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Perverse effect of fiscal adjustment in transition economies

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1. Introduction

The main target of fiscal adjustment in a distorted market economy is associated with the elimination of inflationary pressure stemming from persistent fiscal deficits. Owing to unsustainable public debt, sooner or later such a deficit cannot be financed in a non-inflationary way. The monetization of deficits and imposition of the inflation tax leads to the acceleration of inflation and further deterioration of the fiscal stance (Calvo, 1988). Such developments are detrimental to allocative efficiency and ultimately to economic growth. In the case of transition economies, the situation is quite similar, although there are some specific features which have to be taken into account (Kopits, 1991). The structure of revenues and expenditures in a centrally planned economy (CPE) has significant contrasts with those of a market economy (Chand and Lorie, 1992). The main source for budgetary revenue was state-owned firms, with only a minor role for direct taxes from the private sector and households. The bulk of expenditure was linked to heavy subsidies to support the real income of the population and to subsidies provided to inefficient state enterprises, although the real burden of the latter is often overestimated.

2. Fiscal adjustment

One has to emphasize that the points of departure for adjustment in the post-centrally planned economies (PCPEs) and in the distorted markets of the less developed countries (LDCs) are not the same (Edwards, 1992, Krueger, 1992). The identification of the two, as well as a simplified comparison with the post-war reconstruction of Western European countries (Wolf, 1992), has led to proposals for inappropriate adjustment policies. As for the specific features of the PCPEs, of particular importance is the predominance of state-owned enterprises, which should not be expected to deliver the supply response (and tax revenue) one might foresee under the different circumstances of a market economy. When a crucial element of the stabilization package, namely tough financial restraints, is imposed, the state sector does not react in the same manner as it would under alternative institutional conditions.

Further, it is not precisely true that there was a relatively large fiscal deficit in the CPEs, though such an impression can be gained from certain observations. When the fiscal stance is evaluated from the standpoint of the central government balance, the situation looks discouraging (See Figure 1). But if the surpluses usually existing in the balances of the local governments are included in the survey, then the consolidated state budget balance in the late 1980s seems to be quite manageable[1]. Financial disequilibria were reflected through the inflationary overhang and the persistent shortages rather than through the fiscal deficit.

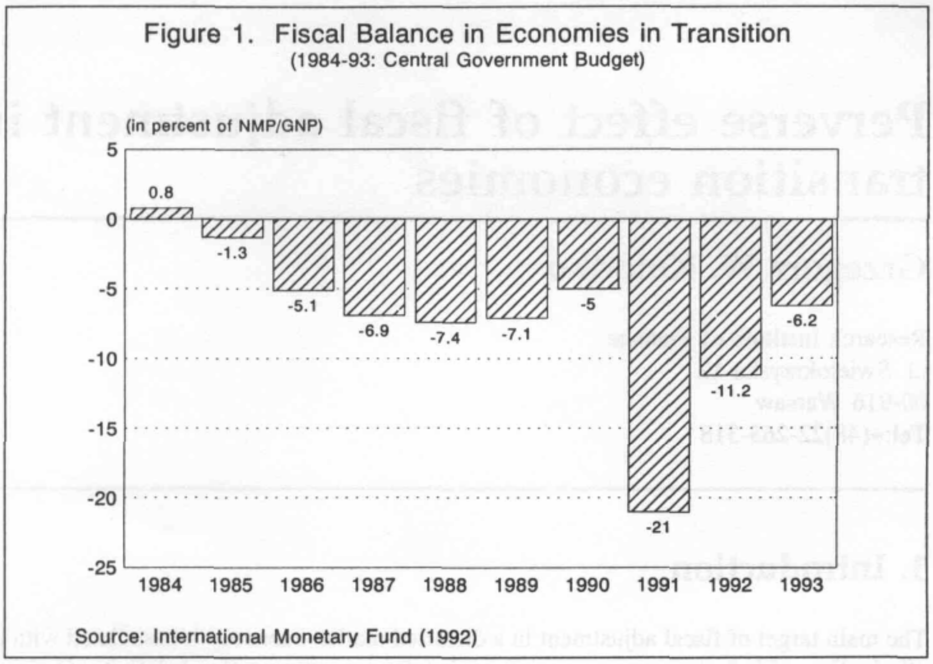


Figure 1. Fiscal Balance in Economies in Transition
(1984-93: Central Government Budget)

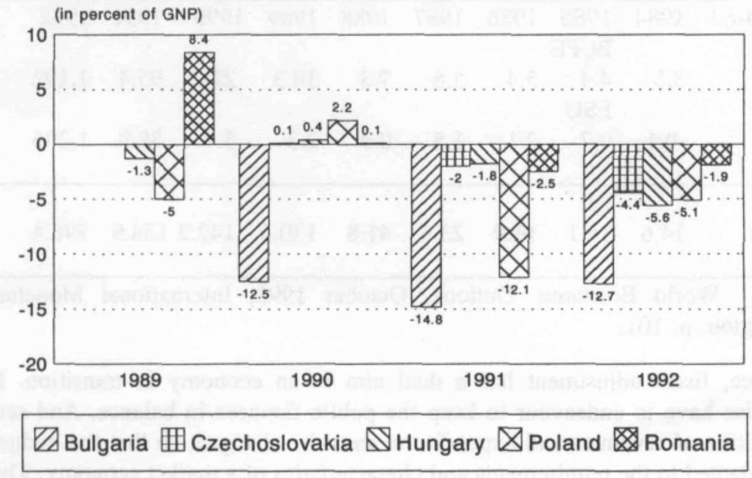
Source: International Monetary Fund (1992)

Of course, the conditions prior to the fiscal adjustment were not the same in every country. As far as Russia and some other former Soviet Union (FSU) republics are concerned, the fiscal deficit has been a great problem since the very beginning of the transition process. But in the case of East European (EE) countries, with the exception of Poland, it was hardly a central challenge for stabilization (See Figure 2). Instead, the main issues for fiscal adjustment were to restructure the budget and to implement comprehensive financial reforms (Tanzi, 1991).

While the fiscal position had been worsening up to the mid-1980s, so price inflation was accelerating. But in the second half of the 1980s the rate of price inflation was still increasing, although fiscal deficits were slowly declining. Open inflation only takes off again later (See Table 1), due to several factors, notably the aftermath of the initial price and trade liberalization.

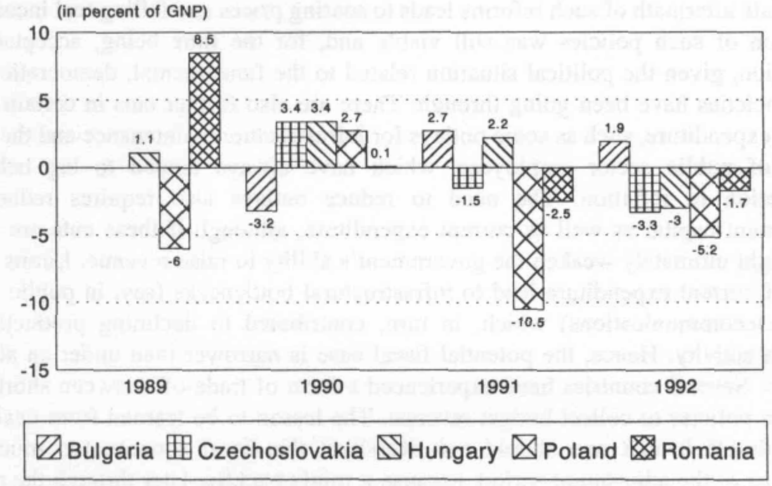
These observations show that the fiscal deficit is not directly linked with open inflation (Fischer and Easterly, 1990; Kornai, 1990; Gotz-Kozierkiewicz and Kolodko, 1992). This is even more so in the CPEs, since fiscal imbalance could be accompanied by more intense shortages, as did indeed occur in the late 1980s, albeit to different degrees in different countries. The best situation was in Hungary, the worst was in Poland.

Figure 2a. Fiscal Situation in Eastern Europe
(Overall Balance on Commitment Basis)



Source: International Monetary Fund
Note: 1989 data for Bulgaria and Czechoslovakia not available

Figure 2b. Fiscal Situation in Eastern Europe
(Primary Balance)



Source: International Monetary Fund
Note: 1989 data for Bulgaria and Czechoslovakia not available

Table 1. Open inflation in centrally planned and transition economics (consumer price index *per cent per* year)

1974-83	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
		PCPE								
3.0	3.5	4.4	5.4	5.8	7.3	18.3	21.2	95.4	1,192	109.6
		FSU								
0.8	- 0.1	0.7	2.1	1.5	0.3	2.3	5.4	88.9	1,296	134.5
		EE								
10.0	14.6	16.1	16.9	23.6	41.8	130.6	142.2	134.9	796.4	42.1

Source: World Economic Outlook, October 1992, International Monetary Fund, Washington, p. 101.

Hence, fiscal adjustment has a dual aim in an economy in transition. First, the authorities have to endeavour to keep the public finances in balance. And second, the composition of revenues and expenditures must be changed, so that the budget will be better adapted to the requirements and characteristics of a market economy. These goals have to be achieved simultaneously, which makes the whole operation even more difficult. The necessity and urgency of very rapid budget balancing at the start of the transition was somehow over-stressed, since at that time it was feasible to equilibrate revenues and expenditures in a more gradual way. It also seems that the risks connected with the restructuring of the public finance system have not been taken seriously enough, primarily because the distinctive features of the transition economy were not properly assessed[2].

On the expenditure side, the main attention focused on radical cuts in subsidies, including the abolition of some, as well as on reforms of the social security system. The immediate aftermath of such reforms leads to soaring prices and falling real incomes. The execution of such policies was still viable and, for the time being, accepted by the population, given the political situation related to the fundamental, democratic changes these societies have been going through. There are also further cuts in certain items of current expenditure, such as some outlays for infrastructure maintenance and the nominal wages of public sector employees, which have always tended to lag behind any acceleration in inflation. The need to reduce outlays also requires reductions in government capital as well as current expenditure, although if these cuts are too deep they might ultimately weaken the government's ability to raise revenue. Limits on some items of current expenditure lead to infrastructural bottlenecks (say, in public transport or in telecommunications) which, in turn, contributed to declining productivity and sluggish activity. Hence, the potential fiscal base is narrower than under an alternative scenario. Several countries have experienced a form of trade-off between short-run and long-run policies to collect budget revenue. The lesson to be learned from dealing with this trade-off is that one should not overshoot the fiscal squeeze too much at the beginning of the adjustment period, because it might backfire later through the relatively lower level of revenue that can be collected in subsequent years[3]. What is required, therefore, is a longer time perspective, exceeding the year-by-year approach which dominates typical budgeting procedures.

Unfortunately, at the same time, other payments from the budget are on the increase. High, and in many countries still rising, unemployment, the result of the transition process and the structural disproportions inherited from the previous system, absorbs additional financial resources because of the escalating costs of retraining, redeployment and social security. The restructuring of industrial capacity requires some fiscal support as well, even after allowing for possible revenues that might be generated through privatization. These costs in some of the PCPEs, especially in the economies which were not sufficiently exposed to foreign competition, are enormous. Notable examples of this are the FSU republics, facing enormous costs for the conversion of military industries for civilian use. More generally, there are also costly demands of infrastructure improvement, since the latter should meet the more exacting requirements of the private sector and the market economy.

On the revenue side, the accent shifts towards indirect taxes, the share of which in total revenue is growing. Of special importance here is the process of widening the tax base and making it more robust: it should not be too sensitive to market fluctuations. From this perspective the introduction of value added tax (VAT) and the implementation of personal income tax (PIT) are being worked out in the PCPEs (Tait, 1992). In some countries these reforms have already taken place, in others they will be implemented very soon. It is usually expected that the introduction and effective administration of the VAT will contribute substantially towards improving fiscal revenues. Although theoretically correct, one has to be aware of the experience of other countries, where this type of reform failed to raise the ratio of taxes to GDP. As for the PCPEs, it is estimated that in Russia, for example, in the first half of 1992 the VAT provided as much as a third of total revenue, but the central government budget was still running a deficit of twelve or more *per cent* of GDP. In Poland, the introduction of the VAT has been postponed repeatedly, and was expected to come into effect later in 1993, after an adequate law was adopted by the Parliament in late November 1992. Both cases strongly suggest that fiscal reforms should be implemented in a more complex manner and in an appropriate sequence.

The revenue level is also influenced by the well known Tanzi effect (Tanzi, 1977). The more rampant the corrective inflation and the weaker the tax discipline (which is, indeed, deteriorating during the early period of transition to the market), the stronger are the forces tending to erode budget revenues. This observation is true *vis-a-vis* both the state sector, which seriously delays its payments of taxes due, and the private sector, which engages in widespread tax evasion owing to the poor standards of fiscal administration and fiscal discipline.

But there are also various extraordinary events, which in the short run lead to further smaller reductions in tax revenue, although real output is already shrinking tremendously. This is possible because, again only in the short term, the profits of the manufacturing sector are not yet in decline, or at least the rate of decline is lower than the rate of output fall. The profitability of enterprises substantially depends upon output being sold at current prices, greatly inflated due to the price liberalization, while a significant proportion of the inputs had been purchased earlier, at much lower prices. Second, there is a process of inventory unloading as the immediate effect of eliminating shortage phenomena. This, too, offers a unique and temporary profit opportunity for firms, since much of the excessive stocks which had been hoarded during the shortage/repressed inflation period can be sold at the new prices, having been purchased at the old ones. Third, when the stabilization package is first implemented, there is usually a wide spread between short-term lending and deposit rates (Kolodko, 1991). This is an important source of higher-than-usual profits for the banking sector, which in turn provide a large contribution to the government's budget, as a result of taxation. Fourth, considering the enterprise sector as a whole, there are illusory capital gains earned on fixed assets as a result of the corrective inflation and the modification of accounting systems and procedures.

Table 2. Estonia, Latvia and Lithuania: main economic indicators 1990-91

	Estonia		Latvia		Lithuania	
	1990	1991	1990	1991	1990	1991
GDP rate of growth (% per annum)	-8.1	-11.0	-3.5	-8.0	-6.9	15.0
Central Government Balance (% of GDP)	2.6	6.4	2.0	8.0	-2.8	3.2
Trade Balance (% of GDP)	-6.1	13.4	-6.8	3.4	-8.6	9.7

Source: World Bank, 1993, and author's estimates.

These are the most common reasons why state enterprises and banks enjoy especially large profits in the initial phase of fiscal adjustment, a phenomenon which has been observed almost throughout the region. But, of course, there are additional reasons specific to certain groups of countries or to a particular economy. For instance, in the Baltic states, which experienced fiscal surpluses immediately after their adjustment and stabilization policies were introduced, the price reform and liberalization contributed to an improvement in their terms of trade. The new political system resulted in a cessation of the net transfers from these states to the FSU (World Bank, 1993). Owing to these facts, *inter alia,* the Baltic republics have enjoyed not only firm fiscal surpluses, but a sizeable trade balance (See Table 2).

In another case, that of Poland, state firms gained extra profits from selling some of the hard currency they had accumulated earlier on special retention accounts. But such temporary sources of budgetary revenue, considering the narrowing tax base, are evaporating very quickly. The shorter the time available to carry out appropriate reforms to ensure the effective substitution of shrinking sources of revenue with alternative sources, the more important it is.

3. The perverse effect

As we have seen above, in the very earliest phase of their transformation, after the initial measures to promote structural adjustment have come into effect, the transition economies enjoy fiscal balance, or even a surplus in some particular cases. But such a situation is short-lived as a consequence of several specific, temporarily favourable conditions, as discussed above. After a brief period when their fiscal position improved, many of the economies in transition are already experiencing severe deficits again. Although fiscal adjustment policies were designed to balance budgets in the short run, it turned out that they, in conjunction with additional unique and specific factors, also brought about the resurgence of even more serious fiscal disequilibria in the medium and long run.

The mechanism behind this is as follows: the initial macroeconomic stabilization requires government expenditures to be reduced more than the decline in revenue due to the output contraction. Therefore, in the short term, it appears that the budget is in order. But further stabilization measures, and some of the institutional changes associated with the transition, have the result that in the medium and longer term, revenues decrease much more sharply than expenditures can be cut back in the same period. Consequently, the fiscal deficit reappears. And this is the **perverse effect of fiscal adjustment in transition economies.**

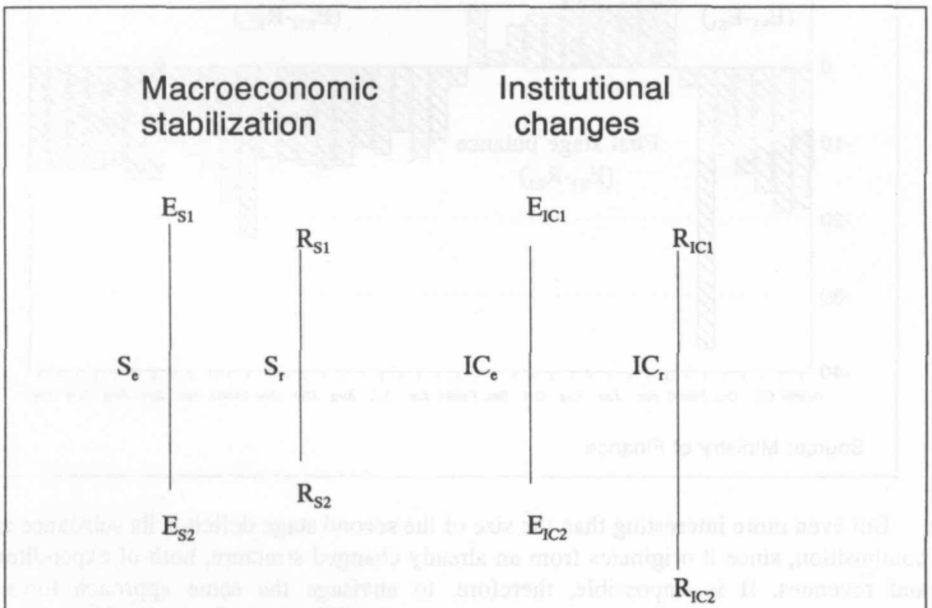
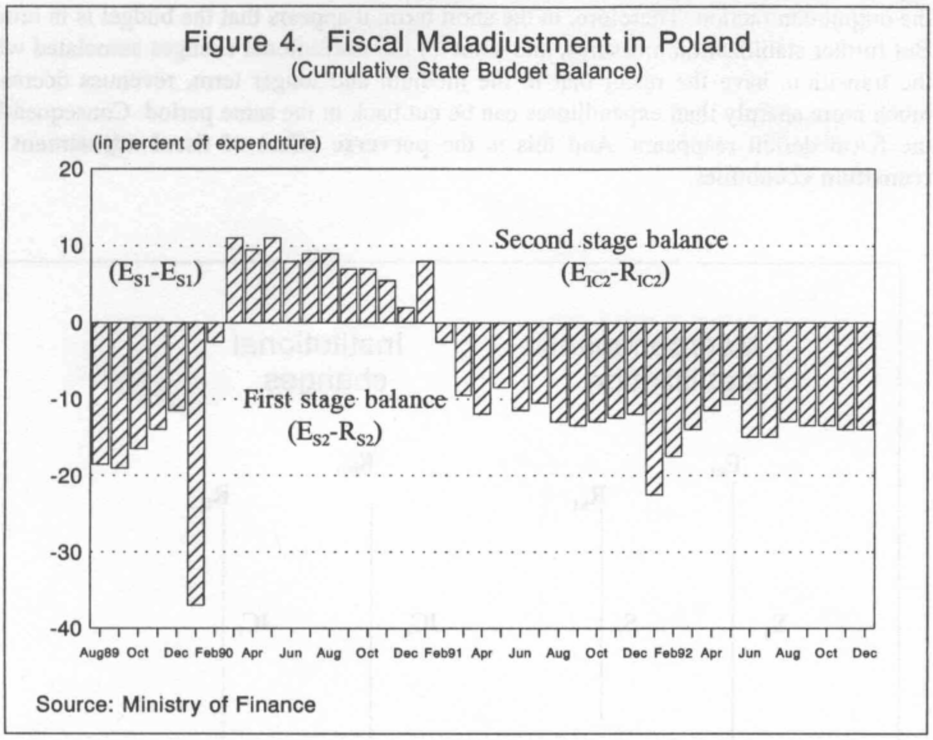


Figure 4. Perverse Effect

This type of fiscal maladjustment is illustrated in Figure 3, where E_s and R_s, and E_{IC} denote fiscal expenditure and revenue affected by stabilization policy and institutional changes, respectively, and S_e and S_r denote the decline of revenue and expenditure owing to the macroeconomic stabilization. The symbols, IC_e and IC_r, describe the decline in both due to the institutional changes. Subscripts 1 and 2 denote the first and second stage of fiscal adjustment, respectively. This process occurs in such a manner that: ($S_e > S_r$); but later, ($IC_r > IC_e$). Of course, the first stage balance *(i.e.* E_{S2}-R_{S2}) is in much better shape, or even in surplus, if compared with the balance before adjustment *(i.e.* E_{S1}-R_{S1}). This is because: $R_{S2} > E_{S2}$. But the second stage balance (E_{IC2}-R_{IC2}) shows an expenditure surplus, that is there is a deficit, because: $R_{IC2} < E_{IC2}$. And, of course, the second stage deficit may be even larger than the deficit observed before the whole operation has taken place[4], *i.e.:* E_{IC2}-$R_{IC2} > E_{IC1}$-R_{IC12}.

Such phenomena of fiscal maladjustment are very clear in the Polish case, where the central government balance changed from a deficit of 4.3% of GDP in 1989 to a surplus of 0.4% in 1990, and then again to deficits of 3.8, 8.1 and over 5% in the years 1991-93, respectively[5]. The sequence of fiscal adjustment in Poland, starting from the period of semi-hyperinflation of late 1989 and continuing until 1993, is illustrated in Figure 4.



But even more interesting than the size of the second stage deficit is its substance and composition, since it originates from an already changed structure, both of expenditures and revenues. It is impossible, therefore, to envisage the same approach towards balancing the budget under current conditions as was feasible during the stage of correcting the initial disequilibrium situation left behind by the old central planning system. First, the subsidies were already substantially reduced and there is now far more rigidity on the expenditure side than there was previously. Secondly, the financial squeeze, imposed particularly severely on the state sector, did provide some extra revenue in the early period of adjustment, but in the longer run it has narrowed the tax base. This very squeeze has contributed to mounting inter-enterprise debt, which has seriously weakened enterprise liquidity and contributed to the present insolvency crisis (Begg and Fortes, 1992). The accumulation of inter-enterprise arrears has potentially serious implications, especially for VAT collection (International Monetary Fund, 1992). A number of enterprises are unable to pay their taxes because other firms are not paying for goods and services they have received. This domino effect has resulted in a deterioration of the overall fiscal situation. In the second stage of adjustment it is not possible to raise the direct tax burden as was done during the first stage. For the state sector is already on the wrong side of the Laffer curve and an additional fiscal squeeze can only worsen an already very difficult situation. Thus, the process of bringing the second stage deficit under control will be considerably more demanding.

4. Concluding remarks

This perverse effect of fiscal adjustment cannot be avoided completely owing to the numerous reasons for the output collapse and financial imbalance. But the scope of the resulting deficits seems to be a function of the restrictiveness of the financial policies implemented at the start of the period of structural adjustment and transition. The more restrictive these policies are, the bigger is the surplus (or the lower is the deficit) in the first stage of adjustment. And the more this balance has been overshot, the deeper the second stage deficit is likely to be[6]. This is so because some of the temporary sources of extraordinary fiscal revenue mentioned above were, unfortunately, also significant factors contributing to excessive output contraction[7]. Consequently, during the second stage, this deep contraction is the main reason for insufficient government revenues, while expenditures cannot be adjusted proportionally.

Owing to the perverse effect of fiscal adjustment and to some specific policy mistakes (Nuti, 1992), the transition economies are doomed to suffer severe fiscal deficits in the foreseeable future. The process of achieving sound fiscal adjustment will last for a number of years and can be accomplished only along a path of sustainable growth (Kolodko, 1992b). But even after this stage is reached, these economies will face a very tense fiscal situation and a worrying public debt. Such a situation will be a serious burden for the PCPEs on their thorny path towards a market system.

Endnotes

1. There are many methodological problems involved in measuring the actual fiscal position in the CPEs. It often happened, for instance, that the items usually regarded as a means of deficit financing in market-type economies were treated as revenue. This included some transfers from the banking sector. Thus fiscal deficits calculated *ex post* widen when they are compared with the earlier data (Cheasty, 1992).
2. Warnings were issued, of course, but the policies actually implemented were based on other proposals. As stressed by Tanzi (1992, p.2), '...it became evident that the lack of knowledge of the fiscal systems of these countries and of the way in which those systems might develop was very limited. This lack of knowledge was likely to lead to mistakes on the part of the economists advising these countries. The institutional limitations to policy changes were likely to be ignored, and unrealistic expectations about how soon new policies could be implemented would be created. In fact the early talk about "big-bang" solutions was largely the result of ignorance of the real situation. In fiscal policy, there cannot be any big bang solution since, before new policies are introduced, new institutions will require a lot of effort and time'.
3. The recent Mexican experience, for instance, seems to support such a conclusion; on this issue, see Loser and Kalter (1992).
4. Note that logically, we should regard the two deficits, (E_{S1}-R_{S1}) and (E_{IC1}-R_{IC1}) as the same, since the two processes, macroeconomic stabilization and the institutional changes, begin together and proceed simultaneously, being simply different aspects of the same process, transition to the market.
5. The budget bill for 1993 assumes the same deficit as in 1992 in nominal terms. Considering the GDP deflator forecast by the Polish government at 36.4 *per cent,* in real terms the central government deficit should decrease to about 5 *per cent* of GDP, though there are reasons for expecting the imbalance to be somewhat larger (Kolodko, 1992b).
6. Of course, there is a link between domestic and external balance. Hence the surplus can surface in the fiscal as well as on the trade, or current account balance. The latter, during the early phase of transition, often performed relatively well as a result of strong export growth and/or import limitations. These developments can be observed in several countries, such as the Baltics (See Table 2).
7. For instance, the high tax burden imposed on state enterprises, or on the profits of the banking sector which resulted from very high spreads between nominal lending and deposit interest rates (Kolodko, 1992a).

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