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From Output Collapse to Sustainable Growth in Transition Economies. The Fiscal Implications

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Abstract

The paper considers the issues of severe breakdown of production and the causes of persisting fiscal deficit in the economies in transition from a centrally planned to a market system. Although these events are due to a legacy of the previous system and to macroeconomic stabilization policies, it appears that the excessive tightness imposed upon the state sector and some policy measures implemented out of sequence have led to unnecessary contraction and caused the perverse effect of fiscal adjustment. Taking into account different composition of expenditure and revenue at the second stage of structural adjustment, it is even more difficult to get rid of the current deficit. This aim can be accomplished only on the path of long-lasting growth and requires proper reorientation of financial policies as well as enhanced foreign assistance, especially a technical one. However, in the transition economies a fiscal deficit, accompanied by a threat of inflation acceleration, will persist for some time--even after the phase of growth is achieved. Therefore, a special policy effort has to be carried out in favor of fiscal stance improvement, recovering output and sustaining growth in the long run.

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Summary

The transition from a centrally planned economy to a market economy entails already about 25 countries of Eastern Europe and the former Soviet Union. But thus far, the optimistic expectations of sound macroeconomic stabilization and a swift turning around of these economies have not been met. The process of structural adjustment appears to last longer and cost more than it had been envisioned at the onset of transformation.

The causes of the output collapse and meager stabilization are complex. The severe fall in production is a legacy of the previous system and stabilization policy itself. Hence, this breakdown to an extent is unavoidable. But in a number of countries there still is a chance to mitigate the scope of contraction through proper reorientation of the policies, since the driving forces behind the output collapse are linked to the mismanagement of state sector and to some policy mistakes, mainly the execution of certain measures out of sequence, the excessive tightness of financial policies and the overshooting stabilization targets.

The very same roots of output breakdown are responsible for the perverse effect of fiscal adjustment. Although the policies were aimed at stabilization, they have led to a resurgence of financial disequilibria in subsequent years. It appears that the more restrictive the financial squeeze was at the early phase of stabilization program, the bigger is the deficit at the second stage. At this period, owing to already changed composition of revenue and expenditure, it is more difficult to accomplish fiscal adjustment.

In the transition economies there is the feedback between fiscal dire straits and output collapse. Only after a sustainable growth is achieved, will there be a chance for sound and lasting improvement of the fiscal stance. In the meantime, there will emerge strong trade-off between public sector borrowing requirements, the private sector demand for capital, and the overall need for new investment. The soaring domestic public debt with the temptation for its partial monetization and the threat of inflation acceleration will be now the new challenge to reconcile. Without foreign assistance, both technical and financial, these countries may not be able to successfully overcome the trade-off between inflation and growth and to avoid the monetary financing of the government deficit.

In the foreseeable future the economies in transition are doomed to suffer the fiscal deficits. Therefore, initially it is necessary to implement the policies securing primary balance as the intermediate fiscal target, although for some time the balance of public sector borrowing requirements will remain negative.

It appears that the fiscal system and policies supporting the savings, investment and growth should be relatively simple, with modest tax rate and exceptional preferences towards different sectors and investors. The most suitable set of policies advancing accomplishment of these aims should consist of the heterodox income policy, accommodating fiscal stance and restrictive monetary measures.

FROM OUTPUT COLLAPSE TO SUSTAINABLE GROWTH IN TRANSITION ECONOMIES. THE FISCAL IMPLICATIONS

I. Introduction

The transition from a centrally planned economy (CPE) to a market economy is a very complex and lasting process. Already about 25 countries, comprising Eastern Europe (EE) and the republics of former Soviet Union (FSU), are engaged in this process, although the degree of their advancement differs. Poland's economy, for instance, is in a much more advanced stage of transformation, because after experiencing some market-oriented reforms in the 1980s it entered this phase earlier than other countries. Kyrgyzstan, for example, joined the post-centrally planned economies (PCPE) later and without much sound economic reforms prior to the transition period. Nonetheless, one may still try to view all these countries collectively and compare their recent experiences as well as draw some general conclusions.

The transition to a market economy can be examined through various methodological approaches. A very useful one is to distinguish between three different spheres of this process, that is macroeconomic stabilization, institutional changes, and microeconomic restructuring of the existing production capacity. It is worth to emphasize that only with the respect to the macroeconomic stabilization so-called shock therapy can be feasible. As for the institutional changes, privatization notwithstanding, only gradual approach can be used, however the faster the appropriate changes are introduced the better. As far as microeconomic restructuring of the industrial capacity is concerned, it is a costly venture and takes time everywhere, even in the late GDR, since it requires strenuous procedures of redeployment of labor, liquidation of obsolete enterprises and investment in the new ones.

This is already a common wisdom of the economics and politics of transition that one should start the entire undertaking with the macroeconomic stabilization. There is not much of a chance for constructive transition if the economy is not able to achieve some critical level of stability. The introduction and development of market economy requires adequate institutions and rules. But they can be observed and perform productively only if the obstacles in the form of the remnants of the CPE institutions, rules and habits are removed and the macroeconomic stabilization is in place. Hence the overwhelming importance of successful stabilization policy at the outset of transition.

Stabilization policies in the PCPE are aimed for double target, what makes this effort still more difficult than in other distorted economies, for instance in a number of the Latin American countries. It is so, because one has to get rid of the shortage phenomenon and to bring the rate of price (open) inflation down to the level controllable by the monetary authorities. Simultaneous improvement on these fields is due to the advancement regarding both, the domestic and external balances. Hence the design of structural adjustment programs for the PCPE ought to be a mix of heterodox and orthodox measures. In the first place there has to be price liberalization and sound fiscal adjustment supported by tough monetary policy for the sake of introducing the market clearing prices and getting rid of so-called shortageflation (Kolodko and McMahon, 1987). The latter, which somehow reminds a mirror image of the Phillips curve, had been a very common feature of the CPE and reflects unknown in a market economy phenomenon of parallel existence of both, price (open) and repressed inflation, what had resulted in persisting shortages. These measures have to be accompanied by additional ones, mainly the means controlling nominal wages growth and supporting the opening-up of the economy.

The stabilization policies across the whole region of the PCPE have brought mixed results (Bruno, 1992, Nuti, 1992a). The biggest breakthrough has been done vis-a-vis the shortage removal and price liberalization, although in a number of countries still much has to be done. The price inflation remains relatively high and there is the threat that it can soar again if some special stabilization measures are not carried out. As for external balance, some countries are enjoying sound trade and current account surpluses, some still cannot stand the foreign debt burden and are not able to make the ends meet with the respect to a payment for their very necessary imports. Though the picture is not yet clear, rather the latter is a dominant case in the PCPE.

Quite complicated is the fiscal situation. Macroeconomic stabilization policies have been targeted, by and large, for the achievement of fiscal equilibrium rather sooner than later. After very short lasting period of improvement being illustrated by modest deficits or even surpluses in the first year, or at most during the first two years of transition, the fiscal stance deteriorates again. Country by country is driven in fiscal disequilibria and growing public debt. It actually may be called maladjustment or, considering the actual policy's target, the perverse effect of fiscal adjustment in economy in transition to a market.

But this phenomenon is very tightly linked to the developments in the real sphere of economy, that is the output breakdown and growing unemployment. The decreasing by a very big factor output causes decline in the level of budgetary revenues. Still worse, growing unemployment, approaching in some countries 15 percent, is quite severe burden on the expenditure side. And, of course, both contribute to the fiscal position of a given country in a negative way. Hence the very important questions arise. First, what are the feedbacks between the transition to a market and falling GDP and, second, what are the links between the collapse of output and fiscal maladjustment. And further, how to deal with the fiscal challenges, if one wants to sustain the growth after this stage will be already achieved?

This paper tries to examine some of these problems. In Section II the issue of output collapse is discussed. Section III touches the problem of fiscal adjustment. The fiscal developments in Poland during transition period are described in Section IV. In Section V the determinants of a recovery and sustainable economic growth in the PCPE are discussed. The thorny road from output collapse to a sustainable growth has several fiscal implications, which are explored in Section VI. And Section VII presents the conclusions and some policy options and recommendations.

II. Macroeconomic stabilization and output collapse

There is a very severe decrease in output across all region of the PCPE. In Albania the industrial output contracted in 1991-92 by as much as half [1/]. In Poland the gross domestic product (GDP) declined in 1990-91 by about 20 percent and was still plummeting in 1992. According to International Monetary Fund estimates (International Monetary Fund, 1992) GDP has decreased in 1990-92 by about 26 percent in the whole PCPE group. This is the result of various rates of the GDP decline in particular countries (Table 1).

The drop of production has been a common feature of the region only recently. One may point to the fact that the CPE enjoyed some economic growth until the late 1980s and merely at that period they lost a momentum and entered the phase of output decline. However, the pattern of growth in the CPE had been of such a nature that it has caused so-called misdevelopment rather than development in the common sense of the word, or a backwardness familiar for numerous less developed countries (LDC). It is clear that in the course of last decade the rate of growth was descending, what ultimately had led to the sluggish economic activity and stagnation in the late 1980s (Chart 1).

Such a trend had occurred for many reasons. In the first place, growing disequilibria and augmenting inflationary pressure did contribute to the deterioration of allocative efficiency. The erosion of the means of central planning made the utilization of resources less and less productive. The investments were allocated inefficiently owing to the distorted price signals and to the lack of sound competition, because of limited access to the external markets as well as due to the lack of foreign firms on the domestic one. All these elements taken together proved that the CPE were not able to adjust accurate to the challenge of the world trade and development.

2/ On the Albanian economic developments under centrally planned regime and recent struggle for transition to a market system see Blejer et al. (1992).

Table 1. GDP Contraction in Economies in Transition: 1990-91
(annual rates in percent)

	1990	1991	1991 (1989=100)
Eastern Europe and former U.S.S.R. 1/	-1.5	-9.7	88.9
Eastern Europe 1/	-7.1	-13.7	80.2
Albania	-10.0	-29.9	63.1
Bulgaria	-10.6	-23.0	68.8
Czech and Slovak Federal Republic	-0.4	-15.9	83.8
Hungary	-4.1	-11.0	85.4
Poland	-11.6	-7.0	82.2
Romania	-7.4	-13.0	80.6
Yugoslavia 2/	-7.5	-17.0	76.8
Former U.S.S.R. 3/	-0.4	-9.0	90.6
Armenia	-8.5	-11.8	79.7
Azerbaijan	-11.7	-0.7	87.6
Belarus	-3.0	-3.0	94.1
Estonia	-3.6	-13.4	83.5
Georgia	-12.4	-23.0	67.5
Kazakhstan	-1.5	-10.0	88.7
Kyrgyzstan	4.0	-2.0	101.9
Latvia	-0.2	-3.5	96.3
Lithuania	-5.0	-13.6	82.1
Moldova	-1.5	-11.9	86.8
Russian Federation	1.2	-9.0	92.1
Tajikistan	-0.6	-8.7	90.8
Turkmenistan	1.5	-5.9	95.5
Ukraine	-3.4	-11.2	85.8
Uzbekistan	4.3	-0.5	103.8
Mongolia	-2.5	-16.2	81.7
Memorandum			
Former German Democratic Republic	-15.0 4/	-21.9	66.4

1/ Excluding Albania.
2/ The territory of the former Socialist Federal Republic of Yugoslavia.
3/ Reliable, comparable economic data for the states of the former U.S.S.R. are not generally available; the estimates presented above should be interpreted as indicative of broad orders of magnitude.
4/ Staff estimate.
Source: World Economic Outlook, International Monetary Fund, Washington, October 1992, and author's calculation

When studying the process of the long term growth of the CPE one may arrive to the conclusion that there was a sort of growth cycles being reflected by the alteration of the periods of faster and slower growth (Table 2). This alteration was going till the late 1980s and have had an endogenous character (Bauer, 1978, Kolodko, 1986b). Later, due to the transition to a market system, the major discontinuities in the trends of main macroeconomic variables have taken place. However, it remains the fact that the severe fall of GDP in the PCPE has appeared in a sequence following the slowdown phase of growth, rooted still in the period of the centrally planned economy.

It has to be stressed that this slump comes together with the acceleration of the transition process and it is associated with this event. Although there are the links between the two, it is obvious that the latter is not a cause through which the former can be explained entirely. And this is because there are at least six groups of causes of the production collapse in the transition economies.

(i) The legacy of the past consists in part of the trend towards economic stagnation at the end of the 1980s. It is of a minor importance, although one may claim that such a trend would lead to a decline of production even if there was no transition to a market system. More significant are the abilities and capacity of the human factor, change of which has to take some time, and the remnants of the old institutions and rules of the centrally planning. Despite the latter have been dismantled quite fast and considerably successfully, they have not been replaced by the new institutions and rules. Therefore, one may observe a sort of the systemic vacuum, when the old institutions are not in place anymore, but the new ones have not been developed satisfactory yet. Under such circumstances it should be obvious that the entire economy's logistical infrastructure is in flux. It also seems to be clear that the more shock is the manner the changes are introduced, the bigger are the frictions and the more severe are the consequences in the real sphere. From such a perspective the point to be raised is that the approach of so-called constructive destruction (Gomulka, 1991) did contribute much to the scope of output collapse. The assumption that the removal of the old system allocation mechanism will set in motion almost instantly its positive alternative, that is the market-based allocation of resources, has turned out to be ill advised (Sachs, 1989). There is nothing like shock introduction of the institutional changes in transition economies. This is a lasting and costly process, which should be orchestrated by the governments. They have to assist it through active policies measures supporting the emerging market forces. Otherwise, hardly a positive supply response may be expected in the short and medium run.

(ii) The roots of falling production are related to macroeconomic stabilization aimed for the shortage removal and introduction of the market clearing pricing. It is well known that stabilization policy brings a contraction of output as a negative by-effect of the demand constraints imposed for the sake of balancing the economy. The more it has to be a case

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Table 2. Economic Growth Cycles in Centrally Planned Economies: 1950-88

Country	Periods NMP growth rates (in percent)									
Bulgaria	...	1953-56	1957-59	1960-63	1964-67	1968-71	1972-75	1976-80	1981-85	1986-88
		6.5	14.0	6.0	9.1	7.4	8.3	6.4	3.5	5.2
		-	+	-	+	-	+	-	-	+
Czecho-	1950-52	1953-56	1957-61	1962-65	1966-69	1970-75	1976-78	1979-84	1985-88	
Slovakia	10.0	6.5	7.4	0.8	7.2	5.3	4.7	1.8	2.4	
		-	+	-	+	-	-	-	+	
GDR	1950-52	1953-56	1957-59	1960-63	1964-69	1970-75	1976-86	1987-88		
	18.0	6.7	8.7	2.2	5.0	5.7	4.4	3.3		
		-	+	-	+	+	-	-		
Hungary	1951-53	1954-56	1957-60	1961-65	1966-69	1970-74	1975-78	1979-85	1986-88	
	9.3	2.0	11.0	5.4	7.2	6.2	5.0	0.9	1.6	
		-	+	-	+	-	-	-	+	
Poland	1950-53	1954-57	1958-63	1964-68	1969-70	1971-75	1976-78	1979-82	1983-85	1986-88
	9.8	9.1	5.4	7.1	3.7	9.8	4.9	-6.5	4.9	3.9
		-	-	+	-	+	-	-	+	-
Romania	1951-53	1954-56	1957-59	1960-62	1963-66	1967-70	1971-76	1977-79	1980-84	1985-88
	17.0	5.0	10.6	7.6	10.5	7.0	11.5	7.7	4.0	5.4
		-	+	-	+	-	+	-	-	+
Soviet	1950-51	1952-53	1954-56	1957-63	1964-68	1969-73	1974-78	1979-88		
Union	16.0	8.2	11.6	6.0	8.2	6.5	5.0	3.3		
		-	+	-	+	-	-	-		

NMP - Net Material Product
... - data not available
"+" - acceleration
"-" - slowdown

Source: Statistical Yearbook, Central Statistical Office, Warsaw (different years), and author's estimates in the PCPE in transition, since it is necessary to bring the aggregate demand down to the level which can be matched by already plummeting supply. But the point here is that initially the demand has to be curtailed by a bigger factor than in a free market economy. In the latter sample, owing to market clearing pricing, the main challenge stems from disequilibria of the flows. It means that in the destabilized market economies the stock of so-called forced savings, or involuntary held money balances, is relatively small or does not exist at all. In the case of the CPE such a situation was always a case, though to a different extent, and surfaced through the excess liquidity, particularly of the household sector. Thus, there were both types of disequilibria, vis-a-vis the flows and the stocks. Consequently, the amount of the effective demand reduction has to be appropriate for getting rid of the excessive liquidity created by both, the flows (current nominal income) and the stocks (so-called inflationary, or monetary overhang).

(iii) The slump in the PCPE stems also from <u>the liquidation of negative value added output</u>. Under the price control system typical for the CPE sometimes it happened that the output had been sold abroad at the prices, which were below the world level of the input used for production (McKinnon, 1991). It was quite often a fact regarding the raw materials which had been supplied to the manufacturers at the low, subsidized prices and then used for the production of exportable goods. Such deals seemed to be profitable from the micro, enterprise view, although it was not so from a macroeconomic perspective. After opening-up the economy through trade liberalization as well as because of the price adjustment and subsidies withdrawal, such a sort of output has been shrinking.

(iv) <u>The pace of trade liberalization</u> is often pointed to as an important source of contraction itself. The more rapid and far going this liberalization is, the bigger is the decline of production caused by this determinant (Rodrik, 1992) 1/. A common feature of the CPE was a monopolistic structure emerging from the long-lasting shortageflation syndrome, where everything was so easy to sell and everything was considerably difficult to buy. Under such conditions the transition economies were not at all prepared for the challenge brought by the world competition. The idea of putting the domestic enterprises at the similar, or sometimes even worse footing than the foreign ones seemed to be correct from the standpoint of acting in favor of the shortage removal and balancing the goods markets. And in this sense it did contribute to a progress regarding the short term stabilization. But at the other end, it was an additional root of the output decline.

(v) <u>The negative external shocks</u>, the other group of the antecedents discussed here, could happen any time. The more they are the trouble maker at already difficult times of transition to a market system. However, the shocks frequently alluded to as one of the leading forces

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3/ In some cases this factor of the output decline was set in motion not immediately after the trade liberalization has taken place, but with some delay. On the Polish export performance during two first years of transition see Kaminski (1992).

behind the recent slump in the PCPE are of a specific nature. Living aside quite often exaggerated impact of the Gulf war, of the greatest importance is the dismantling of the trade system operating within the former Council for Mutual Economic Assistance (CMEA) as far as the EE is concerned, and collapse of the Soviet Union regarding the trade between the FSU republics. There are no doubts that it was the acute shock for many industries in a number of countries, although it has to be brought to the fore that the CMEA disassembling can be seen as a specific self-imposed shock. The harmful way it has been done by the authorities of the involved countries disregarded some alternative proposals for intermediate solutions (van Brabant, 1990), which could cushion to an extent the aftermath of getting rid of the trade typical for the CPE. Of course, it is also true that some transitory schemes of inter-FSU trading have to be worked out before these economies will be able to trade at the world prices and in the hard currency exclusively. Otherwise, this very factor will degenerate the situation in the FSU still further.

(vi) However, the driving forces behind the output collapse these are <u>the policy mistakes, primary the mismanagement of a state sector</u>. One might have expected, considering the very well known nature of a state sector in the CPE, that--due to its rigidity for a relative price changes--there would be a lack of positive supply response. The deflationary measures and the overall liberalization have led rather to a negative reaction reflected in slowing down already sluggish economic activity than to the capacity restructuring and to the proper adjustment on the input side (Pinto, Belka, and Krajewski, 1992). The discriminatory financial tightness imposed on the state enterprises, the continuation of financial redistribution between profitable and unprofitable firms through monetary instruments, and the deficiency of competent governance control over the state enterprises, namely a failure to alter the performance criteria and to fix a system of evaluation of the management, did lead to the misallocation of resources, disinvestment and falling output (Nuti, 1992b). Of special relevance here is a serious delay of such changes like the demonopolization and so-called commercialization (or corparatization) of the public enterprises. These goals should be advanced as much as possible before the price and trade liberalization and simultaneously with the financial squeeze.

The other sort of policy mistakes is linked to the wrong sequence of some policy measures, on the one hand, and to the overshooting some of these measures, on the other hand. Primary, the fiscal reforms and adjustment should be sequenced in a different way, since some of these reforms, namely aimed for a more efficient taxation of private sector and for boosting the indirect taxes (like the VAT) ought to take place prior to, or at least simultaneously with macroeconomic stabilization. Only than it could be possible to match, of course only to a degree, the falling revenue
so far provided by the direct corporate income taxes collected from the state enterprises. There was also a wrong sequence vis-a-vis the particular components of monetary policies, for instance the interest rate adjustment and the approach towards exchange rate management. The attempt to establish a positive real interest rate at the very outset of the stabilization program caused a sort of credit crunch (Calvo and

Coricelli, 1992) and has driven a number of firms in liquidity crisis and nonperforming inter-enterprise debt. At the same time, the deposit interest rate, if compared with the consumer price index, was a negative one in the real terms, what hardly did contribute to braking down the inflationary expectations (Kolodko, 1991) 1/. The management of the exchange rate and the introduction of convertibility have brought mixed results in different countries. In some of them the devaluation of domestic currency had been significantly overshot (for instance, in Poland at the beginning of 1990), in another the effort to use the exchange rate as a nominal anchor of stabilization program has failed (for example, in the former Yugoslavia).

But, albeit sometimes suggested, it is not a policy mistake that stabilization is carried out before privatization, because the other way around is simply not feasible. So, the claim that the current slump is caused by the delayed privatization, what suggests that there have been the alternative choices of sequencing privatization and stabilization, is not justified (Sachs, 1991). Of course, it was attainable to execute the privatization process faster and to a bigger extent that it really has happened (Frydman, Rapaczynski, Earle et al., 1992), but it would not alter the quality of the picture one is facing recently. In the short term a formal privatization, that is a legal transfer of the property rights to the private agents, can be a salvation for the particular firms, but it cannot guarantee the radical improvement of macroeconomic situation, the aggregate supply response and financial equilibria notwithstanding 1/.

As for the overshooting of macroeconomic stabilization targets, the situation varies from country to country (Bruno, 1992, Kolodko, Gotz-Kozierkiewicz, and Skrzeszewska-Paczek, 1992). In the case of Poland it did happen that not only the devaluation of the exchange rate had been overshot, but also the reduction of the aggregate demand and the restrictiveness of the fiscal and monetary policies went to far. It seems also that in some of the PCPE the primary balance has been overshot in this sense, that the excessive tightness of the financial policies led to unnecessary fiscal surpluses at the very early stage of structural adjustment. By and large, as one is getting more experience through learning by doing, it is admitted more often that the financial squeeze imposed on the state sector has been to severe and did contribute to the unnecessary decline of production 1/.

4/ It is essential to note that this very cause of unnecessary output decline was simultaneously the cause of the extraordinary fiscal revenue. In another words, the same set of the circumstances has led to the excessive contraction <u>and</u> to the transitory improvement of fiscal stance (see Section III).

5/ On the suggested sequence of policy measures during transition to a market see Dornbusch (1991b), Fischer and Gelb (1991), Rosati (1991b), and Tardos (1991).

6/ In "World Economic Outlook. October 1992" it has been noted that "In some Eastern European countries there were substantial budget and current account surpluses in the early stages of the reform programs, which might, ex post, suggest that macroeconomic policies could have been less

These are the main roots of the extremely severe contraction of real output in economies in transition 1/. Of course, the actual breakdown was a little bit smaller than the one revealed in the official data owing to numerous methodological biases and because a part of output delivered by mushrooming private sector has been to some extent overlooked in the official statistical reports 1/. However, it does not alter the skeptical message upcoming from the available data. The great slump is a fact. But at least a part of it, connected mainly with the shortage removal effect and with the process of getting rid of a negative value added production, should be considered as a contraction which did not lead to a welfare reduction. What is the actual share of this part, it prevails to be disputable, but often the meaning of it is seriously exaggerated (Gomulka, 1992a, Winiecki, 1991). Having subtracted this portion from a quarter of GDP the PCPE have lost in 1990-92, the remaining part consists of three components. The first one is a legacy of the previous system and from today's perspective could not be avoided. Second part it is a negative by-effect of the very transition, including stabilization policies, and could not be avoided as well. And the third element is due to the subjective factors, mainly the policy mistakes 1/.

(..continued)
restrictive" (International Monetary Fund, 1992, p. 46). One has to comment that such a conclusion should not be derived ex post, since there were great deal of warnings ex ante but, unfortunately, it was not taken enough into account. See, inter alia, Kolodko, 1989 and 1990, Frydman, Kolodko, and Wellisz, 1990, Laski, 1990, Nuti, 1990, van Brabant, 1990, Caselli and Pastrello, 1991, Rosati, 1991a.

7/ This evaluation not necessary has to be in contradiction with the conclusions following different approaches to the explanation of output breakdown. For instance, Borensztein and Ostry (1992) have tried to find the causes of the GDP decline in Poland in 1990-91. First, they have addressed the issues of the short term response to the new price structure and found that its importance was relatively limited. Second, they have compared the significance of macroeconomic factors, namely demand-side shocks and supply-side disturbances, and concluded that their meaning has been changing during specific time periods being examined. However, it seems that from such an angle of considerations the problem of policy mistakes is entirely omitted.

8/ On the methodological aspects of this issue see Berg (1992) and Osband (1992). It happens that there is a clear data manipulation in favor of neglecting the actual output contraction, as for instance in the Berg and Sachs (1992) considerations. Such an approach is strongly opposed by Kolodko (1992), and Nuti and Portes (1992).

9/ Convincing train of thoughts arguing in favor of such a thesis is put forward by Nuti (1992b), when he claims that "...this state of affairs is not a necessary concomitant of transition, nor a consequence of "shock therapy" which might be eased by a more gradualist approach, but the totally unnecessary consequence of policy failures (...) To a very great extent, these failures are linked with ideological totems and taboos, namely obsession with mass free privatization and with instant free trade, and prejudice against the state sector and any attempt at its improvement and reorganisation."

Therefore, one should not doubt that the hardship of the PCPE societies, as well as the dire straits of their economies, could be less austere if many policy mistakes had been avoided. The lessons are to be learned from this experience, because some options already carried out in the more advanced in transition countries are still to be implemented somewhere else. And some conclusions must be derived regarding future policies in the entire region of the PCPE. From such an angle even more important are the fiscal implications of the policies favoring the move from great slump towards sustained growth.

III. The perverse effect of fiscal adjustment

The main target of fiscal adjustment in 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 noninflationary way. The monetization of deficit and imposition of inflationary tax leads to the acceleration of inflation and further deterioration of the fiscal stance (Calvo, 1988). Such developments turn against the allocative efficiency and ultimately against the 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 revenue and expenditure in the CPE had significantly contrasted with this of a market economy (Chand and Lorie, 1992). The main source for the budgetary revenue had been the state firms with only a minor position of direct taxes from private sector and the households. The bulk of expenditure was linked to the heavy subsidies supporting real income of the population and to the subsidies provided to inefficient state enterprises, although the real burden of the latter is often overestimated.

One has to accentuate that the point of departure to adjustment in the PCPE and in a distorted markets of the LDC is not the same (Edwards, 1992, Krueger, 1992). The identification of the two, as well as a simplified comparison to the post-war reconstruction of Western European countries (Wolf, 1992), has led to a guidance of the adjustment policies along non-optimal line. As for the specific features of the PCPE, particularly momentous is the burden of state enterprises, which should not be expected to deliver the supply response (and tax revenue) one might foresee under different institutional circumstances of a market economy (Gelb, Jorgensen, and Singh, 1992).

There are some methodological problems with the measure of actual fiscal position in the CPE. It often had happened that the items usually considered in the market economies as the means of deficit financing were treated as the revenue. Quite important here were some transfers from the banking sector. Thus, the fiscal deficits calculated ex post widen when they are compared with the earlier data (Cheasty, 1992). But the fact is that there had not been a big fiscal deficit in the CPE, though such an impression might appear from some observations 1/. As far as the fiscal stance is evaluated from the position of central government balance, the situation looks discouraging (Chart 2). But if the surpluses of the local governments are included in the estimation, then the consolidated state budget balance in the late 1980s seemed to be bearable. One may claim that the conviction about necessity and urgency of rapid budget balancing was somehow overstressed, since at that time it was feasible--and justified--to equilibrate the revenue and expenditure in a more gradual way.

As the fiscal position had been worsening till the mid-1980s, so was accelerating the price inflation. But in the second half of the 1980s the rate of price inflation was still ascending, although the fiscal deficits were slowly descending. The price inflation soars only later (Table 3), due to a number of factors, in the first place as the aftermath of price

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10/ Hereafter, the following abbreviations are used to describe the fiscal position of a given economy:
OBCom - overall balance on commitment basis;
OBCash - overall balance on cash basis;
PB - primary balance;
CGB - central government balance;
SBB - state budget balance;
GGB - general government balance;
PSBR - public sector borrowing requirements, and
IP - interest payments.

Table 3. Open Inflation in Centrally Planned and Transition Economies (consumer price index)

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

adjustment and liberalization. These facts prove only that the fiscal deficit is not directly linked with the open inflation (Fischer and Easterly, 1990, Gotz-Kozierkiewicz and Kolodko, 1992). It is even more the truth in the CPE case, where the financial disequilibria had been reflected through the inflationary overhang and shortages of goods and services, rather than through the fiscal deficit.

Of course, the conditions prior to the fiscal adjustment were not the same in the particular countries under discussion. As far as Russia and some other FSU republics are concerned, the fiscal deficit has been a great problem since the very beginning of transition process. But in other cases, with the exception of Poland in 1989, it was hardly a main challenge for stabilization. It was rather the trial of recomposition of budget structure and the financial reforms as a such that have to be brought to the attention as the main targets of fiscal adjustment (Tanzi, 1991). Hence, there is a double aim of fiscal adjustment in the economy in transition. First, the effort to keep the public finance in balance has to be done. And second, the formation of the revenue and expenditure must be changed, so the budget will be more adequate to the prerequisites and features of a market economy. Since these targets have to be achieved simultaneously and due to the fact that the risk upcoming from the public finance restructuring has not been taken seriously enough--primary because of the neglect of distinctive features of transition economies--the whole operation has turned out to be even more challenging then previously expected 1/.

On the expenditure side, the main attention is focused on the radical subsidies cuts and withdrawals as well as on the reform of social security system. There are also another cuts, like the limitation of the public sector employees wages, always lagging behind faster climbing inflation, and a restriction of a number of current expenses, such as some outlays for infrastructure maintenance. However, if the curtailments in government capital and current outlays are going to far, it might ultimately cause the drop of the government ability to raise the revenue. It leads to the infrastructure bottlenecks (say, in the public transport or in the quality of the civil servants), which contribute to the worsening productivity and to the sluggish economic activity. Hence,

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11/ They were aired the relevant warnings, however the policies carried forward relied upon another suggestions and did not take these signals into consideration. As it has been stressed by Tanzi "...it became evident that the lack of knowledge of the fiscal systems of these countries and of the way in which those systems might developed was very limited. This lack of knowledge was likely to lead to mistakes on the part of economist 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 can be introduced, new institutions will require a lot of effort and time." See Tanzi (1991, p. 2).

the fiscal base is narrower than under the hypothetical conditions of alternative scenario, that is without some current expenditure cuts and with a little bit more lenient financial policy. Quite many countries have to go through such a type of trade-off between the policies aimed for the collection of the budget revenue in the short and long run. The lesson to be learned from this trade-off is that one should not overshot the fiscal squeeze at the onset of adjustment, because it might fire back later through relatively lower level of the revenue 1/.

At the same time another kinds of payments are on the rise. Soaring unemployment absorbs additional financial resources, due to the escalating costs of retraining, redeployment and social security. The microeconomic restructuring of the industrial capacity needs some fiscal support as well. These costs in some of the PCPE, especially in the economies which were hardly exposed for the foreign competition in the past, are enormous. It is mainly the case of the FSU republics owing to a conversion of military industries for civilian use. There also arise the costly needs of infrastructure improvement, considering that the latter ought to be more adequate to the requirements of private sector and market economy.

On the revenue side, the accents are shifted towards indirect taxes, share of which in total revenue is growing. Of special importance here is the process of widening tax base and making it more steady, that is less sensitive for the market fluctuations. From this perspective the introduction of value added tax (VAT) and the implementation of personal income tax (PIT) is being worked out in the PCPE (Tait, 1992). In some countries these reforms have taken place already, in other they are going to be performed soon 1/. But there are also various extraordinary events which in the short run lead to relatively smaller decrease of tax revenue, although the real output is already shrinking tremendously. It is possible, because the profits of the manufacturing sector are not on the decline yet, or at least the rate of this decline is lower than the rate of output fall. First, the profitability of the firms to quite an extent relies upon the income from the production sold at current prices, which have been very much inflated due to the price liberalization, although significant part of the input had been purchased on the pre-

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12/ The recent Mexican experience, for instance, seems to support such a conclusion. See on this case Loser and Kalter (1992).

13/ It is usually expected that the VAT will profoundly improve the fiscal revenue. Although it might have be the truth, one has to be aware of the experience of some other countries, where this type of reform did not lift remarkable the ratio of taxes over GDP. On this subject see Nashashibi et al. (1992). As for the PCPE, it is estimated that, for example, in Russia in the first half of 1992 the VAT provided as much as 1/3 of total revenue, but the CGB was still running a deficit of dozen or so percent. In Poland the introduction of the VAT is being prepared for July of 1993 after a proper law has been adopted by the Parliament in the late November of 1992. The both cases prove that the sequence of fiscal reforms is crucial and that they have to be introduce in a complex manner.

corrective (hyper)inflation level. Second, there is going on the process of inventory unloading as the aftermath of getting rid of the shortage phenomena. Here once more a unique profits are gained, because substantial part of the excessive stocks, which had been hoarded during the shortageflation period, is unloaded at the new prices, albeit they were bought at the old ones. Third, at the start of the stabilization package implementation, there is usually solid spread between short term lending and deposit rates. This is an important source of sound profits of the banking sector, which are shared with the government. Fourth, at the level of the enterprise sector there are illusory capital gains earned on fixed assets as a result of corrective inflation and the modification of accounting systems and procedures.

These are the most common features of extraordinary sources of state enterprises and banks profits at the early period of the fiscal adjustment, which might have been noticed all across the region. But, of course, there are additional ones, which are specific only for some group of countries, or for a particular economy. For instance, in the Baltic states the price reforms and liberalization contributed to the significant improvement of terms of trade, and consequently to a higher profitability and fiscal revenue. The new political setup brought a cessation of net transfers from these states to the FSU (World Bank, 1992). Owing to these facts the Baltic republics experienced not only a fiscal surpluses immediately after the adjustment effort was undertaken, but also a sizeable positive trade balance (Table 4). In another particular case of Poland, the state firms had gained some extra profits due to the earnings received from selling out the hard currency accumulated earlier on special retention accounts (so-called ROD). But such sources of budgetary revenue, considering the narrowing tax base, are evaporating very quickly. The more important it is, the less time there is left to carry out appropriate reforms, which should secure the substitution of these shrinking sources of the revenue by the alternative ones.

As far as the revenue are concerned, quite important is well known Tanzi effect (Tanzi, 1977). The more rampant is corrective inflation and the lower is the tax discipline, which indeed is deteriorating during that period, the more its performance is eroding the budget. This observation is true vis-a-vis both, the state sector, which is lagging seriously with the payment of due taxes, and with the respect to the private sector, which enjoys wide tax evasion owing to the poor fiscal administration. Therefore, after the initial attempt for structural adjustment, at the very early phase of transformation, the transition economies enjoy a fiscal balance, or--in some particular cases--even the surplus. But such a situation is short lasting owing to numerous specific, happening once-for-all conditions. Therefore, after a brief period of fiscal position improvement, the economies in transition are driving into severe deficits again. Although the fiscal adjustment policies were aimed for balancing the budgets in the short run, it did happen that they caused, together with additional factors _

Table 4. Estonia, Latvia, and Lithuania. Main Economic Indicators 1990-91

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

Source: World Bank, 1992, and author's estimates of specific, or unique nature, the resurgence of even more serious fiscal disequilibria in the medium and long run. The very mechanism of this feature stems from the fact that macroeconomic stabilization requires that the expenditure are reduced by a greater part than, at the same time, the revenue falls due to the output contraction. Therefore, in the short term it seems that the budget is in order. But the institutional changes, the another crucial component of transition, cause that in the medium and long term the revenue are falling down by a bigger fraction that during the same period it is possible to diminish the expenditure. Thus, the fiscal deficit reappears. And this is the perverse effect of fiscal adjustment in transition economies. This type of fiscal maladjustment is illustrated on Chart 3, where E_S and R_S, and E_{IC}, R_{IC} mean fiscal expenditure and revenue affected by stabilization policy and institutional changes, respectively, and S_e and S_r stand for the decline of revenue and expenditure owing to macroeconomic stabilization. The IC_e and IC_r symbols describe the fall of both due to the institutional changes. The subscripts $_1$ and $_2$ denote the first and second stage of fiscal adjustment, respectively.

This process occurs in such a manner, where first:

$$S_e > S_r \qquad (1)$$

but later:

$$IC_r > IC_e \qquad (2)$$

Of course, the first stage balance, (i.e. E_{S2} - R_{S2}), is in the much better shape, or even in a surplus, compared with the balance before adjustment, (i.e. E_{S1} - R_{S1}). This is because:

$$E_{S2} - R_{S2} < 0 \qquad (3)$$

since:

$$R_{S2} > E_{S2} \qquad (4)$$

But the second stage balance (E_{IC2} - R_{IC2} > 0) turns to be negative, that is there is a deficit, because:

$$R_{IC2} < E_{IC2} \qquad (5)$$

And, of course, the second stage deficit may be even larger than the deficit observed before the whole operation has taken place 1/, that is:

$$E_{IC2} - R_{IC2} > E_{IC1} - R_{IC1} \qquad (6)$$

what can be easy read from Chart 2 for the whole group of the PCPE 1/.

14/ By the assumption and the way of reasoning the balances (deficits) described above as (E_{S1} - R_{S1}) and (E_{IC1} - R_{IC1}) are the same, because two discussed processes, the macroeconomic stabilization and the institutional changes, are launched together and are taking place simultaneously as two different aspects of the very same constellation, mainly the transition to a market economy.

But even more contesting than the size is the substance and composition of the second stage deficit, since it originates from different structure of both, the expenditure and the revenue. It is impossible to work out the same approach towards balancing the budget under the current conditions as it was feasible during counteracting the disequilibrium left by the CPE. First off all, on the expenditure side the subsidies were reduced to a big extent and currently there is a higher rigidity than it used to be prior to the first stage. Secondly, the financial squeeze, imposed particularly on the state sector, did provide some extra revenue at the early period of adjustment, but in the longer run has narrowed the tax base. This very squeeze has caused mounting inter-enterprise outstanding debt, what has worsen tremendously the liquidity of the enterprises and actually has led to the insolvency crisis. The accumulation of the inter-enterprise arrears has potentially serious implications, especially for the VAT collection. A number of enterprises are not able to pay their taxes, because another firms are not paying their dues. This domino effect process has deteriorated the overall fiscal situation (Begg and Portes, 1992). At the second stage of adjustment it is not possible to raise the direct tax burden--as it was done during the first stage. The state sector is already on the wrong side of the Laffer curve and additional fiscal constrains can only worsen the already dire straits situation. Thus, the process of bringing under control the second stage deficit will be considerable more strenuous.

This effect of the fiscal adjustment cannot be avoided completely owing to the numerous roots of financial imbalances. But the scope of this very deficits seems to be the function of the restrictiveness of financial policies implemented at the onset of structural adjustment. <u>The more restrictive these policies are, the bigger is the surplus (or the lower is the deficit) at the first stage of adjustment. And the more this balance has been overshot, the deeper a deficit at the second stage of adjustment is going to be</u> 1/. It is so, because some sources of the extraordinary fiscal revenue were, unfortunately, also the very roots of the excessive output contraction. For instance, the high taxation burden imposed upon the state enterprises, or the profits of banking sector stemming from the extremely wide spread between nominal lending and

(..continued)

15/ The fiscal stance deteriorates also in the Baltic states. For instance, in Latvia the deficit of central government budget (CGB)in the first half of 1992 has been estimated at 3.5 percent of GDP, whereas there was 8.0 percent surplus in 1991 (see Table 4). In Estonia the general government budget (GGB) first soared from 2.9 percent in 1990 to 5.1 percent a year later and then plummeted again to 1.6 percent of GDP in 1992, and is expected to be in deficit of 2.2 percent in 1993 (see Saavalainen, 1992).

16/ Of course, there is a link between domestic and external balance. Hence, the surplus can surface on the fiscal as well as on the trade, or current account balance. The latter during the early phase of transition has performed quite optimistic owing to firm export growth and/or import limitation. These developments can be noticed in a number of countries (see, for instance, Table 4 on the Baltic republics).

deposit interest rates, these are the factors, which--through the credit crunch and liquidity crisis--have led to the production decline, though they have delivered some extra revenues in the short run. And consequently, at the second stage, the far going contraction is the main reason of inefficient revenue, which are unable to match unproportionally adjusted expenditure.

IV. The Polish experience

The thesis put forward in the previous Section can be supported by some additional empirical arguments. The best point in case seems to be here the Polish recent experience with fiscal maladjustment. Prior to the transition period the state budget position was relatively solid and there were no structural threats against it (Wernik, 1992). On the contrary, one can claim that the budget was in order, since the deficit was very modest and had been running after the adjustment of 1982 year below 1.5 percent of GDP, on the average (Chart 4). The common believe that the heavy subsidies to inefficient enterprises had consumed a bulk of budget expenditure, accordingly leading to the deficit, exaggerates the actual scope of this burden. Much more important were the subsidies supporting real income of the households 1/. The fiscal policy was a subject of justified criticism, because the overall disequilibrium stemmed from relatively big central government deficit (CGB), which was financed mainly by the surpluses confiscated from the local governments. The government borrowing from the central bank was rather of a technical nature, but still more significant is the fact, that the sums of this borrowing were usually matched by the government deposits with the central bank (Table 5).

The fiscal position did turn much worse in the second semester of 1988 and the first half of 1989 as the result of ill advised fiscal reforms,

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17/ On the income distribution in the CPE and the new developments during transition to a market system see Atkinson and Micklewright (1992).

Table 5. Central Government and Central Bank Borrowing and Deposits (in billions of zlotys)

	1983	1984	1985	1986	1987	1988	1989
Government borrowing from the Central Bank (1)	386	515	685	724	843	1,371	5,824
Government deposits with the Central Bank (2)	323	468	641	722	785	1,164	837
Balance (1-2)	63	47	44	2	58	207	4,987

Source: International Financial Statistics. Yearbook 1992, International Monetary Fund, Washington, p. 579

which decreased the basic corporate income tax rate from 65 down to 40 percent with simultaneous introduction of so-called dividend, actually a sort of property (or assets) tax. As a consequence, the share of taxes and nontax contributions from the gross profits of state enterprises shrank from 52.6 percent in 1988 to 34.6 percent in 1989 1/. At the same time, the system of advance payments of due taxes was abolished what, considering accelerated inflation, had harmed additionally the level of budget revenue. As for the turnover taxes, which in 1988 were contributing to the state budget as much as 62.5 percent of the revenue, they had dropped in 1989 by about one third. Such a slide of crucial incomes was the result of import liberalization, mainly the severe mistakes involving import of alcoholic beverages. Subsequently, in the first half of 1989 nominal expenditure escalated by 148.1 percent, but the revenue only by 47 percent--with the annualized rate of inflation equal to about 160 percent in the same period. At the end of the first half of year the state budget deficit was already running at about 12 percent of GDP. Therefore, the breakdown of the budget did not reflect a long-lasting tendency of the deterioration of fiscal standing, since such a trend had not taken place, but was rather of an incidental character generated by the policy mistakes. Had these errors been avoided, there could have been much milder and manageable imbalance. But it was not the case and already in the second half of 1989 some extraordinary measures were undertaken. Of paramount importance here was the thorough food price liberalization. As a consequence, the share of price subsidies in total budget expenditure plummeted from 45.3 percent in the first half to 25.2 percent in the last quarter of that year. Ultimately, the central government balance for the whole year was negative by 4.3 percent.

Though the incomplete price liberalization and some other reforms of 1988-89 have to be seen as the beginning of the process, the far-reaching effort of fiscal adjustment had been executed in the first half of 1990. The fiscal discipline in the state sector was enforced and numerous tax deductions were lifted, so the share of taxes (dividend included) rose again from 34.6 percent in 1989 to 46.8 percent in the first semester of next year. The price liberalization, which was consequently carried out at the beginning of 1990, contributed to the reduction of price subsidies, which in the entire year were equal to 18 percent of total government expenditure. As the aftermath of this two steps of price deregulation, the corrective inflation reached extremely high level and was running between August 1989 and February 1990 at 38.9 percent monthly, on the average. The state sector profitability boosted along the line of skyrocketing inflation, what had brought sound inflation profits to the enterprise sector and, accordingly, higher fiscal revenues (Table 6).

18/ All data in this Section, if otherwise not stated, is from the Polish Ministry of Finance and from estimates of the Research Institute of Finance, Warsaw. For details see Wernik (1992).

Table 6. Inflation and Profitability of State Sector 1986-90

	1986	1987	1988	1989				1990		
				1Q	2Q	3Q	4Q	1Q	2Q	4Q
Ratio of gross profits and output (in %)	13.3	15.4	17.0	19.7	23.5	24.1	28.8	27.5	23.7	20.1
Average monthly inflation rate (CPI in %)	1.4	1.9	4.1	12.9	9.5	22.4	31.6	35.9	5.2	3.3

Source: Research Institute of Finance, Warsaw, and author's calculation

Considering the mechanism of fiscal adjustment in transition economy, in the Poland's case the first half of 1990 had brought sound fiscal surplus of 7.4 percent of overall budget revenue, despite the paramount--that is about 30 percent--contraction of the industrial output. The negative impact of this contraction for budget revenue has been offset by the taxation of soaring inflationary profits and by the falling expenditure owing, inter alia, to the withdrawal of subsidies. But in the second semester the picture became meager. Although they were some supplementary sources of revenue, like the rising payments of excessive wage growth tax, the fast evaporating inflationary profits as well as other dissipating sources of extraordinary revenue put the central government budget in deficit. In the entire year the budget was, by and large, in the equilibrium, since there was the surplus of 0.4 percent of GDP. However, it has to be stressed that the transfer of central bank profits--both, outstanding from 1989 and due in 1990--did contribute significantly to such a final outcome. Therefore, one can claim that indeed the budget was in order only from the very formal point of view. The equilibrium in the whole year was a mean of big surplus in the first half and no much lower deficit in the second semester (Chart 5).

But the fiscal squeeze levied on the state sector was very much perceived by a number of enterprises which had to pay a dividend, whatever
was their actual profitability status. These fiscal restraints were enhanced further by the tough monetary policy, mainly by the drive towards positive real interest rates for both, the new and old outstanding debts. The high interest rates were working actually as an additional quasi-tax, since a bulk of them have been ultimately collected by the government.
Altogether, these tightness has pushed the economy to the wrong side of the Laffer curve with all negative consequences for the next stage of structural adjustment.

In the course of 1991 the deterioration of fiscal stance continued, albeit it was assumed that the budget will remain in balance 1/. It was presumed that the deficit will be very mild, within the range of 0.4-0.5 percent of GDP. But the mechanism of perverse effect of fiscal adjustment was already fully set in motion. The contraction of output continued to narrow the tax base still more, the extraordinary roots of revenue vanished entirely 1/ and there was no any quick way to raise the

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19/ This expectations were based on the assumptions that (i) the GDP will grow by 4 percent in real terms, (ii) the ratio of gross profits over output (see Table 6) will stand at 22.8 percent, (iii) the annual CPI, on the average, will amount to 52 percent and on point to point (December to December) basis only to 32 percent. It was also believed (iv), this time quite accurately, that the bulk of total revenue (about 84 percent) will be still provided by the state sector.
20/ Schaffer (1992) estimates that the impact of the shrinking enterprise sector profitability decreased the government budget revenue by about 4-5 percent of GDP in 1991. Therefore, as much as about half of

taxes or to find instantly the alternative sources of nontax income. However, at the same time not enough had been done--due to a lack of political will as well as because of the poor tax administration--to improve the process of tax collection from mushrooming private sector. But, even if everything was done for the sake of better tax collection, it would not change the quality of picture, since it was already to late for it. At the first stage of adjustment the primary balance has been significantly overshot owing to the excessive taxation of the state sector and the new fiscal deficit has begun to enlarge accordingly to the sequence of perverse effect. But at that time it has been already the second stage deficit, much more difficult to be tackled.

Hence, the attention had to concentrate on the expenditure side, because it was clear that the budget cannot be balanced through the further increase of taxation burden tied to the state sector. The cuts were carried out quite accidentally and in the short run did not improve enough the fiscal situation. At the other end, they caused much harm in the public service sector, where outstanding obligations have mounted and their payment in the majority of cases has been only postponed. These cuts also did damage part of the infrastructure and human capital in the long run. Thus, it can strike back in the future through lengthening the path leading to the economic growth and slowing down the pace of it.

Consequently, in 1991 the state budget revenue were by 27.1 percent (in nominal terms) lower than planned. But the expenditure were reduced vis-a-vis assumed level only by 17.6 percent, so the deficit amounted to 3.8 percent of GDP. Despite the severe drop of output (above 7 percent of GDP instead of expected rise by 4 percent), which was the driving force behind such a poor performance, the efficiency of the fiscal system has declined. It was forecasted that the government will be able to collect about 31 percent of GDP, but indeed it has raised only 25.6 percent. It was the immediate aftermath of the worsening financial position of the firms sector and the lack of their sufficient liquidity . The ratio of state budget revenue over GDP was quite similar to the one achieved in 1989, though the composition and structure of both sides of budget, as well as the very nature of fiscal deficit, were already considerably distinctive (Table 7).

In the economy in transition, Poland notwithstanding, one might have been expecting the escalating revenue emerging from the private sector taxation. However, it is not a case at the early stage of the transformation process. Strange enough, if the ratio of state firms profits

(..continued)
the swing from the 1990 GGB surplus of 3.1 percent (on commitment basis) to the 1991 deficit of 5.3 percent has been explained by this very factor. On this subject see also Barbone (1992).

Table 7. State Budget Revenue in Poland
(in percent of GDP)

1984	1985	1986	1987	1988	1989	1990	1991
37.1	37.6	37.1	34.0	33.6	25.2	32.8	25.6

Source: Central Statistical Office, Warsaw and the estimates of the Research Institute of Finance, Warsaw over their output remained in 1991 at flat 5.9 percent, the very same ratio of private firms was a meager 2.3 percent. Of course, this observation can not be explained if one will not take into consideration the heedless tax evasion of the latter and the poor administrative ability to counteract it. At this background, the fiscal authorities turned to nondirect taxes and dues, mainly to boosting the turnover tax and import duties collection. Such a shift has brought only modest relief to fiscal dire straits, but it significantly changed the structure of revenue (Chart 6).

This direction of events has been continued later on. In 1992 the share of turnover taxes in the overall fiscal payments of firms sector went up from 45.3 percent in the first quarter to over 53 percent in the first three quarters of that year. At the same time periods the share of both, the corporate income tax and dividend, was on the decline. The ability of the private sector to avoid its tax obligations has occurred to be even stronger than it used to be in the past. Hence, the more the fiscal revenue have had to rely upon the state sector, which has remained in a very awkward financial position. As for the fiscal burden imposed upon it, it went in the first half of 1992 so far, that the scheduled taxes--equal to 33.4 trillions zlotys (including dividend)--have overcome the gross profits of the state enterprises, which reached only 26.2 trillions zlotys. The financial squeeze, as well as a lack of sound fiscal discipline, are reflected in the overdue payments of the state sector. In the first three quarters of that year it had been lagging with the payment of due taxes for 20.6 trillions zlotys, that is the sum equal to about a half of fiscal deficit for the very same period of time (Chart 7).

On the other hand, some of earlier implemented reforms contributed to the fiscal developments in a positive way. In the course of 1992 one might have noticed the growing share of the revenue coming from personal income
taxes, which in the whole year have been only slightly below the expected level 1/. These assertions support the argument that during the transition the share of fiscal burden is shifting from the direct to indirect taxes and from the corporate income tax to the PIT (Kopits, 1991, Tanzi, 1992). But it also proves that in the short and medium terms the elasticity of substitution of the former by the latter is not enough high to secure the financial equilibria.

21/ However, the system of PIT allows for carrying forward some due taxes, what in turn enforces even more the Tanzi effect. The personal income is taxed on the spot by the rate of 20 percent in the overwhelming majority of cases, although there is a progressive rate of taxation reaching in the higher brackets up to 40 percent. The remaining part is paid later, actually in the first quarter of next year. It simply means that the money the tax is paid in are worth less than the money in which the tax base was calculated. In this very case it is less by about one third in the real terms, since inflation (measured by the CPI on December over December basis) runs in 1992 at the rate close to 50 percent.

Altogether, in the Polish instance the sum of budget revenue in 1992 has been significantly below the amount presumed still in June, when ultimately the budget bill was adopted by the Parliament. At that time, the deficit had been foreseen at about 5 percent of GDP, though such an assumption seemed to be too optimistic once more. This is because the revenue again were going to be firmly below a priori expected level, and the expenditure could not be cut much more than they were already adjusted. The former are about 9 percent below the target, and the latter only about 1-2 percent less than planned. Hence, the fiscal deficit amounts to about 8 percent of GDP 1/, what is even worse than in 1991 and in 1989 (Table 8).
The train of reasoning presented so far leads to the conclusion that the real roots of the second stage deficit were not acknowledged early enough, what makes the current challenge of fiscal disequilibrium very arduous. The Polish fiscal stance in the fourth year of transition, although some important progress has been achieved with the respect to particular spheres of fiscal reforms and policies, is indeed worse than it was prior to the transition to a market economy (Table 9).

Thus, the perverse effect of fiscal adjustment in the Polish case is a paramount one. According to the mechanism of this very effect, the second stage deficit emerging in 1991, that is (E_{IC2} - R_{IC2}), is not only a sort of the mirror image, or a reversion of firmly overshot first stage balance (surplus) appearing in 1990, (i.e. E_{S2} - R_{S2}), but is significantly larger than the 1989 deficit (E_{S1} - R_{S1}), that is the deficit existing prior to the adjustment effort. Unfortunately, such a deterioration of the fiscal stance continues later (Chart 8).

For the 1993 year the Polish Government has envisioned the state budget deficit of about 81 billions zlotys, that is at the similar nominal level as in the previous year. Though one may point to the important reasons suggesting that a bigger disequilibrium can emerge, the state budget deficit is estimated for around 5.1 percent of GDP. These proportions will contribute to further development of the public debt, which is going to reach by the end of 1993 about 2/3 of GDP. The share of the domestic debt within the total public debt--which was equal to about 1/4 in 1992--will be on the rise, owing to relatively higher real interest rate vis-a-vis domestic debt than with the respect to the foreign one (Table 10). In the meantime, the burden of outstanding foreign debt remains very high despite the recent debt reduction. By the end of 1992 the Polish foreign debt has reached 50 billions USD. This sum includes already executed forgiveness of the part of official Polish debt, according to the agreement achieved with the Paris Club.

22/ As late as in November the Parliament has adopted the amendment to the June budgetary bill accepting the deficit of state budget (SBB) equal to 7.5 percent of GDP.

But, despite the fiscal burden of the enhancing public debt, there are some additional contributing causes of the growing deficit. Of great

Table 8. Fiscal Balance in Poland 1989-92

	1989	1990	1991	1992
CGB	-4.3	0.4	-3.8	-8.1
SBB	-5.0	0.6	-6.3	-8.0
GGB	-6.0	3.1	-6.0	-7.6
OBCom	-6.0	2.2	-12.1	-8.1
OBCash	-4.0	1.9	-9.6	-8.1
PB	-6.0	2.7	-10.6	-5.2
IP	0.0	-0.5	1.5	2.9

Source: Data for 1989-91 from the Ministry of Finance, Warsaw, for 1992 the author's preliminary estimates

Table 9. General Government Financial Position 1/

	Trillions of Zlotys		% of GDP			
	1991	1992	1989	1990	1991	1992
Revenues	212.1	338.1	25.2	32.5	25.7	28.3
Enterprise income taxes	42.3	52.2	6.9	11.8	5.1	4.4
Turnover taxes	58.6	114.9	7.2	6.2	7.1	9.6
Personal income taxes	-.-	72.0	-.-	-.-	0.2	0.8
Excess wage growth tax	27.1	16.9	1.4	1.4	3.3	1.4
Other taxes	52.2	51.4	6.1	8.1	6.3	4.3
Nontax revenues	30.1	20.7	3.5	5.0	3.7	1.7
Privatization revenues	1.7	10.0	-.-	-.-	0.2	0.8
Expenditures	264.1	403.6	30.2	31.8	32.1	33.8
Current	245.8	384.5	27.5	29.1	29.8	32.2
Consumption	100.9	244.6	10.3	13.0	12.2	20.5
Subsidies	38.3	21.9	12.1	8.7	4.7	1.8
Transfers 2/	88.3	89.3	5.2	7.1	10.7	7.5
Interest 2/	18.4	28.7	0.0	1.4	2.2	2.4
Capital	18.2	19.1	2.7	2.7	2.2	1.6
State budget balance	-52.0	-65.5	-5.0	0.6	-6.3	-5.5
Extrabudgetary funds	2.5	6.2	-1.0	2.4	0.3	0.5
Transfers from state budget 2/	60.7	103.0	4.1	6.0	7.4	8.6
Other operations 2/	-58.2	-96.8	-5.1	-3.6	-7.1	-8.1
General government balance	-49.5	-59.3	-6.0	3.1	-6.0	-5.0
Net borrowing	49.5	59.3	-6.0	3.1	-6.0	-5.0
Domestic	50.4	55.7	6.3	-2.4	6.1	4.7
National bank	27.4	30.0	4.2	-1.7	3.3	2.5
Domestic banks	13.8	15.7	0.8	0.1	1.7	1.3
Nonbanks	9.2	10.0	1.4	-0.8	1.1	0.8
Foreign	-0.9	3.6	-0.3	-0.7	-0.1	0.3
Memoranda:						
State budget cash balance	-37.7	-65.5	-3.4	0.3	-4.6	-5.5

1/ 1989-91: Accruals basis except for foreign debt interest payments; 1992: Cash basis.

2/ 1989-91: Foreign debt interest payments paid by extrabudgetary funds financed through transfers from state budget.

Source: Ministry of Finance, Poland, and the estimates of the Institute of International Finance, Washington

Table 10. Poland: Main Macroeconomic Indicators 1991-93

	1991	1992	1993
GDP in billions of zlotys (current prices)	824.3	1,150	1,600
Rate of growth of real GDP (in percent)	-7.6	-1.6	2.0
GDP deflator (in percent)	150.9	141.1	136.4
State budget revenue (in billions of zlotys)	212.6	306.6	433.5
State budget expenditure (in billions of zlotys)	243.6	388.4	514.5
State budget deficit:			
in billions of zlotys	31.0	81.8	81.0
in percent of GDP	3.8	7.1	5.1
in percent of expenditure	12.8	21.1	15.7
Public debt - end of year:			
in billions of zlotys	664.4	1,003.7	1,425 1/
in percent of GDP	80.6	87.3	89.1 1/
Consumer price index	170.3	145.6	139.0
Producer price index	148.1	123.8	130.9
Central Bank refinancing credit (average annual interest rate)	53.6	38.0	28.7
Current account balance (in millions of USD)	-1,359	152	-534
Change of the official foreign currency reserves (in millions of USD)	866	-374	-50

1/ Author's estimates

Source: 1991 - Statistical Yearbook 1992, Central Statistical Office, Warsaw, 1992. Data for 1992-93 from the draft 1993 Budget Bill, the Council of Ministries, Warsaw

importance here are the soaring expenditures provided from the state budget to three extrabudgetary insurance funds, namely the workers' pensions fund (FUS), the farmers' pensions fund (KRUS), and the Labor Fund supporting the unemployment benefits (Gomulka, 1992b). The total expenses from these three funds increased from 11 percent of GDP in 1987 to 18 percent in 1991 and to
above 21 percent in 1992. Only the pensions were estimated for 6.6 percent of GDP in 1987, but already for 11.1 percent in 1991 and as much as 13.5
percent of GDP in 1992 (Table 11). But the economy experiencing such severe financial difficulties--as it is the case with Poland as well as with a number of other PCPE--is not able to match such a burden. It has to be mitigated in the future, though the accomplishment of this task is going to be very difficult and sensitive from social and political perspective. The more urgent are the reforms of the social security system in the transition economies.

Table 11. Transfers from State Budget to Social Insurance Funds

	1988	1989	1990	1991	1992
To FUS:					
percent of state budget	2.0	4.2	4.5	10.5	15.8
percent of FUS expenditures	8.0	12.5	16.3	19.2	26.2
To KRUS:					
percent of state budget	1.9	3.5	3.8	6.5	7.9
percent of KRUS expenditures	75.0	99.7	96.8	87.3	94.2

Source: Ministry of Finance, Warsaw

V. Towards a sustainable growth

Quite common expectations with the respect to transition and growth in the PCPE were taking as almost granted that after painful but rather short lasting structural adjustment these economies will experience the high rates
of growth. It was anticipated that the PCPE could be on the rise again already in the late 1991 and than the pace of growth should accelerate 1/ (Table 12).

The arguments supporting such expectations were tied to the hopes of firm improvement of allocative efficiency, which was supposed to thrive soon after the macroeconomic stability was achieved. This pretended improvement was to be further supported by the appropriate institutional changes and the microeconomic restructuring of industrial capacity 1/. One might have shared such a view, although at least four special aspects have to be taken into account. First, the process of macroeconomic stabilization is still under way and the current situation in the PCPE can hardly be considered as a stable one. Second, the period between output collapse at the onset of transition and the takeoff for development lasts several years. Third, the signs of a recovery do not mean that the economy has already achieved the

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23/ For instance, Gomulka (1990) was predicting the rate of GDP growth in Poland for 4.7, 8.7 and 7.9 percent in 1991-93, respectively, what altogether should bring sound growth of about 22 percent in subsequent three years. Actually, the economy has contracted at this very period of time by additional 10 percent (assuming growth of 2-3 percent in 1993). Borensztein and Montiel (1991) have forecasted 6.5 percent rate of growth, on the average, in 1991-95 for Hungary and Poland and 3.25 for Czecho-Slovakia. Summers (1992) has expected that the Polish economy would turn around already in 1991 (2 percent growth) and thereafter will soar by 6 or 5 percent yearly. He has foreseen the positive growth in case of Hungary, Poland, Romania, and Yugoslavia since 1992, and in the case of Bulgaria and Czecho-Slovakia since 1993, with the acceleration of non-weighted mean rate of growth for the whole EE going up from 0.8 percent in 1992 to about 4 percent by the end of decade.

24/ It has happened that such envisaged way of developments has taken place only, and to an extent, in the unique case of the late GDR, where sound rate of GDP growth by as much as 7 percent has been expected in eastern Germany in 1993 (see the forecast of the German Government's Council of Economic Advisers reported in Financial Times, November 16, 1992, p. 1). However, the scope of output breakdown in 1990-92 and the costs of structural adjustment have been much larger than foreseen at the outset of German unification. On this subject see Siebert (1990) and Akerlof, Rose, Yellin, and Hessinus (1991).

Table 12. Expectations of Growth and Fiscal Balance in Economies in Transition

	1990	1991	1992	1993	1993-96
			A		
Post-Centrally Planned Economy					
Real GDP	-3.8	-4.1	-2.1	-	1.2
Fiscal Balance 1/	-8.0	-6.7	-6.5	-	-
Eastern Europe					
Real GDP	-8.6	-1.5	2.8	-	4.4
Fiscal Balance 1/	-1.8	-0.6	-	-	-
			B		
Post-Centrally Planned Economy					
Real GDP	-1.5	-9.7	-16.8	-4.5	-
Fiscal Balance 1/	-5.0	-21.0	-11.2	-6.2	-
Eastern Europe					
Real GDP	-7.1	-13.7	-9.7	2.4	-
Former Soviet Union					
Real GDP	-0.4	-9.0	-18.2	-6.5	-

1/ Central Government Balance in percent of GDP

Source: A: World Economic Outlook, May 1991, p. 28; B: World Economic Outlook, October 1992, p. 93, 106. International Monetary Fund, Washington phase of sustainable growth. And fourth, the attempt of getting to the latter stage requires some special measures, which have to be undertaken by all parties involved--the societies, the governments, and the international community.

(i) Macroeconomic stabilization is seen usually as a prerequisite for healthy economic growth 1/ (Dornbusch, 1991a). This is especially true in the case of the PCPE. Even if the stable financial and political conditions are secured, what definitely is not a case of economies in transition (Kolodko, 1992), there is still the problem of the credibility of financial policies and the challenge of the implementation of institutional reforms. It has to take some time to convince the emerging business sector that the introduced changes are of a lasting character and can be counted as a such for the sake of investment decisions. In transition economies the situation is even more difficult, since one should expect a different supply response from the state enterprises and from the private sector. The former one, by the very nature of the process, are on the decline and hardly should be expected to invest in the future as long as they are told that there is only the past for them. The latter, though on the rise, is suffering from the lack of experience and capital, both necessary to tackle the issue of expansion.

The unstable situation turns against long term considerations, with all the consequences for the real output. Besides, the positive supply response from the private sector at the early stage of transition is not able to substitute the shrinking output of the state sector, considering the share of both in total production. Hence, there is a necessity to continue the struggle aimed for sound macroeconomic stabilization. Some degree of price stabilization, or at least a steady, predictable inflation rate, as well as relatively stable rules of the game between the government and the enterprise and banking sectors are essential. Otherwise, the growth, even if accomplished for the time being, might appear to be not a sustainable one 1/.

25/ There are very few examples of fast growth in an inflationary environment and the case in point here is that such growth is not a sustainable one. The recent Turkish experience, with relatively high rate of growth achieved under the conditions of inflation running at about 60 percent yearly, is rather an example where the solid real GDP growth has taken place not because of the fiscal deficit and inflation, but despite of them and due to other factors. On this case see Kopits (1987), van Wijnbergen (1989), Kopits and Robinson (1990), and Rodrik (1990). See also deGregorio (1992) on the Latin American affair with the inflation and growth.

26/ It has been convincingly argued upon the Spanish experience that "First, sound financial policies without fundamental structural reform cannot succeed in bringing about durable price stabilization and sustained growth. Second, a policy mix that associates a restrictive monetary policy and income restraint with a lenient fiscal stance may help mitigate the social costs of restructuring the economy, thereby preserving the social consensus needed to implement the reforms. However, such a policy mix is bound to boost real interest rates, which

(ii) The time needed for the real turning around the economies in transition is not a short one, because of the relatively prolonged maturing period of the new institutions. From the perspective of growth a fundamental meaning has the capital formation, where a fiscal policy is of special purpose, and amelioration of this very capital allocative efficiency. On the part of the involved societies it is necessary to raise permanently their propensity to save. There should not be an illusion that without intense domestic savings the PCPE can get to the well being of their populace. But additionally, the lack of proper institutions--in the first place the financial intermediaries--is a serious obstacle, which makes the transformation of these savings into well performing capital still more difficult 1/. Having this procedure fulfilled, the problem with the most efficient allocation of scarce capital emerges. Here again the lack of experience, institutions and developed financial markets is a hindrance, removal of which takes time and requires foreign assistance, especially a technical one.

It has to be accentuated that the rate of investment in the PCPE will be lower than it had been in the CPE, whereas it has to be risen vis-a-vis the level it has had during the recent years. In addition to the very severe fall of GDP, the drop of this rate by about 10 percentage points between 1989 and 1993 has brought the absolute level of investment to indeed extremely low amount (Chart 9) 1/. But there is a chance that the market institutions and rules will provide better economic performance than it used to be in the past. Hence, they will be able to secure--owing to the improvement of allocative efficiency--the real growth, despite the lower share of investment in the GDP.

(iii) One has to distinguish between the bottoming-out of a particular economy, or a sort of recovery coming after the depression the PCPE have been going through, on the one hand, and the factual takeoff for a sustainable growth, on the other hand. The former may happen due to some rejuvenation of the aggregate demand taking place after the financial squeeze is a little bit eased. But it might happen without the genuine restructuring of the industrial capacity and without the sound improvement of the competitive edge. As a such, this type of growth

(..continued)
tends to offset the favorable investment effects of lower labor costs and burden the budget" (Spitaller and Galy, 1992, p. iii).

27/ The fiscal policies are important for both aspects of the improvement of investment efficiency, that is they may influence a level of savings and their rate of growth as well as a capability to transform these funds into the working capital. On the experience with these policies in the LDC, which somehow is relevant to the case of the PCPE, see Blejer and Cheasty (1989).

28/ Such a tremendous--both, in relative and absolute terms--drop of investment was a sort of cushion against to far-reaching decrease of the real consumption. In another words, there was the significant shift within the GDP utilization ratios in favor of consumption, what subsequently led to relatively greater investment decline.

cannot last for a longer period of time 29/. The latter has to be backed by the solid stabilization, the radical institutional changes, and the capacity restructuring oriented for a competition boosting. For the success of all these measures the new investments are essential. Of course, the political stability is on stake here as well. Otherwise the transient rising output together with the revival of inflation and destabilization can lead to a slowdown again 30/.

Therefore, the first clues of turning around in the PCPE ought to be approached with a caution. If these indications are accurately taken care of, they might become sustainable. There is a chance, assuming that a necessary progress with the respect to further stabilization is going to be achieved, that it may be the case of Poland already in the late 1992. After the contraction of industrial production by above 40 percent, the output is on the rise again. Between March and December of 1992 it was in the real terms by about 5-6 percent higher from the same three quarters of previous year. In the entire 1992 the industrial production exceeds the 1991 output by about 3 percent and though similar developments can be noticed in construction and other industries, the GDP falls again by about 2 percent, mainly because of the further contraction in agriculture, caused inter alia by the severe drought (Table 13).

The main contributor to these changes--but not the exclusive one, what has to be emphasized--is the private sector, which during transition is

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29/ There is a great deal of experience with failed struggle for growth and development in the LDC which--considering all the differences involved--should be very instructive for the PCPE. On this subject see Blejer and Chu (1989), and Dornbusch and Edwards (1992).

30/ It has been stressed that "Achieving growth without stability may be technically impossible over the longer run; achieving stability without growth may be politically impossible, except in the short run(...) The design of adjustment programs should integrate stabilization with growth, or demand-management policies with structural, supply side policies" (Tanzi, 1989, p. 15). See also Kastberg (1991) on the Polish case and deGregorio (1992) on the conclusions upcoming from the Latin American developments.

Table 13. Industrial Output and Construction in Poland
(same month of previous year = 100)

Jan.	Febr.	March	April	May	June	July	Aug.	Sept.	Oct.	Jan.-Oct.
Industry										
84.8	90.8	99.2	103.5	102.7	107.9	109.6	106.8	113.1	109.4	101.8
Construction										
101.8	116.7	113.5	100.4	101.2	98.2	99.5	101.6	104.0	102.4	103.0

Source: Basic Tendencies of 1992, Central Planning Office, Warsaw, November 1992 provided with strong preferences, including the fiscal ones 1/. Regarding its flexibility and expansion ability due to these advantages and primarily because of the extensive privatization, denationalization and restitution of private property, the supply response from private sector has been a positive one, although not to the extent quite often believed. While taking again a look for the Polish experience, one sees this expansion quite clearly. In 1992 about 58 percent of labor (including agriculture) has been employed in the private sector, which provided above 45 percent of GDP against 28.4 percent in 1989. This share in output varies from 28.4 percent in the industrial production, through 76.8 percent in the construction and over 80 percent in the agriculture and retail trade. With such a structure of ownership and employment one might have envisioned that the growth will come together with the increasing output of the private sector. But in the majority of countries under discussion, the situation is less favorable one, since the share of private activity is still much more limited, so the positive supply response from this side of economy will emerge later and only if there will not be the barriers against its development. The more the state sector has to be taken care of, otherwise the stage of economic growth will be postponed even more.

(iv) The thorny road towards a sustainable growth has to be supported by all parties involved. As long as there is a sort of dual economy (Kornai, 1990) the governments have to make an effort to improve the corporate control over the state firms 1/. Since not all of them can be

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31/ In the case of Poland the private sector, contrary to the state enterprises, does not pay so-called dividend and the excess wage rise tax (see Section IV). The relative fiscal burden imposed upon the former is lower than in the case of the latter. In 1991 the private sector reported meager profitability rate of 2.3 percent only, when the state sector statistically was in a better condition having this very rate at 5.9 percent. The effective rate of private sector profit taxation was 28.1 percent, remaining below the average for the whole economy.

32/ The accomplishment of this task is much more difficult than the reliance upon mystified market forces and their ability to perform in the PCPE. As it has been claimed by Nuti and Portes (1992, p. 14-15), "...the authorities should immediately take steps to reverse the 'state desertion' that has left state-owned enterprises floundering: commercialize them, pay attention to their management and the environment in which it operates, improve corporate governance insofar as is possible without privatization, and rehabilitate industrial policy. The experience of Central Europe shows that we cannot trust the market to select and eliminate negative value-added activities and to develop those that do have good long-run prospects. The market cannot and will not restructure the large state-owned enterprises - and they are to big to fail, until they are broken up and there is some expansion elsewhere in the economy. Simply citing Erhardt, the Wirtschaftswunder, and Ordnungspolitik will not do (and is a misuse of history). The modus operandi and experience of the Treuhandanstalt confirm that even Germany recognizes that. But we cannot trust the old nomenklatura to guide the privatized in the short and even medium run, and some of them will be not privatized at all, it is indispensable to exercise proper corporate control, mainly through sound commercialization and management contracts (Frydman and Rapaczynski, 1991). The state sector, although by and large predetermined for privatization, should be put for the time being on the similar footing as a private one. And this is true also with the regard to the fiscal policy. Otherwise, the bulk of economy will not be able to contribute to getting rid of the current inefficiencies and to overcoming the depressed output. On the contrary, it will remain a burden to the state budget rather than a solid source of its revenue. The only alternative to such an approach is very fast, adventurous privatization. It may--or may not, depending on the whole set of supplementary measures--improve the microeconomic condition of many enterprises, but definitely not all of them, since for some it is to late and they are destined for liquidation. But such a privatization cannot in the short term recuperate the fiscal stance [1/].

The painful and lasting process of the industrial capacity restructuring and the labor redeployment should be based on wide political consensus ensuring the desired social security and support for unavoidable reforms. The restraints stemming from this hardship have to be eased by coordinated foreign technical assistance and financial engagement. Further debt relieve, both in the form of rescheduling and in some particular cases the conclusive cutbacks will be on the agenda. It is so, because some of the PCPE might not be able to meet all their payment obligations under the circumstances of weak performance of their economies, entailing fiscal disequilibria, on the one hand, and large demand for capital and investment, on the other hand (Table 14). But the foreign assistance should be provided mainly through the direct investments, since such a flow of capital not only fosters the growth immediately, but it recuperates the overall economic efficiency owing to the removal of bottlenecks and because of the improvement of know-how and managerial skills. But still all these measures are only of a supplementary meaning, following the earnest effort of the societies and the governments involved in transition to a market system.

(..continued)
restructuring any more than the market. This is therefore a major challenge for foreign advice and advisors" (underline added).

33/ In some cases the immediate fiscal effect of privatization is a negative one. The government is not anymore collecting some type of taxes (like, for instance, so-called dividend and excess wage growth tax in Poland) and this loss is not offset by the revenue received from the sold assets. Besides, the latter should be regarded rather as a mean of financing deficit than as a nontax revenue. At least this money should be use for the infrastructure investment and only exceptionally for the current government expenditure.

Table 14. External Debt and Debt Service of Economies in Transition 1989-93

		1989	1990	1991	1992	1993
in billions of US dollars						
total debt						
PCPE		154	170	176	193	215
EE		126.5	146.4	166.8	162.3	148.9
debt service						
PCPE		22	34	29	16	17
EE		17.6	15.2	18.0	15.3	13.6
in percent of export of goods and services						
PCPE	total debt	77.0	89.8	122.3	153.5	151.3
	debt service	10.9	18.1	19.8	12.7	12.3

Source: World Economic Outlook, October 1992, International Monetary Fund, Washington, p. 155-156

VI. The fiscal implications

It appears quite clearly that during the struggle for sustainable growth the PCPE will face burdensome fiscal challenge. The perverse effect of fiscal adjustment has caused so serious deficit, that its elimination will be possible only on the path of long term growth. Although there are already some symptoms of improvement in the production sphere, the financial situation is lagging behind these changes. The mechanism of fiscal adjustment works in such a manner that initially the falling real revenue
are lagging behind still faster contracting real output, what leads to the first stage balance. Than the revenue are declining even more than production, that is the second stage deficit appears. Later, the recovering revenue are still lagging behind the real output, which itself is already growing. And only after, when the growth is sound and lasting, the fiscal revenue can regain a momentum. Together with adequate expenditure adjustment it can ultimately put the budget back in order 1/.

Therefore, the fiscal disequilibria will accompany the developments in the transition economies at least in the medium term, although there is a serious threat that they may last much longer, if the relevant problems are not taken care of properly and on time. Some of these issues require a special consideration. First, the policies controlling the size of fiscal deficit and the time horizon within which the budget is going to be balanced. Second, the means of narrowing the fiscal gap through the undertakings realized on the both sides, the revenue as well as the expenditure. Third, the proportions between the domestic and foreign sources provided for the financing of the remaining gap. Fourth, the trade-off between noninflationary deficit funding and crowding out effect with its anti-growth implications. And fifth, the threat of deficit monetization and the risk of a resurgence of rampant inflation.

(i) There is going to be the strong temptation in the PCPE to maintain relatively large fiscal imbalance for a number of years. The bigger is the second stage deficit, the more this temptation arises. In many cases the political conditions and weakening popular support for the continuation of necessary reforms further deteriorate the situation. However, it must be stressed that there is the need to decrease the existing imbalances, what seems not to be so apparent approach in the

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34/ It may be the case of the Laos economy which, after contraction of the late 1980s, enjoys in 1991-93 the GDP growth of 4.0, 6.5 and 7 percent. The rate of inflation has been brought under control and went down from 10 percent in 1991 to 7 percent a year later (see Financial Times, November 3, 1992, p. 6). At the same time, according to the IMF estimates, the fiscal balance (OBCom and PB, respectively) declined from -9.7 (-9.1) in 1991 to
-5.0 (-4.4) in 1992, and is expected to fall to -4.4 (-3.7) percent in 1993.

countries involved. There is a belief that the deficit can be managed even in the long run and experience of some western market economies, like Greece or Italy for example, is often brought to the fore. But one of the important difference between the PCPE and the market economies is that in the former there are hardly enough developed capital markets, which are indispensable for noninflationary deficit financing. In the long run the increasing fiscal deficit definitely will act inflationary, because there is a limit for the sale of government bonds. When this limit is reached--and it will happen rather sooner than often expected--the persistence of budget imbalance will require the inflationary taxation as a mean of deficit funding.

This temptations stems also from the extremely short term oriented policy approach. The pressure of the events is indeed tremendous and the attention of the authorities can be biased towards current issues and, at the best, only to the medium term considerations. But the present fiscal policies and the size of current deficit are already setting in motion the processes, which will bring unfavorable consequences in the future 1/. The more necessary it is to lengthen the time horizon, within which one deals with the fiscal issues. There always should be a path of medium and long term policies aimed at the process of public finance balancing. Otherwise, the struggle over the current balance management may cause even further deterioration. In another words, in the fiscal policy the foreseeable future should last not only for a year or two, but for a number of years, because all sequence of fiscal developments can be affected by the current settlements.

(ii) Having already said that the PCPE are for many years to come doomed for the anguish of fiscal deficit, the more imperative it is to take a look for a reasonable way of bringing this deficit down. It has to be accomplished without further damage of the real economic processes, mainly the very output. On the revenue side the improvement can be achieved through widening the tax base by more efficient taxation of the private sector. It requires not only better tax management, but the political will of the authorities as well. The endorsement of the emerging and fast expanding private property should be compatible with the firm profits taxation, although one may expect there would be strong restraints against such a policy. But the situation, where the better performing private sector pays relatively less taxes than the worse functioning state firms, is hardly tolerable. It seems also to be the truth that in the transition economies the lavish reserve of potential revenue is so-called shadow economy, mushrooming during the transition

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35/ According to the evaluation carried out in December of 1991 by the Berlin Ost-West Wirtschaftsakademie, the fiscal situation in transition economies has been seen as a serious obstacle to the growth. Using the scale between -5 and +5 points, the impact of the state budget for so-called growth potential has been ranked for -3 points in the case of Bulgaria, -2 in Czecho-Slovakia, -4 in Hungary, -2 in Poland, and -2 in Romania. The overall growth potential, taking into account 18 different criteria and summing up the relevant points, was ranked for -34, +10, +13, +3, and -22 points, respectively.

period. These activities must be institutionalized, that is registered and taxed properly. It is extremely difficult to evaluate adequately the size of the shadow economy, although it is believed that it runs between 10 and 20 percent of the official GDP (Dallago, 1992). Hence, one can count--considering the profitability of the activities carried out in the shadow economy--that it might be feasible to collect additional taxes reaching up to 2-3 percent of GDP.

The fiscal squeeze against the state sector has to sustain, by and large, but only to the extent securing a return to the right side of the Laffer curve 1/. There are also some chances to narrow the fiscal gap through further expenditure cuts, though after the already carried out adjustment one should not exaggerate these possibilities. Nonetheless, the governments still must try to save on their own expenditure, especially by reducing the expenses for administration and state bureaucracy as well as for the arms and military.

(iii) The next aspect deals with the way the fiscal deficit burden is going to be shared by the PCPE and their international partners, although there should not be a doubt that in the long run this ordeal is to be born by the very societies of these countries with only modest foreign nondebt aid. But as an intermediate solution in a number of cases the foreign credits are a must. The limits for borrowing should be agreed upon with the international organizations assisting the transformation process. This involvement should be used also as a persuasion against the temptation to maintain persisting deficit and it ought to act in favor of meeting the obligations to serve outstanding external debt. It seems unavoidable that in the medium term, mainly when the PCPE face the challenge of second stage deficit management, the external financial commitment is going to be relatively more intensive. Only after, when a sustained growth will be already established, this assistance will be on the decline. Of course, the proportions of domestic and foreign financing has to be discussed on case by case basis, since there are different needs under different conditions (Cheasty, 1992). And there is a positive feedback between the foreign financial engagement, the economy's turning around and growth acceleration, the improvement of fiscal stance and the service of external debt. Only after the mechanism securing such a sequence will be set in motion, the transition economies will be on the right track.

(iv) However, the crucial relevance for stable and sound growth seems to have the implication involving trade-off between the alternative requirements of macroeconomic stabilization, institutional changes, and microeconomic restructuring of the industrial capacity. The former demands that the domestically financed part of fiscal imbalance will be covered by the government bonds and bills. The middle one calls for as big as possible scale of sale of state assets to the households for the

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36/ It has been argued that in the case of the PCPE a simplified broad-based system of taxation with relatively low rates can be better fitting the growth requirements than preferential taxation vis-a-vis different groups of potential investors (Anderson, 1992).

sake of acceleration of privatization process. And the latter needs the firm allocation of scarce capital through new investment supported by the banking credit, what in the PCPE instance means that these investments basically have to be supported by the households deposits with the banks. Therefore, in the short run:

$$GBB_1 + SPH_1 + HDB_1 = f_1 \qquad (7)$$

where (everything in nominal value terms):

GBB - the government bonds and bills sold to the households, firms, and banking sector;
SPH - the shares purchased by the households and private firms from the state due to the privatization;
HDB - the households and private sector deposits with the banks, and
f - given for the short period of time amount of available funds for these three alternative targets.

But in the longer term--owing to the rising propensity to save, which is likely to enhance after the sound stabilization is reached--the sum of these three components should be ascending as well, so therefore:

$$GBB_1 + SPH_1 + HDB_1 < GBB_2 + SPH_2 + HDB_2 > f_1 \qquad (8)$$

As the consequence, the tensions between the three components of these trade-offs should ease a little bit. But always there will be a contradiction between a drive towards stability, which has to be backed by noninflationary deficit funding (i.e. the bonds issue and sale at the primary market), the effort to privatize a bulk of assets (denationalization, that is the sale of shares by the state), and the attempt to encourage investments for the reason of rising the competitive edge of industrial capacity.

Of special importance here is the crowding out effect causing weak investments in the private and state sectors. Since the government is forced to borrow money on the open market, it sells the bonds and short term bills at much higher interest rate--trying to attract sufficient demand for the government papers--than at the same time the banks are providing for the deposits 1/. In turn, it causes the increase of nominal interest rates and, consequently, crowds out from the capital market relatively less competitive firms, including private ones. This clear mechanism illustrates a negative feedback between the fiscal deficit and the growth revival 1/ . But in a destabilized and running high inflation

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37/ In Poland, for example, one year bonds have the interest rate equal to the ex post rate of inflation (CPI) augmented by the premium of 10 percentage points. As for the medium term bonds (maturing in three years), the actual annual gains are exceeding the current rate of interest of the central bank bills by 5 percentage points.

38/ These very features have been observed in many similar cases. For instance, in the recent Mexican experience "...the fiscal policy may have been consistent in the long run with a significant reduction of inflation transition economies even worse aspect of crowding out regards the lack of inclination to risk new investments by the firms sector, since the nominal rates of return guaranteed by both, the government bonds and the bank deposits, are often higher and first of all easier to obtain than the profits from the investments into the physical assets. Simultaneously, one may note another aspect of crowding out effect, that is the fast growing share of government bonds in the assets portfolio of the banking sector. For instance, this share in the Poland's case in the second half of 1992 has reached about 17 percent.

(v) Thus, having already done its best, the governments of the PCPE in many cases will be left with no alternative, but they will be forced to monetize the remaining, residual part of deficit through borrowing from the central bank, that is ultimately the excessive money issue. The faster the public debt will increase, the more it might happen to be necessary. It ought to be very serious concern of both, the governments and the international financial institutions alike, that the amount of this very debt will not get out of control. Such a threat seems to be quite imaginable, either in the light of inability to decrease the present disequilibrium, or because of the aversion to go to far with current deficit monetization. <u>It will be one of the common features of transition economies that they will be enmeshed in the serious struggle with the burden of domestic debt.</u> By the end of the decade it can even happen that this very debt will impose bigger burden upon the PCPE than currently is the case with the foreign debt. More, there will be the temptation to inflate the former, if only it will arise to unbearable amount, since it will be not feasible with the latter.

Under some specific conditions, which are hardly met in the transition economies, such a monetization of public finance deficit may contribute to the real growth. It can take place owing to the increasing aggregate demand and, consequently, the capacity utilization improvement and ultimately the growth of production. But in the transition economy it is more likely that after short lasting period of some recovery the inflation will soar again and in the long term will cause slower pace of growth that otherwise achievable. In another words, <u>in still distorted and unstable transition economies the monetization of fiscal deficit will bring to a bigger degree inflationary effects than revival of production</u>. However, considering the perverse effect of fiscal adjustment and the magnitude of the future fiscal challenge, it may happen that the only workable way to go through it will be to move along such a line. Therefore, <u>the trade-off between acceleration of inflation and a sustainable growth will remain a robust one for many years to come</u>.

(..continued)
even in the context of sharply reduced access to foreign financing. In the short run, however, the crowding out of private investment arising from the need to finance public deficit with domestic debt and the substantial transfer of real resources exacerbated the slowdown of economic activity and the persistence of inflation." See Loser and Kalter, 1992, p. 19.

Of course, a profound progress towards a market economy has been done in the PCPE, whatever are the reservations and doubts described here and elsewhere. Hence, one should put the recent and forthcoming developments in the right perspective, since the process of fiscal adjustment and the struggle for sustained growth is in statu nascendi. Considering the point of departure at the break of 1992 and 1993 one may expect that the sound improvement vis-a-vis both will not come soon. The PCPE output has to be on the rise first, since it is a prerequisite for solid and lasting fiscal adjustment. For the time being, there are rather the negative trade-offs, and only later they might be replaced by a positive feedback between the sustained growth and sound fiscal adjustment. The sequence of the events in the past, as well as a likely, although optimistic future scenario corresponding with such a train of thought, are illustrated on Chart 10 vis-a-vis the PCPE and on Chart 11 with the respect to the Poland's case 1/. Assuming that the events in 1993 and thereafter will go along the line described in these scenarios, one may observe relatively weak correlation between the rate of growth of GDP and the fiscal stance measured by CGB (Table 15).

Owing to the climbing costs of domestic public debt service in the 1990s, the return to a growth path in transition economies will improve the overall fiscal balance only to an extent, because the better position of primary balance will be offset by the growing burden of interest rate payments (IP). The latter will be ascending till the end of decade.

The actual pace, as well as the course of changes, since it is probable that there will be the moves forward and backward alike, will differ from country to country. The more these scenarios should be taken with the

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39/ The data till 1991 is actual according to the national and the IMF statistics. The evaluation for 1992 and predictions for 1993 are from the IMF estimates (International Monetary Fund, 1992) and the forecast for 1994-2000 is the author's own best guess. It has to be added that the presented reflection of the factual situation is somehow distorted by the manipulating of the median index for whole group of the PCPE. The more it is important, the bigger are the deviations from these averages in particular cases. And indeed they are the significant ones, since the fiscal balance in 1992 has differed from close to 20 percent of GDP in Russia and Ukraine to about 12 percent in Bulgaria or Mongolia, and less than 2 percent in Romania. In addition, the non-weighted mean indexes used in these estimates bias the image even more, so one has to approach them as the very proxy evaluation.

Table 15. GDP Growth and Fiscal Balance in Transition Economies 1986-2000

	PCPE		Poland		
years	GDP rate of growth in %	CGB in % of GDP	GDP rate of growth in %	CGB in % of GDP	years
1986-89	3.1	-6.6	2.9	-1.9	1986-89
1990-94	-6.9	-9.3	-6.9	-3.8	1990-92
1995-2000	4.3	-4.3	5.4	-3.7	1993-2000

Source: Data for 1986-1991 from national statistics and the IMF estimates, for 1992 and 1993 from International Monetary Fund (1992), and for 1994-2000 author's own forecast special reservation. In the very long run these differences will mitigate, although one should not expect that the situation will change within the entire group of the PCPE in a similar way.

VII. Conclusions

Although it should to be emphasized once more that there are substantial distinctions between particular countries described as the post-centrally planned economies, there seems to be as well a great deal of common experience and evidence, which allows to draw the following eight groups of conclusions upon the fiscal implications of the process of going from the output collapse to sustainable growth in transition economies.

(i) The perverse effect of fiscal adjustment in transition economies is unavoidable, although its magnitude is due to the level of the restrictiveness of financial policies and to the scope of contraction in the real sphere of economy. If the macroeconomic stabilization policies have been carried out in a more lenient way and if the primary balance has not been overshot, the second stage balance would be in a better condition.
Therefore, not only the actual fall of real output in the past would be less severe, but also the perspectives for future growth would be better.

(ii) Consequently, the economies in transition are doomed for suffering a long-lasting fiscal deficit owing to the developments in both, the real and financial sphere. The process of balancing the public finance is more difficult at the second stage of fiscal adjustment, mainly because the majority of subsidies have been liquidated at the first stage. The foremost cause of this deficit stems from structural inability of the PCPE to raise the revenue to the level which could match already quite reasonable adjusted expenditure.

(iii) At the second stage of fiscal adjustment it is more important to expand the tax basis and to improve the fiscal administration, especially vis-a-vis the private sector, although the rationalization of the expenditure can not be neglected. However, further going reduction of some of these expenses, primary for the human capital (health care, education, culture) and for the infrastructure will negatively affect the growth as well as ultimately will turn against the government ability to raise the fiscal revenue. In another words, there is a trade-off between various measures used in favor of balancing the budget in the short and long run, therefore the longer perspective should be given a priority.

(iv) For the sake of the avoidance of the resurgence of rampant inflation the orchestrated foreign assistance--financial and first of all a technical one--will be necessary. There are no doubts that the PCPE in the foreseeable future cannot stand the fiscal disequilibria on their own, though the main burden of tackling this challenge remains a matter of the
economies and societies involved in the transition process.

(v) In the late 1990s and thereafter the majority of transition economies will face the new challenge of soaring public debt. Considering the limits for foreign borrowing, the governments will be forced to borrow money on domestic capital market at high interest rate. There is a serious threat that some of these countries might be driven into a sort of domestic debt trap, similarly as some of them were caught in a trap of external debt in the 1980s. The sooner this risk is in a responsible manner taken care of the better. For this reason it is necessary to monitor the fiscal developments, especially through the control of primary balance performance. In the strategy aimed at financial equilibrium the time regime of closing this gap must be strictly followed. The PCPE should get rid of the primary deficit in rather short period of time and only later they will be able to counteract the deficit regarding the public sector borrowing requirements.

(vi) There are the strong trade-offs between the public sector borrowing requirements, the private sector demand for a capital, and the need for new investments. These trade-offs can be mitigate, and only to an extent, by the foreign lending, but for the time being partial monetization of budget deficits is hardly escapable. Thus, in the medium term the PCPE are doomed for suffering relatively high, definitely not a one digit, rate of inflation. Such an inflationary climate will be unfavorable for supporting a sustainable growth, although it is probable that one will observe the both, inflation running for 20-40 percent annually and relatively high rate of the GDP growth--within the range of 4-7 percent annually.

(vii) The radical change of awkward fiscal position of the PCPE can happen only on the path of sustainable growth. There has not been a chance whatsoever to solve this dilemma on the basis of free falling output, that means at the time when these economies were shrinking. It turned out very fast that the improvement of fiscal stance--if it has occurred at all--has been rather illusionary one. The strong positive feedback, contrary to a negative one performing at the early phase of transition, can be set in motion only after the transition economies will successfully implement the structural adjustment.

(viii) Nonetheless, even under the circumstances of relatively fast and lasting for a longer period of time growth of real output, what seems to be plausible scenario in a foreseeable future, the fiscal situation will persist tense. Considering the progress accomplished until now and whole set of the recent challenges, the general conclusion is that one should not shorten the time perspective and underestimate the costs which are still to be paid before a sound fiscal stance tied to a vigorous and balanced growth is reached. It seems that in the transition economies the most suitable set of the policies supporting the accomplishment of these aims should consist of the heterodox income policy, accommodating fiscal stance and restrictive monetary measures.

Tables:

Charts

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Chart 3

Perverse Effect of Fiscal Adjustment