Working Papers
Institute of Finance, Warsaw
№24
1991

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Fiscal Adjustment and Stabilization Policies in Eastern Europe

On the background of general considerations concerning a lack of automatic link between the fiscal deficit and inflation an attempt at even more careful formulation of that relationship for postsocialist economies being in transition has been undertaken. The challanges and constraints in fiscal adjustment make it so much desirable as also very difficult task. An illustration for it offers the Polish stabilization program implemented since 1990 with results considerably different from the assumed ones, not only in the state budget but also in the other sectors of economy. In the Polish case too restrictive fiscal policy (in addition to tight monetary policy and income control) has contributed to a relatively very sharp decrease in the real product and rather "heavy dose of overkill" of economy has resulted, in turn as a feed-back effect, in reduction of the state budget revenue, with the fiscal deficit having appeared with the time-lag as a consequence of phenomena specific for a postsocialist economy in transition to a market. So far, a fundamental question has been left open about the most reasonable approach to the fiscal adjustment in the short-run with no plain detrimental effects for the role of public finance taken as necessarily required minimum for protection of the real product against the fall in it conceived as too high economic and social cost.

1. Introduction

In traditionally formulated expectations towards public sector the responsibility has been assigned to maintaining full employment and price level stability as well as to attaining a desired rate of growth (Musgrave, 1990). Notwithstanding the stance of fiscal policy as the most aggregative indicator of its role in the above mentioned fields, important for broader concept of economic stabilization, Government sector operations have been often used explicitly to influence the level of economic activity, the allocation of resources and the distribution of income. The impact of those operations on income growth, inflation and the balance of payments may be of some contribution to the stabilization of economy.

The attention paid to the role of public sector in adjustment programs of highly indebted developing countries in the last twenty years has led the one particular point to come to the fore: the impact on inflation. In the light of discussion on the source of high inflation in a small open economy (Solimano, 1990) they have been mostly often identified with the deficit in the public sector and with accomodative or, even worse, expantionary monetary policy. So far, elimination (or considerable reduction) of that deficit together with compliance with the corrective "rules of the game" in money supply have been treaated as the core of stabilization.

The above mentioned approach has been of an important contribution to the way of tackling stabilization policy in postsocialist economies in transition (Allen, 1991). With quite many problems similar to those appearing in developing countries, there are also many other, specific for transformation and systemic changes. They must result in aggravating of difficulties and in the extensive recourse to the second best solutions as the only acceptable in practice of stabilization policies, particularly in the period of the transition to a market economy.

Stabilization in terms of highly indebted economy in general, and of the postsocialist economy particularly, requires to be differently approached in the relatively short and in the longer run. The former approach refers to the measures conditioned by, first of all, deep internal and external disequilibria. The latter means necessity of providing conditions for continuous development of investment, production and trade, based on increasing efficiency understood as ability to multiply the real product. A certain link for the above two approaches may be found in fundamental changes of the comprehensively conceived economic structure and system.

Those two approaches seem to be useful as a general framework for an attempt to determine also the role of public finance in economic stabilization. Taking for granted that, according to rational expectations, the role in the longer run should be much the same as in a regular market economy (comprehensively described in public finance literature), considerations would be concentrated on the short run stabilization approach, with some reference only to those more durable effects of the particular elements of strategy, which cannot be omitted.

A special attention has to be paid to the role of public finance and fiscal adjustment during transition to a market economy in postsocialist countries. This case is somehow different from the very well known cases of extreme monetary instability and stabilization efforts of some developing economies (Dornbusch, 1990). Policies aimed to bring state budget in order in transitional economies have to consider all complex of macro-stabilization measures, institutional changes and restructuring of the real sphere of economy (Kolodko, 1991a). Of course, these developments are very strong feed-backs with both revenue and expenditure of the Government, and hence they have significant influence upon public finance.

From such a perspective in Section 2 we discuss the problem of mutual links between budget deficit and inflation. Our main concern is the question to what extent a common wisdom about these links is appropriate vis-a-vis some specific features of postsocialist economies being involved into transition to a market.

In Section 3 some issues related to challenges and constraints of fiscal adjustment are considered. Main attention here is focussed on the relations between financial and real sphere of the economy. Also some comments on specific features of transitional economies are pointed too, since it can be concluded, that under the conditions of postsocialist economies there are some untypical phenomena, which should to be approached in a proper way.

Section 4 and 5 can be seen as a special case study, since they discuss the Polish recent experience with fiscal adjustment, macro-economic stabilization and transition to a market.

This case is not a unique one, but only most spectacular among the economies involved. So, one can rely upon the conclusions we draw from Poland's experience but - of course - only to the extent.

Finally, Section 6, presents general comments and conclusions emerging from all our considerations. There is no doubt that balanced budget contributes in the longer run to macroeconomic stabilization and firm operations of public finance sector. But it should be as obvious that to have budget in order cannot be a target of economic policy itself. All sort of policies measures aimed for stabilization and growth have to be seen via the perspective of public finance sector, what is not only very important itself, but also is feed-backed with other spheres of the economy and their performance.

2. Budget deficit and inflation

An attempt to determine the role of public finance, potential and actual, in stabilization process requires consideration of its functions in the three at least most important aspects: revenue of public sector, public expenditure and their mutual adjustment, i.e. the budgetary balance. The latter represents the most synthetic measure in the above given respect. Its indicative value should, however, be judged together with some additional indicators on the side of revenue and expenditure and keeping in mind the fact that a given balance may be achieved at different level of both of them.

For an assessment of the fiscal deficit impact on inflationary processes consideration of some at least fundamental prerequisites to link the both phenomena is required. Although an influence of considerable and permanent budget deficit on macroeconomic stabilization is hardly to be denied, it does not mean, however, an automatic link between budget deficit and inflation. There are quite many reasons for it (Fischer, Easterly, 1990). Among the most important one may enumerate:

- The scale of the fiscal deficit which may be recognized as clearly inflationary depends on economic growth and monetary policy. A low economic growth rate and restrictive monetary policy (as well as a shallow financial market) work in general towards less fiscal deficit being admissable. Much the same would be a relationship between tax system and public expenditure efficiency and the fiscal deficit. Low efficiency of the government budget revenue and expenditure has been, as a rule, reflected in a lower economic growth rate.

- Option for financing sources of the fiscal deficit (printing money, use of foreign exchange reserves or foreign loans, eventually internal debt) generally leads to different and differently spread over time effects. The scale of these effects depends on the size of fiscal deficit itself and on economic dynamics together with monetary policy variables.

- The other causes of a lack of an automatic link between the state budget deficit and inflation have been more closely connected with the type and sequencing of stabilization policy undertaken. An example may be an increase in inflation rate because of rise in controlled prices of goods and services produced by public sector and elimination of subsidies, accompanied by a reduction in the state budget deficit as a result of decline in public expenditure. It seems to be a case typical for postsocialist economies in their transition to a market.

A low correlation between the state budget deficit and inflation may result also, among others, from a time-lag in adjustment to the changes in rate of inflation, and from public expectations as to the way of reduction (or elimination) of the fiscal deficit by the Government.

On the other side, in stabilization policy, and particularly in the heterodox programs with transitory controls (freeze) of prices, incomes and rate exchange being used and with often quite spectacular results in inflation reduction in the period of that controls a considerable reduction or even elimination of the state budget deficit could be observed. However, unsustainability of the budgetary balance restored (if accompanied with giving up a more sound reform in the public sector) may be conceived as a symptom of misinterpretation of an apparently automatic link between the fiscal deficit and inflation.

Lack of such a link seems to be particularly distinct in a planned (modified planned) economy. However, a source of it has been different from that in a market economy. The role of public finance in a planned economy has been essentially different if compared to that role in the latter (Kopits, 1990). In the former the state budget assumes the role of planning instrument, used to transfer financial means among enterprises as a part of allocative processes of the state-owned capital. The immediate involvement of the budget into the economic activity corresponds with a concept of fiscal policy different from the one typical for a market economy.

A different approach should also be required to assess public sector equilibrium. Its indicative role from the point od view i.a. of its linkage to the economic stabilization, and, by the same, to the inflationary processes has been considerably limited. It results from the techniques of budgetary plan implementation and from a specific contribution of the state budget to the financing of the state-owned enterprises (in the form of the so-called "soft budget constraint") (Kornai, 1990), and, first of all, from open and suppressed (hidden) inflation at the same time, or so-called shortageflation (Kolodko, McMahon, 1987). The first has been reflected in general price level increase, the second - in shortages. Their financial counterpart has been inflationary overhang, it is a stock of "empty money" created as a result of cumulation of inflationary flows in consecutive periods. It makes "non-formal internal public debt" of its specific kind, which, together with the quasi-fiscal deficit of a central bank, should be treated as one of important indicators of economic disequilibrium, with indirect contribution of the state budget.

It does not mean, however, that at a time of distinct acceleration of an open inflation also in the state budget of a modified planned economy certain phenomena characteristic for revenue and expenditure development in a market economy could not appear. And here, the Oliviera-Tanzi effect (Tanzi, 1977) can be, i.a. included. With an effect on intensification of disproportions between differently spread over time budgetary expenditure and revenue, a high rate of inflation has been contributing to increase (or generating) of the state budget deficit. Inflation acceleration becomes than a feed-back effect of the financing deficit by printing money.

In assessment of inflation roots in a market economy with some distortions or constraints a central role has been assigned to a budget sector disequilibrium and overexpansive monetary policy. In an economy in transition in its starting point causes of the given inflation as a monetary phenomenon may be identified first of all as some voluntarism in money issue. Its part to cover directly the public sector deficit may be relatively not so much significant. In any case, it does not reflect, as a rule, a true, structural depth of a hidden shortage of financial means.

As a consequence, in stabilization measures programming a r ke in the form of overrestrictive fiscal policy seems to be easy to make. Elimination of t ven "open" budget deficit may actually lead to a dramatic reduction in the public sector. Whereas keeping the deficit unchanged (or reduced) might have been implicating high stabilization effort in fiscal domain as well as in the economy as a whole[1].

Summing up, first, the budgetary balance is, to a large extent, endogenous for processes in the economy. With an undeniable effects on stabilization, it has been, on the other side, under impact of those processes. Second, it would be hardly acceptable to avoid even a relatively small budgetary deficit at any price. In policies so far an account of "pros-and-cons" must be taken into consideration, and especially an impact on the real processes (production and employment).

Third, in a stabilized postsocialist economy in transition in the short-run there are particularly unfavourable circumstances which bring about a reduction in the state budget deficit to be equally required and very difficult. Decrease in real product and tight monetary policy as well as foreign indebtedness cause any budget deficit to be of destabilizing impact on the economy.

Fourth, choice of the appropriate criteria for assessment of true depth of potential and actual budget sector deficit in the starting point of stabilization of postsocialist economy being in transition may be of fundamental importance for the fiscal adjustment to be built-in in the right way in the stabilization policies package.

3. Fiscal adjustment: challenges and constraints

In the short term the essential task of fiscal adjustment consists in elimination of source of inflationary pressure and measures undertaken with the respect to this task are mostly those demand restraining, i.a. by restrictive fiscal policy. The field (margin) of maneouvre particularly on the side of revenue, but also of public expenditure, in such a short period is very limited. There are many causes of that.

Some most important factors which limit the elasticity of growth of budgetary revenue and have an impact for their development may be enumerated.

First, the system of taxation mostly often considerably distant from the one adequate to the market economy. Introducing of the comprehensive changes (tax reform) into the system requires relatively longer period necessary, i.a. for the design of the respective legislation as well as for the adjustment of tax administration to the new tasks (Tanzi, 1991).

Second, stabilization in the short run in postsocialist economy in transition has to be probably accompanied by some decrease in the real product. It means important consequences for dynamics of the budget revenue. Leading to a reduction of the broad (macroeconomic) base of taxation it results in an automatic adjustment in tax receipts to the general disadvantage of the state budget (Anand, 1989). This phenomenon, characteristic

[1] Problems in measuring the fiscal disequilibrium and the needed fiscal correction have been also quite difficult in many developing countries' adjustment programs. High inadequacy of the commonly used measures in that respect has been raised by V.Tanzi (1990). The case of postsocialist economies in transition seems to be, however, the one requiring even more careful attention in view of very specific characteristic features of the modified planned economy.

for any economy, is of particular importance in the postsocialist economy in transition. It consists, i.a. in relatively very high share of corporate taxes (from the state-owned enterprises) in the total budget revenue[2]. It creates therefore an extensive possibility of a relatively strong feed-back effect of increased tax burden on the industrial sector (more restrictive fiscal policy) for a production decrease, with the final result in a fall of the Government revenue from that source[3].

Third, development of the budget revenue (and also of public expenditure)) at the given moment as well as changes of its level over the time, depend to a large extent, not only on the overall concept of macroeconomic policy, but also on its particular components or changes in its instruments. There are, first of all, changes in real exchange rate and in the level of interest rates. The rate of inflation itself may be also of some importance (Tanzi, 1989).

On the expenditure side, a careful analysis of items is required to get reasonable solutions. The essential field of maneouvre may be offered, first of all, by elimination of subsidies. Other items, would be unproductive investment, eventually also the wage bill of the public sector, to some extent at least military expenditure and unproductive expenditure (for example subsidization of unnecassary activities (Tanzi, 1990).

To the public expenditure deserving to be saved or even increased one should include public productive investment and above all investment "to rehabilitate decaying infrastructure (Allen, 1991). There are also expenditure on particular public goods as health and education, and one more item important from the point of view of social safety - financing of unemployment.

A careful selection must be needed to preserve from a situation in which excessive tax effort unavoidable to cover too large expenditure could mean burden too high for economic agents not to have a negative impact on their business activity.

There are few at least questions of fundamental importance to be answered which are related to the role of public finance in economic stabilization in the short run. They should concern, as follows:

1) evaluation (estimation) of the true depth of fiscal imbalance at the starting point (before the beginning of the stabilization program) as required to determine the necessary effort to get equilibrium in the public sector, or eventually a reduction in its deficit;

2) the reasonable choice of priority assigned to the internal or external economic equilibrium. Following that choice, the concept of budgetary balance needs also the respective adjustment;

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[2] In Poland the share of the socialized sector payments in the total state budget revenue in 1988 and 1989 amounted to as much as 86 percent and 80 percent, respectively. Predominant part of it came from the state-owned enterprises (Bolkowiak, 1991).

[3] That trend may be transitionally neutralized, at least to some extent, with the growth of profits of the enterprises, coming from their monopolistic behaviour and patterns of business conducting characteristic for a planned (or modified planned) economy. A good example of this phenomenon has been offered by the Polish stabilization program. The share of the socialized sector payments in the total state budget revenue in 1990 was 81 percent, however, if calculated on net basis (revenue minus subsidies) it has been dramatically increased to 64 percent in 1990 if compared to 45 percent and 48 percent in 1988 and 1989 respectively (Bolkowiak, 1991). The share of corporate income tax in the total Central Government revenue has been increased from about 26 percent in the third quarter of 1989 to about 40 percent in the fourth quarter of 1989 and to almost 47 percent in the first quarter of 1990; having come down in the consecutive quarters to 41 percent, 39 percent and 35 percent respectively (data of the Ministry of Finance).

3) the both of the above mentioned questions make an essential background for the decision how far the fiscal balance should be achieved according to some predominantly "mechanical" concept of it, or rather on the basis of a compromise concerning a preservation of a certain (required as a minimum) role of public finance in the economy growth as targeted ex ante in financial programming and the cost of some inflationary impact eventually left.

The predominantly mechanical concept would mean the Government's readiness to sacrify a relatively large part of public expenditure with the purpose to eliminate budgetary source of inflation in the short run.

Into a compromisive approach much more careful examination of particular social expenditure and public investment should be involved. Some budgetary deficit, if recognised as unavoidable with the maximum tax effort being given in the short period would be eventually left. In other words, the fundamental question in the short run is how far the budget equilibrium could be achieved with no plain (difficult to be acceptable) detrimental effects for the role of public finance taken as necessarily required minimum for protection of the real product (national income) against the fall in it conceived as too high economic and social cost. In general, it is a problem of an approach to the Government budget constraint.

Sequence of restoring internal and external equilibrium is of essential importance for budgetary policy. Assigning priority to the first in the short run (with relatively low current account surplus) is tantamount to relatively lower budget surplus for foreign debt service (before interest payment) with the state budget assumed to get it equilibrium. This surplus equivalent to amount for debt service in national currency is necessary with an assumption, that a source for debt financing should be public savings. (Such an assumption is the right one for postsocialist economy in transition in the short run) (Gotz-K[illegible]kiewicz, 1989). So far limitation of debt service is tantamount to reduction in budgetary [illegible]enditure as well as, by the same, a relatively less tax effort as necessary for a respective revenue increase. Therefore, formulated in a distinct way targets in foreign debt service are an important element to determine role of public finance in stabilization program.

A "mechanical" concept of restoring state budget equilibrium, however hard to be totally avoided (in view of many unknown variables on revenue side), seems to be particularly controversial because of its eventual economic and social effects. This concept may be reflected in threefold types of trends in public expenditure. First, it may concern excessive limitations of the part of expenditure essential for economy functioning and for maintenance certain necessary minimum of social protection and provision for human capital development (health and education). Second, it may be reflected in maximum delay in financing of part of expenditure. Then, with a cash principle used as a rule in approach to state budget revenue and expenditure a trend may appear to a transitory (for example, in monthly scale) revenue surplus. It has been a phenomenon which one may interpret as an artificial forcing of a short run budgetary equilibrium. It has been accompanied by respective negative effects in activities of the sectors being of concern for expenditure. Third, cumulation of a part of delayed (deferred) expenditure in the end of budgetary period may also lead to drop them at all as an arbitrary decision to preserve budget equilibrium, and particularly when tax revenue appear to be too low to finance the above mentioned expenditure. All the three options one may find out in the Polish stabilization program.

4. Stabilization and transition

In the Polish inflation of the 80s several distinct phases could be distinguished. After the acceleration of price rise in 1980-1982, it slowed down after the 1982 stabilization and was further falling till 1985. At the same time, the scale of shortages was somewhat reduced too. Then, from 1986 till mid-1989, a renewed acceleration of price inflation rate could be observed. It grew from somewhat less than 15 percent in 1985 up to about 160 percent in the former half of 1989. What is more, this time a reversal of the favorable trend from the preceding period with respect to shortages was also noticed, as their scale was growing too.

The essence of the shortageflation syndrome shows that, in the face of intensification of both the open and repressed inflations above a certain critical level, the syndrome can not be overcome without price liberalization, the latter being - as is well known - contrary to the command-type economy management system. Attempts at partial price liberalization not supported by other necessary measures tightening the budgetary constraints imposed on all economic agents through appropriate fiscal, monetary and income policies, lead in the long run exclusively to an acceleration of open-inflation processes, and by no means eliminate the shortages.

It was against the above background that the transition from galloping price inflation, with the accompanying shortages, to quasi-hyperinflation took place in Poland beginning with August 1989. Till the initiation of the stabilization package, this hyperinflation was accompanied by shortages, so for half-a-year we had to do with hypershortageflation. This resulted from the only partial liberalization of prices, namely liberalization of food prices in August 1989. The huge inflation acceleration was also a result of the introduction of a general income indexation system imposed by the Solidarity. After the power takeover by Solidarity in September of that year, indexation rules were somewhat modified, but this change was already unable to stop hyperinflation.

This temporary hyperinflation was of induced character (Kolodko, 1991b). It was to a certain extent provoked by the macroeconomic policy carried out in the peculiar period of fundamental political transformations in Poland. The hyperinflation was induced, on the one hand, by political struggle and, on the other hand, by the conviction that under hyperinflation conditions it would be easier to lower substantially the level of real wages and to depreciate the value of money balances, especially in possession of households. In addition, the induced quasi-hyperinflation perceived in this way resulted from the conviction that hyperinflation would be easier to overcome than the shortageflation syndrome in the form in which it existed immediately before. But above all, the more or less deliberate option on behalf of hyperinflation ensued from the priority given to objectives bearing on the transition to a market economy, since the implementation of this task requires, among other things, an almost full liberalization of prices and a deep money devaluation related to the introduction of the currency convertibility as well as a rise in credit costs up to their real level. Under conditions of such a considerable monetary destabilization with which we had to do in Poland, the achievement of the above objectives was not possible otherwise than by passing through hyperinflation phase.

An assessment of stabilization program results separately from the broader context of systemic transformation oriented towards creation of market economy would be one-sided and over-simplified. The stabilization package being implemented in Poland - as well as in other postsocialist countries - must be perceived in a broader perspective of the complex market transition process. Hypothesis can be framed that, in reality, stabilization has been subordinated to transition in so far as transition is the primary strate[illegible]oal to be attained, even at the cost of failure of the stabilization policy, inclusive of fur[illegible] destabilization.

What is more, transition is to a certain extent enforcing destabilization, this being especially visible in post-communist countries of Central and Eastern Europe in which, before the acceleration of the market systemic transformation, inflationary processes were relatively little developed (Czechoslovakia, Bulgaria, Romania, Baltic republics of the USSR i.e. Lithuania, Latvia and Estonia). This results from the simple fact that market oriented transition requires economic liberalization. So, in the initial period, orientation towards a market economy brings about an acceleration of inflationary processes rather than their check.

The 1990-1991 stabilization constitutes not only a fight for internal and external equilibrium of the economy, but also for the creation of a different economic mechanism. It is accompanied by construction of appropriate institutional surroundings for the market and the use, especially in the fiscal and monetary areas, of over more numerous policy instruments typical of the market economy. Thus, when looking at the Polish stabilization program in this perspective, its assessment requires relativization. It is true, that the stabilization policy of the first postcommunist government has led to the deepest recession in postwar Poland and, at the same time, the deepest one in contemporary Europe, with simultaneous stabilization of the inflation on the highest level in Europe in 1990. But it is equally true that the Polish economy is clearly nearer - with respect to institutional changes and economic policy - to a market economy than any other postcommunist country. Subsidies have been markedly cut, the budget has been balanced during the first year of the stabilization program and its possible deficit must, by law, not be monetized, prices are to a very large extent liberalized, internal currency convertibility has been introduced, privatization process has been set in motion, elements of financial markets are being developed, etc.

5. The case of Poland

As far as fiscal adjustment is concerned, the stabilization program assumed balancing of the state budget in 1990. It was to be mainly achieved through a radical limitation - and in many cases complete abolishment - of subsidies. Their share in the state expenditure was to fall from about 38 percent in 1989 to about 14 percent in 1990. The state budget equilibrium was also to be helped by improved fiscal discipline, ban on contraction of non-interest bearing loans from the central bank (intermediate crediting on commercial terms must not exceed 4 percent of the budget in the first quarter of the year and 2 percent in the following quarters) and substantial reduction in or elimination of previously numerous tax exemptions.

The institution of public debt was also introduced. An issue of government bonds amounting to ZL 4,1 trillion (as compared with ZL 197 trillion of the budget on both sides) has been planned. The bonds could be exchanged for shares in privatized state enterprises. The treatment of possible receipts form such bonds as budget revenues is controversial. However, because of the fact that the state is not obliged to redeem these bonds in financing this expenditure from budget resources but has to exchange them for equities of privatized enterprises, we do not have here to do with a conventional internal debt. So, in this connection, receipts from this specific bond issue can be considered to be budget revenue rather than budget debt contracted in the open market. Also, emission of short-term treasury bonds had been admitted for the case of insufficient budget revenues, but their amount must not exceed 4 percent of the total budget.

At the beginning of January 1990 the shock therapy was applied. As far as the budget was concerned, subsidies to unefficient production, in particular subventions to energy prices, were substantially reduced. Many arbitrary tax exemptions and reductions were abolished and the collection of budgetary revenues was disciplined. There also was a delay in the execution of a part of payments which had to compensate the public sector and its workers for the inflationary price rise. Nevertheless, the fact stands, that over the first half of 1990 the budget was not only equilibrated but a certain surplus of revenue over expenditure persisted (Chart 1). However, it is to be remembered that, in the Polish financial system the three first months of the year have always been somewhat specific. In January, many distortions appear resulting from the settlement of outstanding dues and obligations from the preceding year. In February, so-called "compensation-taxes" on high personal incomes are paid. In February and March special remunerations (so-called "thirteenth pays" and "profit shares") are paid which temporarily raise the level of the household sector incomes. Nevertheless, it can be stated that: first, budgetary subventions have been substantially cut; second, fiscal discipline has been improved; third, no substantial savings (other than subsidies cut) in the public sector expenditure have been achieved; fourth, the scale of income redistribution through the budget has been reduced; fifth, the budget has been practically equilibrated throughout the first year of stabilization effort.

The problem is, however, that in the second half of 1990 there was budget deficit again. Especially in November and December the expenditures were much above the level of revenues, what caused decline in the yearly surplus down to about 1 percent. This was a result of very deep recession and decreasing revenues - on the one hand - as well as the consequence of higher public expenditures being postponed from the first half of the year due to fiscal adjustment, on the other hand. This process has been even enforced in the first quarter of 1991, because of declining profitability of the state sector, what appears to be one of the by-effects of whole macrostabilization policy. The state enterprises ability to pay taxes diminished because of the overall recession caused first of all by very harsh demand constraints imposed as counterinflationary measures.

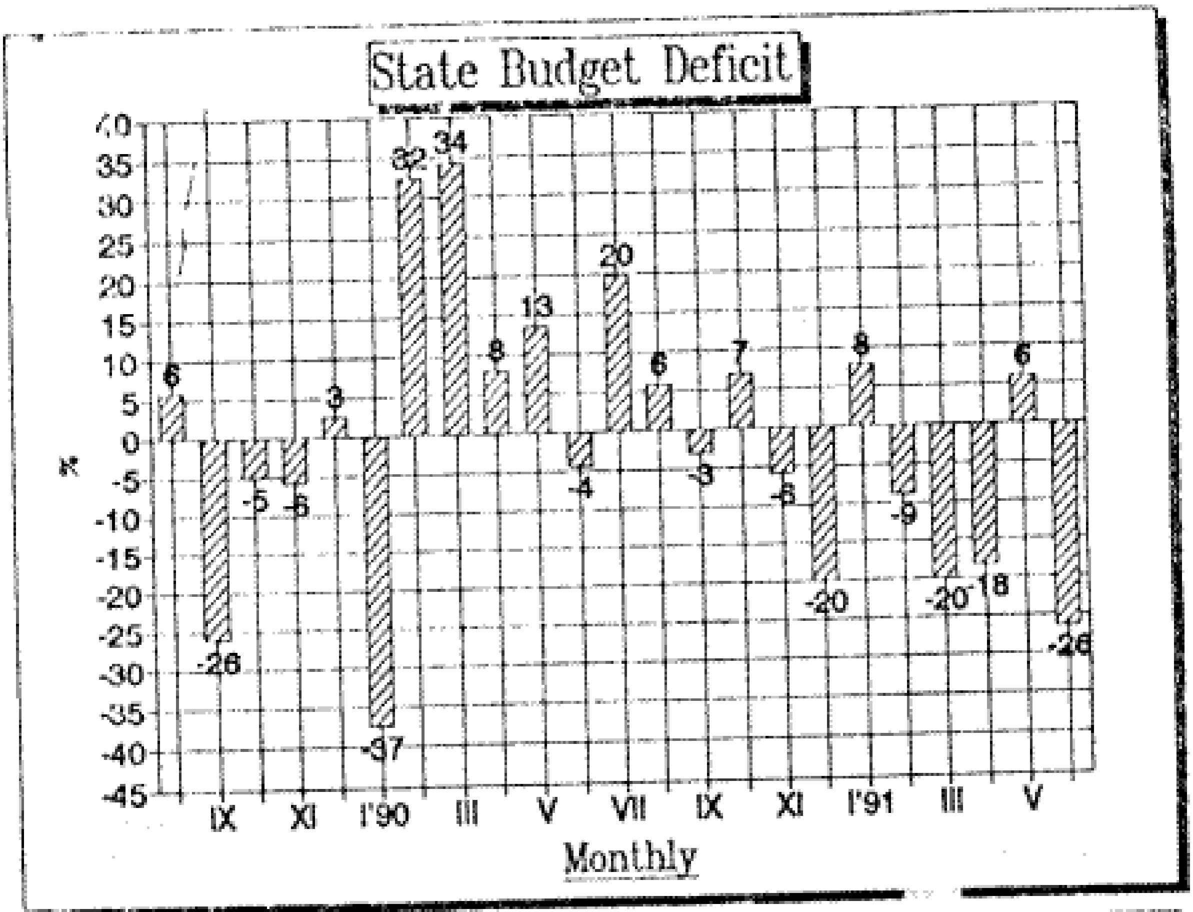
We mentioned above that the 1990 budget assumed the state would sell long-term bonds (convertible into shares in privatized enterprises) for the amount of over ZL 4,1 trillion. But because of mismanagement of the operation and as result of the excessive drainage of the populations money balances and its general pauperization the government was able to sell bonds for only about 1 percent of the proposed amount, this fact creating a threat to budget revenues and to the fragile budget equilibrium.

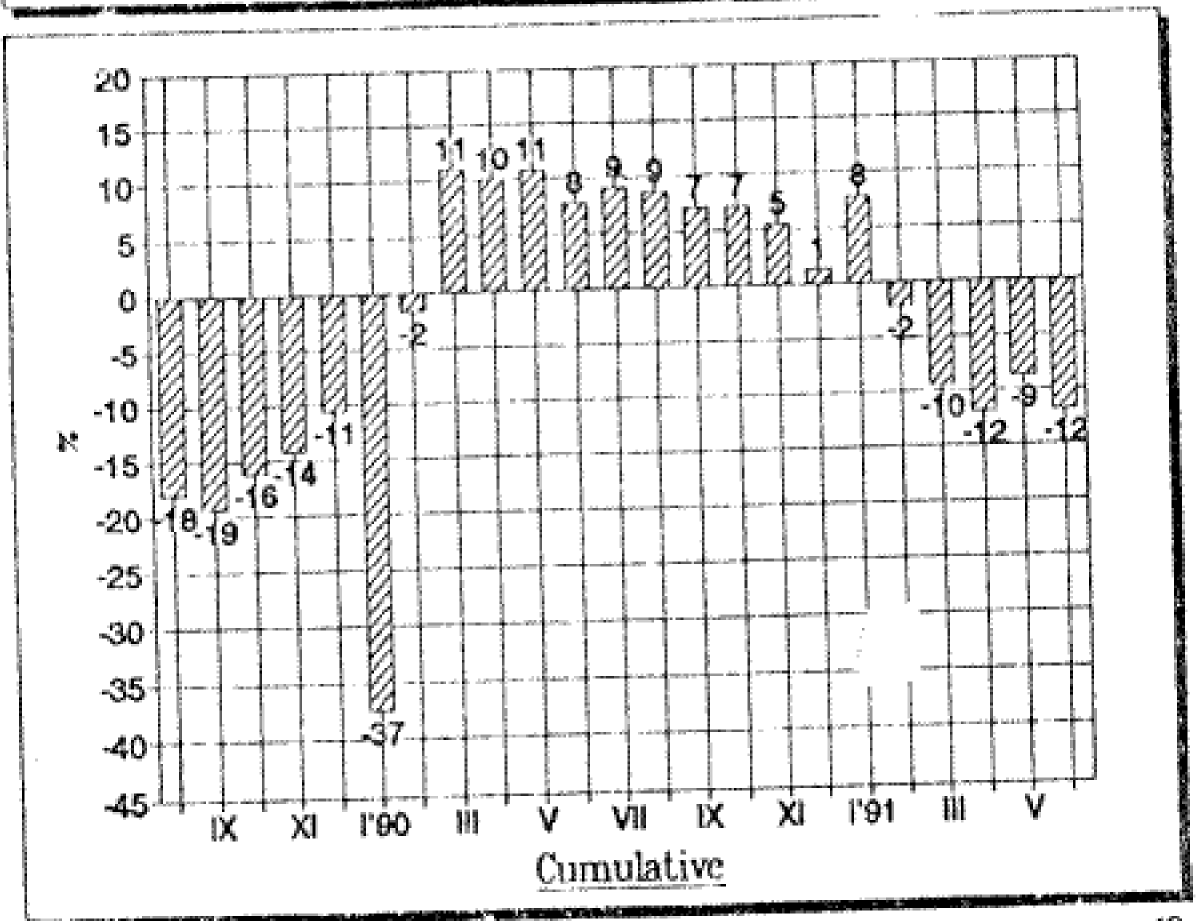
But a still greater threat comes from the continuing huge economic recession. It was assumed that:

a) industrial production would fall by 5 percent (during the whole 1990 in comparison with 1989);

b) the GDP would be reduced by 3.1 percent only;

c) consumption by 1 percent only.





Source: Ministry of Finance, Warsaw

Such optimistic assumptions might well be a remnant of the wishful thinking typical of the central planning period, since they were not backed by reliable and convincing economic calculation. The actual results are given in Table 1.

Table 1

Stabilization Program in Poland in 1990: Assumptions and Results

Rates of Growth (in percent)	Assumptions	Results
Industrial production	-5.0	-25.0
Unemployment rate	2.0	6.3
Inflation (consumer price index, "point to point")	60.0	580.0
Gross National Product	-3.0	-12.0
Real Wages	-20.0	-30.0
Trade balance (billions of dollars)	-0.8	+2.2

Source: Central Statistical Office and National Bank of Poland.

The resulting threats to the budget and the inflationary implications are twofold. First, revenue from income taxes has been lower because the economic activity is very much weakened. The decline in industrial production (measured by the sale of production of the socialized sector) in 1990 by as much as 25 percent[4] and by additional 10 percent during first three quarters of 1991 (private sector included) must be considered to be very drastic indeed. This is an unnecessary cost of the excessively restrictive monetary and wage policy. What is more, in mid-1991 one can see actually the budget collapse. Sustaining recession has led to significant decline in the budget revenue, and - consequently - caused budget deficit which has required special adjustment efforts, in the fast place in the form of sharp decrease in budget expenditure (see Table 2 and 3).

Table 2

State Budget Revenue in 1991

in trillion Zl

	Plan	Implementation Jan. - June	Forecast July - Dec.	Yearly target revised
Total revenue	289.2	98.0	129.0	227.0
from enterprises	242.9	79.5	100.8	180.3
- banks	15.6	6.3	8.4	15.7
- private sector	11.1	6.7	10.5	17.2
- privatization	15.0	0.8	6.2	7.0
other domestic	4.4	4.6	2.0	6.6
foreign	0.2	0.1	0.1	0.2

Source: Ministry of Finance.

[4] The drop in industrial output including private sector is estimated for - 23 percent.

Table 3

State Budget Expenditure in 1991

in trillion Zl

	Plan	Implementation Jan. - June	Forecast July - Dec.	Yearly target revised
Total expenditure	293.5	110.0	141.0	251.0
subsidies	37.4	15.0	14.3	29.5
foreign debt service	13.8	3.9	7.5	11.4
social security	25.6	12.4	20.5	32.9
current expenditure	174.5	68.7	79.0	147.7
settlements with the banks	13.8	2.7	8.4	11.1
capital expenditure	27.3	7.3	10.7	18.0
Government's reserve	1.0	-	0.4	0.4

Source: as in Table 2.

Second, the unemployment resulting from such a deep recession can prove much more costly for the budget in augmenting its expenditure much over the planned level; since, in the budget resource for 1990 were reserved for covering the costs of the expected unemployment level of about 400,000 persons. In July, the unemployment has been already in excess of the level of half million persons; in December it reached 1.1 million; in the summer of 1991 it has approached 1.8 million and the unemployment is bound to grow still to some extent in the latter half of the year because of the lag effect : a time-shifted employment adjustment to the level of demand for labor correspondin h recession. In other words, while in the recession phase the industrial output fell by a ich as 25 percent, the employment diminished by "mere" 10 percent. But in the depre phase (which as been practically lasting from February 1990 following the January breakdown), with production decline practically stopped in absolute terms, the employment level will further decline[5].

So, the question arises, did not certain positive effects achieved with respect to transition to a market economy unavoidably require such high costs finding their expression in the destruction of the real sphere and decline in the population's standard of living as those actually finding place? These costs are huge indeed, and attempts (Sachs, 1990) to belittle them do not change the facts; they at most can purposely present them in false light. However, detailed analyses (Kolodko, 1991b) show that the huge costs of market institutional transformation and stabilization policy have not been unavoidable. Their magnitude could have been much less - and that with achievement of non worse but, may be, even better effects with respect to systemic transformation - if the numerous errors contained in the stabilization package were avoided and if the package was not evidently overshot.

[5] There are other factors involved which have caused that such difference between output fall and employment decrease should not be considered as a surprise. On this subject see Kołodko and Rutkowski (1991)

6. Conclusions

An attempt to assess the role of public finance in economic stabilization in transition to a market economy based on theoretical approach as well as on the particular experience in the Polish case since the beginning of 1990 requires an insight into some least points of importance.

1. Specific characteristic features od planned (modified planned) economy create extreme difficulties in measurement of fiscal deficit, potential and actual, and hence the assessment of the fiscal corrections needed for economy in transition is also rather a very complicated task.

2. The circumstances of stabilization, systemic and structural changes as well as relatively strongly limited field of maneouvre on side of public revenue and expenditure make this task hard to be achievable, especially when the state budget balancing should be conceived as essentially viable and not of a fragile character.

3. The actual results in the Polish fiscal policy implemented since the beginning of 1990 have appeared to be completely different from those assumed. This statement concerns not only the fiscal policy itself but also almost any other indicator of adjustment.

4. The results of fiscal policy have been much differentiated in the consecutive stages of the program implementation, however, the right selection of these stages must be of discretionary rather than formal character. The spread over time of particular sub-stages comes, first of all, from untypical character of adjustment of economic agents, but also from elements of macroeconomic policy design and their results not necessarily the same as they should be according to the forecast.

The year 1990 as a whole brought considerable budget surplus in the order of Zl. 2.5 trillion (1,3 percent of budgetary expenditure as compared with Zl. 3.6 trillion deficit or 11 percent of budgetary expenditure in the previous year). This has been a symptom of restrictive fiscal policy (with real revenue fall by 5 percent and real expenditure fall by 16 percent; and the former having been much less than that for households and enterprises (Górski, Jaszczyński, 1991), but to some extent a reflection also of some other factors. An essential difference in budget performance in the first and in the second half of the year could be observed. In the former major sources of revenue have been based on two particular groups of factors.

The first one has been connected with the more or less typical performance of tax collection procedure in the Polish economy. The other one has come first from an unexpected, at least on such a scale, however, to some extent foreseeable, elements of lack of adjustment of quite many economic units (the state-owned enterprises) and sectors (the banking sector first of all) and second - from particular instruments of macroeconomic policy implemented.

The state-owned enterprises response consisted essentially in reduction in their product manufacturing with parallel relatively high growth in their profits. And one very particular reason for that increase in the first months was utilization of inventories accumulated before January 1990. At the same time the deep devaluation of zloty against US dollar (actually having been a considerable overshooting of the exchange rate) was that one which offered high profitability to some exporters at least and to trading companies. The banks on the other side have been practically mostly dependent on the concept of monetary policy but to some extent also using their monopolistic position to derive high profits from their activity. The main source of those profits have been interest rate much higher for credit granted than for bank deposits.

In the second half of 1990 an important source of the state budget revenue have become payments by the state-owned enterprises in the form of tax on excessive wage increase. But at the same time with profitability of enterprises having been reduced and necessary financing of some deferred public expenditure, November and December have been marked with some shortage of revenue. A recourse to financial means accumulated in the first half of year (budgetary surplus) was tantamount to some inflationary impact on economy.

The trend marked in the second half of 1990 has become distinctly clear in 1991 with the budget deficit amounting to Zl. 12 trillion, it is about 11 percent of the budget expenditure, in the first half of the year.

The final conclusion concerning the fiscal adjustment must, first of all, point to unexpectedly good results at the beginning of program implementation and to classical (from theoretical point of view) difficulties of the state budget balancing particularly in 1991. It should be stressed, however, that relatively high budget surplus in the first half of 1990 should be assessed as controversial from the point of view of general stabilization (with deep recession). And strict Governmental control exerted in day-to-day manner over public expenditure in 1991 has meant necessary cut particularly in education, health and culture expenditure.

5. The general conclusion drawn on the basis of the Polish stabilization experience seems to be that too restrictive i.a. fiscal policy has contributed to a relat[illegible]y sharp decrease in the real product (especially in its part generated by the state-owned s[illegible]) and that rather "heavy dose of overkill" of economy has resulted in turn as a feed-back effect in reduction of the state budget revenue. The state budget deficit in the first half of 1991 has been a classical example of the one of endogenous character having appeared only with the time-lag as a consequence of phenomena specific for a postsocialist economy in transition to market.

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Editor
Witold Małecki

Cover designed by
Michał Jędrczak

DTP Halina Szewczuk

Institute of Finance, Warsaw 1991
1st edition, 200 copies, 1,5 printed sheet
Offset paper, 3rd class, 80 g, format A4
Gone to press: September 1991, printing completed: October 1991
Institute of Finance, Information and Publication Section
Warsaw, Świętokrzyska 12