nominal wages turns out to be significantly less than the maximum allowable nontaxed increase. This may happen in the context of prudent fiscal and monetary policies, and when structural changes which harden the budget constraints of state enterprises have been implemented. However, the presence of an incomes policy may reduce pressure on the authorities to pursue expansionary fiscal and monetary policies in the first place, and thus may only appear to have been redundant. Another consideration is that incomes policy may complement sound fiscal and monetary policies, but can never substitute for them. More

specifically, a well-designed incomes policy may be judged to have failed because nominal wage targets exceeded the norm implied by the incomes policy, yet would have achieved its objectives if the authorities had been able to implement sound fiscal and monetary measures. Thus judging whether an incomes policy is successful is a complex task that should take into consideration a country's entire package of policy measures.

5. Approaches to incomes policy--experiences and lessons

This section evaluates the usefulness to Russia of four approaches to incomes policy, in light of historical experience with incomes policies and taking into account Russia's current institutional structure.

First, consider a policy based on collective bargaining, with national coordination of the process. This type of policy was used successfully in Austria, Norway, and Sweden during the post-World War II era. <sup>1/</sup> Success depended upon three areas of consensus: institutions existed which were considered valid representatives of labor, management and government; all sides perceived labor's share of national income to be roughly acceptable; and each party understood how its actions could contribute to a wage-price spiral and agreed that such a spiral must be avoided.

In Russia, the Government has represented both management and itself, hence has not played an independent role in wage negotiations. Moreover, Russian trade unions have not united to form unified national labor organizations and have been skeptical of the Government's ability to dampen inflation. Thus, the first option seems unsuitable for Russia.

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<sup>1/</sup> Success was especially evident before the second oil shock of 1979. For a explanation of the centralized wage-bargaining system, see Soskice (1992, pp. 41-43).

Second, consider a policy of decentralized collective bargaining with strong trade unions such as existed in Great Britain during the 1950s and early 1980s. The acrimonious strikes and deteriorating labor-management relations of this period were not encouraging. In the U.S., during the 1960s and 1970s, similar conclusions could be drawn even though the strikes were less contentious. In some areas of the Russian economy (energy and transportation), this approach has been in place since the late 1980s but has not led to more cooperation between trade unions and the Government. More generally, few observers have confidence in the Government's ability to resist union demands as long as large firms continue to be able to extract highly subsidized financial transfers from the Government.

Third, consider wage indexation in which upper bounds on job-specific wage schedules move with inflation according to a coefficient determined during tripartite bargaining. This policy, used in Western Europe mostly to set wage schedules for government employees, often proved unsatisfactory because the negotiated coefficient initially was set at a high level, then moved even higher over time. Thus, wage indexation became associated with prolonged wage-price spirals due to the high level of indexation and because government employees lowered their opposition to inflationary policies. Moreover, this type of incomes policy seems ill-suited for Russia where relative wages have not reached stable positions. 1/

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1/ In Russia's budgetary sphere, upper bounds on job-specific wage schedules have not been indexed to inflation, but rather these schedules have been modified in accordance with government decisions whenever the authorities have not wanted increases in wages in the budgetary sector to lag too far behind increases in wages in the non-budgetary sector.

Fourth, consider a TIP characterized by taxing, at prohibitive rates, excess wages, which are defined by the extent to which growth in either an enterprise's wage bill or average wage exceeds some norm. The norm tends to be a function of either past or forecasted inflation. This fourth variant also includes either an agreement to reopen negotiations whenever inflation exceeds--by some pre-specified amount--forecasted inflation, or an agreement on the maximum allowable decline in the real wage (for those firms that have sufficient net income to fund nominal wage increases above the norm). 1/

In Poland, a TIP on the wage bill was applied to both the state and private sectors on January 1, 1990. 2/ The norm moved with consumer price increases, the coefficient varying between 0.2 and 1.0 during 1990. 3/ If an enterprise did not take advantage of the margin under the norm during the early part of the year, it had the option of catching up later. For the first six months of 1990, wage growth was under the norm, quite possibly because enterprises had agreed to wage increases relative to forecasted inflation, while actual inflation was much higher. 4/ Enterprises more than caught up in the second half of 1990, reaching wage levels slightly

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1/ In IMF (1992, p. 30), a proposal was put forth calling for a ceiling on each enterprise's consumption fund equal to a base level increased by 0.7 times the forecasted rate of increase in consumer prices. Whenever the price forecast would have been incorrect, an adjustment would have been made at the end of the quarter.

2/ As of January 1, 1991, the tax base was shifted from the total wage bill to an enterprise's average wage.

3/ 0.3 in January, 0.2 for February-April, 0.6 for May-June and August-December, and 1.0 in July. Labor's acceptance of low coefficients may have been due to initial enthusiasm for and trust in a Solidarity-led government.

4/ This divergence was one of the reasons the coefficient was revised from 0.3 to 0.6.

above the norm. Nevertheless, the average real wage in 1990 fell by 31 percent year-on-year, close to the Government's target of 30 percent.

The Polish authorities made three adjustments at the end of 1990: the TIP would no longer apply to firms in the private sector; the excess wage tax would apply to only one half of the 1990 overruns; and 50 percent (as compared to the original allowance of zero percent) of any 1990 overrun would be added to that enterprise's starting base for 1991. In addition, the tax base was switched from the wage bill to the average wage in order to moderate the incentive to shed labor. The same basic pattern repeated itself in 1991--only about one third of the excess wage tax was paid and then mainly by heavily subsidized state enterprises. <sup>1/</sup> Once again at the end of 1991, 50 percent of any overrun was added to the starting base for 1992. Moreover, enterprises quickly became quite adept at avoiding TIP penalties by shifting funds from the wage fund to the collective-consumption fund (for kindergartens, clinics, sports facilities, and so forth), by running up wage tax arrears, or by granting employees loans at below market interest rates. So even though the system appeared to be restrictive in 1992 with the coefficient remaining at 0.6, the policy was not restrictive in practice because of exemptions, adjustments, nonindexed modifications to the norm, and the accumulation of large excess wage tax arrears.

On the positive side, Poland's income policy may have dampened pressure for loose financial policies in 1990 and may have saved the Government from innumerable negotiations designed to contain state-sector wages. Rapid

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<sup>1/</sup> While the revenue generated by the excess wage tax equaled about 3 percent of GDP, the heavily subsidized Polish railroads paid one third of this amount.

growth in overall unemployment along with employment opportunities in the private sector also helped to constrain wage demands in the state sector. In any event, such wage regulation was discarded at the end of 1992 because by then it was viewed as being ineffective. In addition, the private sector's share of total employment was well over 50 percent by that time.

The authorities in the former Soviet Union, reacting to the sharp jump in wages relative to productivity in 1988, experimented unsuccessfully with several types of incomes policy. In 1989, a guideline was introduced to hold the growth of a firm's wage fund to no more than that firm's growth of measured labor productivity. During the first three quarters of 1989, wages rose much faster than productivity. Therefore, the authorities implemented a TIP with prohibitive tax rates. However, the authorities provided exemptions to "high priority" branches and then extended exemptions to firms in other branches as well. The pervasiveness of the exemptions rendered this TIP ineffective. By February 1990, yet another variant appeared which redefined thresholds and exempted certain branches. <sup>1/</sup>

These incomes policies fell prey to soft budget constraints. Hard budget constraints may have been difficult to enforce because the level of the tax-exempt wage fund was based on firm-specific productivity growth measured in nominal terms. Yet such a productivity indicator hard may have been to justify in light of the administered price increases and piecemeal price liberalization which were being implemented during 1989 and 1990.

In 1991, the authorities in Romania introduced a combination of upper limits to some job-specific wages and taxes on above-norm growth of the wage

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<sup>1/</sup> A Study of the Soviet Economy (1991, Vol. 1, p. 28).



bill of state enterprises. This scheme probably contributed to the 14 percent decline during 1991 in the average real wage--substantial, but considerably less than the 25-30 percent fall initially envisioned--and to the shedding of a great deal of labor as firms sought to protect the wages of remaining employees. 1/ It is likely that the massive increase in unemployment during 1991 also helped to restrain wage growth. In 1992, the norm continued to be indexed (with a 50 percent coefficient) to inflation, but the wage bill was adjusted upward at the beginning of January, May, or September whenever representatives of labor and government determined that the inflation of the past four months exceeded expectations.

In July 1991, the Bulgarian authorities adopted a TIP that included quarterly opportunities to readjust both wage bill ceilings and the minimum wage whenever the increase in the agreed upon price index exceeded its forecasted level by more than 10 percent. 2/ The wage bill ceilings, determined during tripartite negotiations, were set to achieve a decline in the state sector's average real wage consistent with macro stabilization and

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1/ The upper bound on the wage bill during the first half of 1991 was based on the level during the fourth quarter of 1990, with a lump sum adjustment after the first four months and indexation thereafter, Jackman and Pages (1993, Table 1A). From May 1990, the norm was based on a coefficient of 0.5 indexed to inflation. Inflation was measured by a consumer price index that covered 60 percent of the typical expenditures of the average family. See Jackman and Pages (1993) for more details.

2/ During the first half of 1991, Bulgarian authorities still maintained tight control over wages. During this period, they engineered a sharp drop in the average real wage while at the same time increasing the minimum wage substantially. General dissatisfaction with the extent of the fall in the real wage and with the compression of wage differentials encouraged the authorities to soften the initial nominal wage ceilings, introduce the above-mentioned TIP, and revive the tripartite "National Council for Social Partnership". With respect to the TIP introduced in mid-1991, the minimum wage remained unchanged from July 1, 1991 to July 1, 1992, while consumer prices rose by over 80 percent.

structural transformation. In 1991, the average real wage in the state sector fell by 42 percent (more than the 35 percent originally targeted) and unemployment rose from 1.6 percent to 10.2 percent. This trend continued during the first quarter of 1992 with the average real wage falling faster than targeted, and unemployment growing rapidly. Thus, real wage growth in Bulgaria may have been limited more by the widespread unemployment and the hardening of enterprise budget constraints than by wage ceilings. 1/

In 1991, the authorities in the former Czech and Slovak Federal Republic adopted a two-stage TIP and created the tripartite Council for Economic and Social Agreement. During the first stage (January-February 1991), the average wage level of state enterprises in the nonbudgetary sphere could have increased without penalty by a cumulative 5 percent (6 percent for entities in the budgetary sphere) above the level of December 1990. If inflation for the first two months exceeded 25 percent (which it did), the wage ceiling was to be adjusted so that the average real wage in March would have been fallen by not more than 12 percent below the December level. For the rest of the year, the indexation was designed in a manner consistent with a maximum 10 percent decline in the real wage relative to December 1990 for those enterprises that could afford to increase nominal wages. 2/ In practice, the decline in the real wage was much greater than anticipated and the prohibitive tax rates were never utilized because state enterprises faced hard budget constraints. In fact, the average wage levels

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1/ See OECD (1992, Table 1, p. 15) for evidence on the hardening on enterprise budget constraints.

2/ OECD (1991, p. 137).

of most state firms rose less than the permissible nominal wage increase, which during 1991 had been reduced by the tripartite council.

The final example is Hungary, which prior to 1990 had had disappointing experience with TIPs. In 1990, the authorities rejected the idea of a TIP that included prohibitive penalties on excess wages and instead adopted a system based on the nondeductibility from taxable profit of that portion of the wage bill in excess of a pre-specified norm. The norm itself was based on forecasted consumer price increases. Tripartite bargaining was employed and wage negotiations could be reopened whenever inflation exceeded forecasted inflation by a sufficient amount (which never happened). Declines in real wages were targeted in 1990 and 1991, but the parameters were not set tightly enough to have much of an impact. Incomes policy was abandoned at the beginning of 1992 in the belief that state enterprises already were facing hard budget constraints.

These examples suggest that at best a TIP should be a temporary measure that may inhibit managers of state enterprises from raising nominal wages as much as enterprise funds permit. Moreover, the goals of a TIP are more likely to be met when firms face hard budget constraints and the fear of unemployment causes workers to restrain their wage demands. Ideally, a TIP would embody tripartite negotiations which lead to increased cooperation between labor, management and government. In general, a TIP should control the wage bill in the nonbudgetary sphere of the state sector rather than the average wage in order to encourage movement out of this traditionally inefficient part of the economy. However, in areas such as education where profitable output is a vague notion, average wage regulation may be

appropriate. Ultimately, incomes policy is only as good as the fiscal and monetary policies it supports. Alone it can anchor nothing.

6. Microeconomic costs of a TIP

The microeconomic costs of a TIP have been the reasons that countries have shied away from their introduction. For instance, if the wage norm is based on the average wage, a TIP could impede adjustments in relative wages through the penalty on high-wage earners and the reward to low-wage earners. More generally, a TIP makes it more difficult to establish a link between productivity increases and wage increases because a TIP should be based on uniform guidelines for all state enterprises to simplify its administration and avoid endless requests for exemptions. In addition, a TIP may encourage enterprise managers to spend valuable time and resources trying to circumvent the TIP restrictions. Finally, it may encourage excessive outflow of the most talented people from the state sector.

7. Equity

Equity considerations might also inhibit the introduction of a TIP that has prohibitive tax penalties. First, such a TIP generally applies to wages and bonuses in the state sector, but in Russia it has become difficult to differentiate between state and other enterprises. For instance, should an enterprise with 40 percent employee/management ownership and 15 percent local government ownership be considered a state enterprise? Second, private-sector employees would not be subject to income constraints. If the incomes of those not constrained were to follow a much more favorable path than the incomes of those in the state sector and if incomes policy was perceived to be an important cause of this divergence, then an anti-

government backlash could unfold. On the other hand, such discrimination against the state sector could accelerate privatization. Third, a TIP applied to the wage bill could accelerate labor shedding, which may be a positive development from an economic perspective. However, given the role enterprises have traditionally played in the provision of social services, one could argue that at the very least a TIP should be introduced only after a satisfactory social safety net has been put in place.

8. Practical considerations for Russia

Whether the wage growth objectives embodied in an incomes policy are met depends on the credibility of the sanctions for violating the policy, the hardness of enterprise budget constraints, the tightness of fiscal and monetary measures, and the social safety net. In theory, if a tax-based incomes policy with prohibitive penalties for excess wages were in place in Russia, the authorities might find it easier to enforce suitably tight monetary and fiscal policy. Such an incomes policy might also provide some assurance to most workers that they are all enduring about the same magnitude of decline in their standard of living in the short run.

In this vein, any incomes policy for Russia should be temporary, applicable to only state enterprises and include prohibitive penalty tax rates. In addition, regulation of the wage bill would be preferable to average wage regulation because the state sector has yet to shed itself of surplus labor. Tripartite bargaining over the TIP should focus on the maximum allowable decline in the real wage in those state enterprises which have relatively high net income and on the parameters of the social safety net. Revision of excess wage norms whenever inflation exceeds forecasted

inflation by a sufficient amount should also be part of any TIP in order to protect labor from unsound fiscal and monetary policies. Finally, given soft budget constraints, managers who "allow" excess wage payments should have their own compensation packages reduced accordingly.

That being said, when thinking about the practicality of implementing incomes policy in Russia, many negative considerations come to mind. First, most Russian political leaders have not favored the introduction of prohibitive penalty tax rates on excess wages. Those in power during 1992-93 have seen incomes policy as an outdated remnant of the pre-reform period and as a policy which has proven difficult to enforce. At the same time, the most prominent political parties would likely favor an industrial policy which allowed differentiation across branches of the economy over a policy of free-market oriented macroeconomic stabilization and structural reform which included a uniformly enforced incomes policy. Second, corporatization and privatization are being implemented in Russia. These processes have made it quite difficult to draw a line between state enterprises and other enterprises. Third, if hard budget constraints are not in place, then Russian enterprises will use time and resources to circumvent the spirit of any incomes policy. If hard budget constraints characterize the economic environment, then an incomes policy might turn out to have been redundant. Fourth, the fairness of an incomes policy is more difficult to justify in 1994 than it was several years ago because average wage differentials across branches have widened for reasons unrelated to productivity differentials. Thus, the question of introducing incomes policy in Russia at this stage should be viewed with considerable caution.

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