V

Progress with Fiscal Reform in Countries in Transition

This chapter focuses on the role of fiscal policy in macroeconomic adjustments in the transition countries. Attaining reasonable balance in fiscal positions has played a crucial role in the initial achievement of macroeconomic stability and in the responses to episodes of renewed macroeconomic instability—for example, in Bulgaria in 1996–97. With the initial task of fiscal and macroeconomic stabilization complete or nearly so in most transition countries, the focus of fiscal policy is shifting to the challenges of ensuring a sustainable path in the future. For countries more advanced in transition, a key fiscal issue in the coming years is to contain overall government expenditure levels, mainly by improving the cost-effectiveness of social spending.[139] Some countries less advanced in transition have to give priority to addressing severe revenue collection problems and eliminating deficits that are still excessive. More generally, all transition countries need to implement “second generation” reforms aimed at improving the quality and efficiency of government, including improvements in the institutional framework that supports the budgetary process and in the transparency of fiscal accounts. In a number of transition countries, including Russia, fiscal issues are currently the main policy challenge (Box 9).

Although this chapter focuses on the transition countries, the issues examined have broader applicability. Many developing countries and advanced economies face similar issues of rectifying macroeconomic imbalances stemming from lax fiscal policies, redefining the role of the state, working toward increased transparency in government operations, improving the efficiency of public services, and implementing policies to spur private sector development and productivity growth. As the transition countries have progressed in their transformation, the challenges they face have become increasingly similar to those faced by policymakers worldwide. The chapter extends the analysis of fiscal challenges in the May 1996 *World Economic Outlook* (Chapter V, pp. 77–92).

From Stabilization to Sustainability

Most transition countries have made substantial progress toward achieving reasonable fiscal balance, with 16 of 26 transition countries projected to have a general government deficit of 3 percent of GDP or less in 1998, compared with 13 countries in 1997 and only

Table 17. Countries in Transition: General Government Balance
(In percent of GDP)

Country	1992	1994	1995	1996	1997
Albania	–20.0	–7.0	–6.9	–10.7	–12.0
Armenia	–37.6	–16.4	–11.1	–9.3	–6.7
Azerbaijan	3.5	–11.4	–4.3	–2.6	–2.8
Belarus	–2.8	–2.6	–1.9	–1.6	–1.2
Bulgaria	–5.2	–5.8	–6.4	–13.4	–2.6
Croatia	–4.0	1.5	–0.9	–0.5	–1.4
Czech Republic	–2.1	–1.2	–1.8	–1.2	–2.1
Estonia	–0.3	1.3	–1.2	–1.5	2.4
Georgia	–34.5	–16.5	–5.3	–4.5	–5.0
Hungary	–6.9	–8.3	–7.1	–3.1	–4.6
Kazakhstan	–7.3	–7.1	–2.2	–3.0	–3.7
Kyrgyz Republic	–17.6	–7.7	–13.5	–6.3	–5.7
Latvia	–0.8	–4.0	–3.3	–1.3	1.4
Lithuania	0.5	–4.8	–4.5	–4.6	–1.9
Macedonia, former Yugoslav Republic of	–9.6	–3.2	–1.3	–0.4	–0.3
Moldova	–23.9	–9.1	–5.8	–6.6	–6.8
Mongolia	–6.0	–10.3	–6.4	–9.0	–9.0
Poland	–8.0	–2.0	–2.7	–2.5	–1.7
Romania	–4.6	–1.8	–2.6	–3.9	–4.5
Russia	–18.4	–10.4	–5.8	–9.5	–7.5
Slovak Republic	–11.9	–1.3	0.2	–1.3	–4.9
Slovenia	0.2	–0.2	–0.0	0.3	–1.2
Tajikistan	–31.2	–10.5	–11.2	–5.8	–3.4
Turkmenistan	13.3	–1.4	–1.6	–0.8	–0.0
Ukraine	–24.0	–8.7	–4.9	–3.2	–5.6
Uzbekistan	–12.2	–6.1	–4.1	–7.3	–2.8
Memorandum					
Major advanced economies[1]	–3.8	–3.5	–3.3	–2.8	–1.5

Source: IMF staff estimates.
[1]Canada, France, Germany, Italy, Japan, United Kingdom, and United States.

[139]As in past issues of the *World Economic Outlook*, a broad distinction is drawn in this chapter between countries “more advanced” in the transition process and those “less advanced.” The former group comprises the Baltic states together with the countries of central and eastern Europe except Albania, Bosnia-Herzegovina, Bulgaria, the former Yugoslav Republic of Macedonia, and Romania. The “less advanced” group comprises the five southeast European countries mentioned, Russia, the other 11 countries of the former Soviet Union, and Mongolia.

Table 18. Countries in Transition: General Government Revenue
(In percent of GDP)

Country	1992	1994	1995	1996	1997
Albania	23.5	24.5	23.9	18.3	16.4
Armenia	29.1	27.7	19.3	17.2	17.4
Azerbaijan	61.5	24.5	15.0	16.2	17.4
Belarus	46.0	47.5	42.7	40.9	40.9
Bulgaria	38.4	39.9	36.6	34.3	31.5
Croatia	33.2	43.2	45.8	47.0	46.8
Czech Republic	45.0	44.9	43.8	42.7	40.7
Estonia	34.6	41.3	39.9	39.0	39.4
Georgia	19.0	7.7	7.1	9.4	10.4
Hungary	53.4	51.4	48.1	46.8	44.9
Kazakhstan	24.5	22.5	24.6	22.9	23.4
Kyrgyz Republic	17.5	20.8	16.7	17.1	17.6
Latvia	28.1	36.5	35.5	36.5	39.0
Lithuania	31.6	32.7	32.8	30.1	33.5
Macedonia, former Yugoslav Republic of	38.6	51.0	45.3	44.3	42.4
Moldova	30.3	33.5	33.9	32.1	34.3
Mongolia	28.6	30.3	33.7	30.6	29.0
Poland	43.8	47.5	45.7	45.1	44.1
Romania	37.4	32.1	31.9	29.8	27.0
Russia	38.3	34.6	31.9	32.1	33.0
Slovak Republic	46.1	46.4	47.1	46.9	41.5
Slovenia	45.9	45.9	45.7	45.2	45.0
Tajikistan	26.6	44.5	15.2	12.1	11.6
Turkmenistan	42.3	10.4	12.5	16.5	29.2
Ukraine	34.0	41.9	37.8	36.7	38.4
Uzbekistan	31.5	32.3	34.6	34.2	30.2
Memorandum					
Major advanced economies	36.2	36.2	36.5	36.8	37.3

Source: IMF staff estimates.

Table 19. Countries in Transition: General Government Expenditure
(In percent of GDP)

Country	1992	1994	1995	1996	1997
Albania	44.0	31.2	30.8	29.0	28.4
Armenia	66.7	44.1	30.4	26.5	24.1
Azerbaijan	57.9	36.0	19.3	18.8	20.2
Belarus	48.8	50.1	44.6	42.5	42.1
Bulgaria	43.6	45.7	43.0	47.6	34.1
Croatia	37.2	41.8	46.7	47.4	48.2
Czech Republic	47.1	46.0	45.7	43.9	42.8
Estonia	34.8	39.9	41.1	40.5	37.0
Georgia	53.5	24.2	12.3	13.9	15.3
Hungary	60.3	59.7	53.2	49.9	49.5
Kazakhstan	31.8	29.6	26.8	25.9	27.1
Kyrgyz Republic	35.1	28.6	30.2	23.4	23.3
Latvia	28.9	40.5	38.8	37.8	37.6
Lithuania	31.1	37.5	37.3	34.7	35.4
Macedonia, former Yugoslav Republic of	48.2	54.2	46.5	44.7	42.7
Moldova	54.2	42.6	39.7	38.7	41.1
Mongolia	34.6	40.5	40.0	39.6	38.0
Poland	51.8	49.5	48.4	47.5	45.8
Romania	42.0	33.9	34.5	33.7	31.5
Russia	56.7	45.1	37.7	41.6	40.4
Slovak Republic	57.9	47.7	46.9	48.3	46.4
Slovenia	45.7	46.1	45.7	44.9	46.2
Tajikistan	57.8	55.0	26.4	17.9	15.0
Turkmenistan	28.9	11.9	14.0	17.2	29.2
Ukraine	58.0	50.6	42.7	39.9	44.0
Uzbekistan	43.7	38.5	38.7	41.5	33.0
Memorandum					
Major advanced economies	40.0	39.7	39.8	39.6	38.8

Source: IMF staff estimates.

7 as recently as 1992 (Tables 17–19).[140] Large changes in revenues or expenditures have typically been associated with the aftermath of macroeconomic crises, as in the case of the fiscal retrenchment in Bulgaria in 1997; this occurs in part because instances of high inflation can skew fiscal statistics, as is evident, for example, in the increase in the expenditure share of GDP, driven by the magnification of nominal interest payments, in Bulgaria one year earlier. In the past few years, countries such as the Czech Republic (following the May 1997 currency crisis) and Hungary (in early 1995) have responded to financial market pressures by taking resolute action to curb recurring fiscal imbalances. Most of the countries that still have large fiscal deficits are those less advanced in the transition process, including Moldova, Russia, and Ukraine, where deficits remain above 5 percent of GDP (Figure 29). It is now well established that countries that implemented tight fiscal policies early in the transition resumed growth sooner, and experienced more rapid growth subsequently, than countries that maintained unsustainably large budget deficits and the associated high levels of government expenditure.[141] Continued prudent fiscal policies to eventually attain balanced budgets remain important, in order to avoid diverting saving away from badly needed private sector investment and to reduce the risk of financial crises.

Ensuring Fiscal Sustainability

Fiscal imbalances are worrisome because they draw resources away from investment and, when deficits persist, lead to a buildup of government debt and a consequent servicing burden that can become unsustainable and can threaten macroeconomic stability.

[140]As discussed below, fiscal data for a number of countries in transition have to be interpreted with caution, since they continue to suffer from various weaknesses, including incomplete coverage of quasi-fiscal transactions, which have been relatively large in some cases.

[141]See Nina Budina and Sweder van Wijnbergen, "Fiscal Policies in Eastern Europe," *Oxford Review of Economic Policy*, Vol. 13 (Summer 1997), pp. 47–64.

Box 9. Russia's Fiscal Challenges

Russia exemplifies many of the fiscal problems that still confront countries less advanced in transition. A substantial revenue shortfall, a distorted structure of expenditures with payment arrears, and significant weaknesses in the institutional arrangements that underpin revenue and expenditure management together make fiscal issues the main policy challenge in Russia.[1] Tax reforms have lagged, both on the policy and on the administration side, resulting in a downward trend in revenue. General government revenues fell by 3.7 percentage points of GDP during 1992–94, and by an additional 2.5 percentage points of GDP during 1994–96 (*see table*). In 1997, the federal government collected less than 12 percent of GDP in revenue, about 30 percent less than what was targeted in the budget, and up to 20 percent of revenues took the form of offsets of mutual tax and payment liabilities and other nonmonetary transactions, rather than cash income to the budget. The revenue shortfall forced the federal government to adjust expenditure downward, while the deficit remained high, in excess of 7 percent of GDP in 1997. With interest payments rising, noninterest expenditure fell from around 21 percent of GDP in 1994 to 14 percent in 1997 (to around 11½ percent if cash expenditures only are considered); subsidies, transfers to the regions, and capital expenditure were among the items most affected, whereas wages and social transfers were better maintained. The (partial) expenditure adjustment has occurred in a rather ad hoc manner, with little support from the weak institutions responsible for budget preparation, execution, and evaluation. Attempts to maintain expenditure commitments, as opposed to cash spending, led to sequestration, use of noncash means to settle budgetary obligations, and accumulation of payment arrears. Although the federal government cleared wage arrears by the end of 1997, this was replaced by a sizable buildup of new arrears to suppliers. The finances of regional and local authorities and of the extrabudgetary funds, the other constituents of the general government, have deteriorated as well, and subnational governments have accumulated undocumented arrears on wage payments and payments to suppliers.

The persistent weakness of revenue and the pervasive problems of ad hoc expenditure cuts and arrears reflect fundamental weaknesses in tax policy, tax administration, and budgetary management. Moreover, the problems of weak revenue collection, expenditure control, and spending policy are interlocked. Weak tax collection is linked to persistent problems in controlling expenditures. The lack of expenditure control and the inability of the government to pay its own bills, combined with the extensive resort to noncash mechanisms to settle budgetary arrears against the arrears of tax debtors, severely undermine incentives for paying taxes in cash. Noncash tax arrangements hinder public expenditure on wages and other social commitments that can be satisfied only in cash.

Progress in *tax reform* in Russia has been inadequate. The tax system remains complex, with up to 200 types of taxes, numerous and sometimes arbitrary exemptions, narrow tax bases, and, partly as a result, high statutory tax rates on labor income. The revenue structure relies heavily on payroll taxes that are likely to lead to distortions in the economy. The tax regime of the energy sector in particular suffers from a number of shortcomings.[2] The relative tax burden of the oil and gas sectors—defined as the sectors' shares in general revenues divided by their estimated shares in GDP—was around 1.6 in 1996, lower than in comparable oil- and gas-producing countries; and actual revenues were only slightly more than half of the liability as estimated on a statutory basis. An inappropriate tax structure, together with exemptions, is one of the main reasons for the low tax revenue. To simplify the tax system, broaden the tax base, and reduce the number of exemptions, the government has submitted to parliament

Russian Federation: Summary Operations of the General Government
(In percent of GDP)

	1992	1993	1994	1995	1996	1997
Federal government						
Revenue	15.6	13.7	11.8	12.2	13.0	11.6
Expenditure	26.0	20.2	23.2	17.6	22.1	18.4
Interest payments	0.7	1.9	2.0	3.3	5.7	4.4
Transfers	1.7	2.8	4.2	2.1	3.1	3.8
Balance	–10.4	–6.5	–11.4	–5.4	–9.1	–6.8
Subnational governments						
Revenue	13.5	16.7	18.0	14.2	14.5	16.1
Transfers	1.7	2.6	4.1	1.6	2.7	2.9
Expenditure	12.0	16.1	17.5	14.5	14.8	16.9
Balance	1.5	0.6	0.5	–0.3	–0.4	–0.8
Extrabudgetary funds						
Revenue	10.9	8.6	9.1	7.6	7.7	9.1
Transfers	—	0.2	0.1	0.5	0.4	0.9
Expenditure	8.4	8.0	8.6	7.6	7.7	9.0
Balance	2.5	0.6	0.5	—	—	0.2
General government						
Revenue	38.3	36.2	34.6	31.9	32.1	33.0
Expenditure	44.8	43.6	45.1	37.7	41.6	40.4
Balance[1]	–18.4	–9.4	–10.4	–5.8	–9.5	–7.5
Memorandum						
GDP (in trillions of old rubles)	19	172	611	1,630	2,256	2,675

Sources: Ministry of Finance; Central Bank of Russia; *Goskomstat*; and IMF staff calculations.
[1]For 1992–93, including unbudgeted import subsidies.

[1]For recent overviews of fiscal developments in Russia, see "Russian Federation—Recent Economic Developments," IMF Country Staff Report 97/63 (Washington, 1997); and OECD, "OECD Economic Survey. Russian Federation 1997" (Paris: OECD, 1997).

[2]See Dale F. Gray, "Evaluation of Taxes and Revenues from the Energy Sector in the Baltics, Russia, and Other Former Soviet Union Countries," Working Paper 98/34 (Washington: IMF, March 1998).

a comprehensive draft Tax Code, expected to be adopted by the middle of 1998, with most provisions coming into effect on January 1, 1999. When adopted, the code will introduce on a gradual basis accrual accounting for indirect taxes other than oil and gas excises and for profit taxes; increase the share of personal income taxes in total revenue; and reform the taxation of the energy sector.

Fundamental weaknesses in *tax administration* have also been a critical factor in Russia's persistent revenue shortfall. In addition to procedural and organizational problems—including the lack of coordination among the various tax collecting agencies, enforcement agencies, and the Ministry of Finance—insufficient political will has been an important reason for the continuing weakness in tax administration; tax-collecting agencies have tolerated the increasing use of barter transactions for tax avoidance purposes and the accumulation of tax arrears, particularly by large enterprises. Tax arrears are highly concentrated, with the energy sector traditionally accounting for the major share; in 1997, efforts were made to clear tax arrears in the gas and electricity sectors. To improve tax collection, the authorities have recently taken a number of steps. Noncash tax arrangements have been abolished, measures against large debtor enterprises have been announced, and tax-collecting agents have begun to work on the premises of the major companies in, among others, the gas and electricity sectors. Other proposed measures include the implementation of administrative units aimed at large taxpayers and the introduction of realistic penalties for noncompliers.

In addition, Russia still has a long way to go in establishing the appropriate institutions and mechanisms for the *preparation, execution, and evaluation of the budget*. The overall legal framework for budget management, which is little changed from the law that applied immediately after the breakup of the Soviet Union, is deficient. In addition, there are more specific shortcomings at all three stages of the budgetary process. At the preparation stage, these include a tendency toward overoptimistic macroeconomic and revenue forecasts, a lack of expenditure prioritization, and a complex and lengthy budget adoption procedure. At the second stage, the budget is not fully executed according to the approved appropriations; adjustments to new macroeconomic and revenue developments are made in an ad hoc fashion, resulting in arrears and sequestration; and the budget execution reports are incomplete and based on outdated accounting frameworks and methods. Auditing and evaluation, finally, are virtually absent in the budget cycle in Russia. Improving the quality of budgetary and expenditure management at all levels of government is among the most important remaining fiscal challenges in Russia. Key measures in this area that the government intends to take in 1998 include significantly strengthening the capacity of authorities to control and monitor expenditures by moving all the financial operations of federal agencies and ministries into the federal treasury; introducing more effective sanctions on agency heads who exceed the spending limits of the budget; requiring preapproval of large-size contracts by the Ministry of Finance; establishing a monthly system of reporting on payables by ministries and other agencies; and settling the outstanding expenditure arrears.

An additional area of institutional weakness is the system of *intergovernmental fiscal relations*. The fiscal decentralization process in Russia has been rapid and ad hoc, and the emerging system of federalism is nontransparent and fluid. Decentralization proceeded very fast during 1992–94.[3] While federal budget revenues shrank from around 15½ percent of GDP in 1992 to 12 percent in 1994, regional revenues expanded from 13½ percent to 18 percent, in part because of an increase in federal transfers from 1½ percent of GDP to 4 percent. In more recent years, however, a trend toward gradual recentralization of tax revenues and reduction in federal transfers has emerged, and regions saw their share of revenue to GDP decline again. The federal government, in an attempt to curb its deficit, has also shifted additional expenditures, mainly relating to social and capital outlays, to subnational levels. As a result, the overall budget balance of the regions moved from a small surplus in 1994 into a deficit from 1995 onward.

Despite some improvements since 1994, the system of intergovernmental fiscal relations continues to suffer from significant weaknesses.[4] First, current expenditure assignments and tax-sharing arrangements remain nontransparent and leave room for discretion. This leads to continual lobbying and negotiating, undermines fiscal accountability and responsibility at lower levels of government, and contributes to the practice of withholding from the center federal taxes collected at the local level. Ill-defined local tax rights reduce private investment and the provision of public goods and infrastructure and encourage tax evasion.[5] Second, the system of transfers has not been effective in reducing the large disparities among regions in per capita revenues, or in achieving greater equalization of per capita outlays on such items as social safety nets, education, and health.[6] Third, no adequate arrangements are in place to avoid financial imbalances at the subnational level giving rise to arrears or excessive borrowing, including in the international markets.

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[3]Russia is a three-tiered federal state that, in addition to a central government and local administrations, comprises 89 geographic administrative authorities that carry varying descriptions, largely reflecting differences in the relative degree of autonomy from the center and in the ethnic mix of the populations of the region concerned.

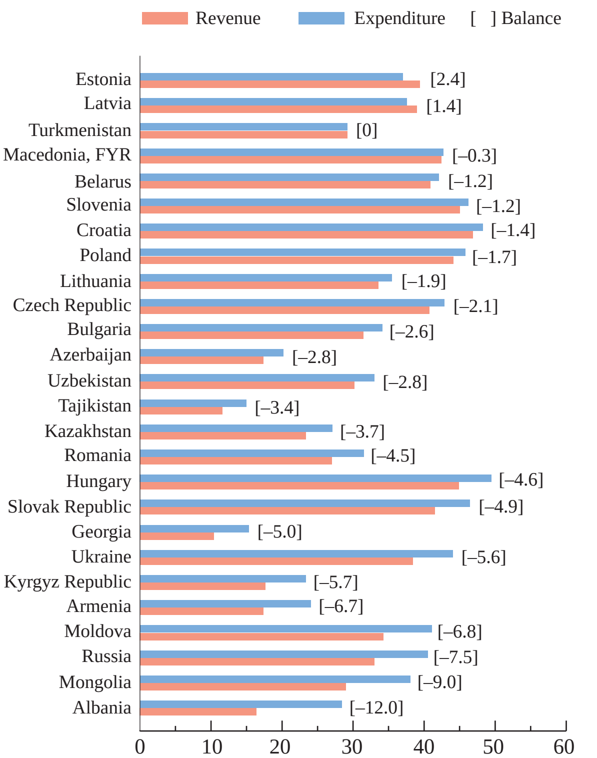
[4]For an overview of intergovernmental fiscal relations in Russia, see Jon Craig, John Norregaard, and George Tsibouris, "Russian Federation," in Teresa Ter-Minassian, ed., *Fiscal Federalism in Theory and Practice* (Washington: IMF, 1997), pp. 680–701.

[5]Daniel M. Berkowitz and Wei Li, "Decentralization in Transition Economies" (unpublished; Pittsburgh, Pennsylvania: University of Pittsburgh, September 1997).

[6]Kitty Stewart, "Are Intergovernmental Transfers in Russia Equalizing?" Working Paper 97/22 (Badia Fiesolana, Italy: European University Institute, April 1997).

Figure 29. Countries in Transition: General Government Revenue and Expenditure, 1997[1]
(In percent of GDP)

Most countries in transition are still running government deficits, but they are close to balance in a number of cases.



[1]The ordering of countries is based on the fiscal balance in 1997.

A simple indication of the sustainability of a country's fiscal program is provided by a comparison of the actual primary balance (the government balance excluding interest payments) with the primary balance that would be needed to stabilize the ratio of debt to GDP at its current level. The difference is a measure of the additional "fiscal effort" needed to stabilize the debt. It will depend on the level of debt, the interest rate, and the growth rate of GDP, as well as on the actual primary balance.[142] For the situation in which the interest rate exceeds the growth rate, a primary surplus would be needed to stabilize the debt-to-GDP ratio; with a growth rate higher than the interest rate, the debt-to-GDP ratio will fall without the need to run a primary surplus. Table 20 shows illustrative calculations for the Czech Republic, Hungary, Russia, and Ukraine. The primary balance (as a share of GDP) that would be needed to stabilize the debt-to-GDP ratio is shown for several scenarios of real interest rates ranging from an optimistic case (in which low interest rates exceed the growth rate by only 1 percent) to a pessimistic case for Russia and Ukraine (in which the differential is 10 percent).[143] In the optimistic scenario, the four countries would need to run primary surpluses of under 1 percent of GDP to stabilize or reduce the debt-to-GDP ratio, as was the case in Hungary in 1997. In the Czech Republic, the debt-to-GDP ratio increased somewhat in 1997 after several years of decline, although a recent fiscal adjustment is projected to move the economy toward a balanced budget (and thus a primary surplus) in the next two to three years. In Russia and Ukraine, along with other countries less advanced in the transition, high real interest rates exacerbate the burden of debt servicing and imply that either substantial primary surpluses or sharp accelerations of growth are required to stabilize the debt-to-GDP ratio. Of course, this does not imply that the fiscal positions in other transition countries are unsustainable or that any particular country is insolvent, since solvency depends on the ability of the country to repay its obligations into the future. Instead, it indicates that adjustments are likely to be needed in future years in these coun-

[142]See the May 1996 *World Economic Outlook*, footnote 25, p. 50; see also Willem H. Buiter, "Aspects of Fiscal Performance in Some Transition Economies Under Fund-Supported Programs," Working Paper 97/31 (Washington: IMF, April 1997).

[143]Although real interest rates at a particular time depend on inflation outcomes that are not yet known, it is estimated that real interest rates in advanced countries such as the Czech Republic and Hungary range from about 2 to 4 percent, with real interest rates in less advanced countries such as Russia and Ukraine expected to range from 10 to 20 percent. In Russia and Ukraine, tight monetary policy to maintain low inflation and support exchange rate target bands will entail high interest rates on debt denominated in domestic currency. A depreciation of the currency and ensuing rise in inflation would lower real interest rates on domestic debt but would lead to an offsetting increase in the real burden of foreign currency debt.

Table 20. Selected Countries in Transition: Scenarios for Fiscal Sustainability
(In percent of GDP)

	Czech Republic	Hungary	Russia	Ukraine
Ratios of debt to GDP, end of 1997	11	76	50	30
Real output growth, forecast for 1998	2.2	4.8	1.0	—
Ratio of primary balance to GDP, 1997	–0.6	3.5	–3.1	–3.8
Primary balance (share of GDP) needed to stabilize ratio of debt to GDP for a real interest rate that exceeds the growth rate by:				
1 percent	0.1	0.7	0.5	0.3
3 percent	0.3	2.2	1.5	0.9
5 percent	0.5	3.6	2.5	1.5
10 percent	. . .	. . .	5.0	3.0

tries to prevent a continuous buildup of debt and to ensure sustainability.[144]

The sustainability of a country's fiscal policy has implications for the sustainability of its external position. In transition countries, sizable fiscal deficits have generally not been offset by higher private saving and have consequently been reflected in large current account deficits. In fact, with low rates of private saving—as well as public sector dissaving—the transition countries have rates of national saving below those of emerging market countries in other regions such as Asia and Latin America, while facing investment needs that are at least as high. In countries such as the Czech Republic and Estonia, large current account deficits have been indicators of overheating and have stemmed from consumption outpacing the growth of income rather than from rapid growth in investment. In Poland, the current account deficit remains large, but it mainly reflects the growth of investment, which has outpaced consumption growth in recent years. These current account imbalances, along with the ensuing buildup of external debt in some countries, have raised questions about sustainability. For example, research has suggested that persistent current account deficits in excess of 5 percent of GDP are a presumptive indication of unsustainable macroeconomic imbalances, particularly if the deficits result from a boom in consumption rather than investment and are combined with low national saving rates (see Box 8).[145]

For many countries in transition, government deficits have been financed in large measure through external borrowing in foreign currency, with most of the outstanding stock of external debt in each country owed by the government. Sizable external borrowing to finance productive investment may well be appropriate during the transition, given the large potential returns from investment and the relatively high cost of domestic finance (stemming from the lack of domestic financial intermediation).[146] Recently, however, governments in some countries have turned to foreign currency borrowing to finance current expenditures, such as paying off wage and pension arrears, and to retire domestic debt, while using nonrecurrent revenues such as those arising from privatizations to balance the budget.[147]

Solvency Versus Liquidity

The importance of the distinction between solvency and liquidity has been demonstrated by recent events in Asia. A country may be solvent in the sense that its forecast growth path is expected to permit the servicing of its obligations, but it could still face a liquidity crisis that inhibits refinancing of debt falling due in the near term. The maturity structure of the debt thus becomes crucial, since lumpiness in the stream of payments, especially the concentration of debt at short maturities, can lead to a liquidity crunch. Such a crisis can threaten fiscal and macroeconomic stability. External debt finance also increases a country's vulnerability to a financing crisis—by exposing the value

[144]Jean-Claude Chouraqui, Robert P. Hagemann, and Nicola Sartor, "Indicators of Fiscal Policy: A Re-examination," Working Paper 78 (Paris: OECD, Department of Economics and Statistics, April 1990); and Jocelyn Horne, "Indicators of Fiscal Sustainability," Working Paper 91/5 (Washington: IMF, January 1991), discuss forward-looking measures of fiscal sustainability.

[145]See also Nouriel Roubini and Paul Wachtel, "Current Account Sustainability in Transition Economies," Working Paper Series, No. EC-97–03 (New York: New York University, June 1997).

[146]For example, Jong-Wha Lee, "Capital Goods Imports and Long-Run Growth," *Journal of Development Economics*, Vol. 48 (October 1995), pp. 91–110, shows that growth is positively related to the share of capital goods in imports. However, there is as yet little direct evidence to support the proposition that investment-driven imports enhance a country's ability to repay its external obligations. As recent experiences in Asia make clear, the quality of the investment is also an important consideration in evaluating the effects of a current account deficit.

[147]See Stefano Manzocchi, "External Finance and Foreign Debt in Central and Eastern European Countries," Working Paper 97/134 (Washington: IMF, September 1997), for discussions of debt burdens and related policy issues.

of the payment stream to the risk of a depreciation of the domestic currency that increases the burden of the debt, as well as to the risk of a shift in market sentiment that leads lenders to require increased interest rates to extend new credit to roll over existing debt. Such a shift may happen, for example, as a result of crises in other markets, as appears to have been partially the case in the Czech Republic and Slovak Republic in May 1997 and more recently in Russia and Ukraine. The dangers of adverse contagion effects are particularly acute for countries, including Russia and Ukraine, where the financial sectors still suffer from substantial structural weaknesses and are the main source of financing for the government.

To avoid a bunching of debt repayments that may threaten to provoke a liquidity crisis, countries have to adopt explicit strategies to govern the timing, amount, and maturity structure of their external borrowing. In many countries, this requires development of the institutional capabilities necessary to monitor existing debt and limit additional deficit financing, including the financing of quasi-fiscal obligations. An important means of smoothing the stream of obligations is to lengthen the maturity composition of debt, although this could in some cases limit a country's ability to borrow at a particular point in time, and of course it could be desirable to avoid long-term borrowing at times when events lead to temporary increases in interest rates.[148] This depends largely on progress in the transition: although interest rate premia have fallen and maturities have lengthened over the transition, debt issues in most transition country securities remain limited to relatively short maturities, typically of less than three years in countries more advanced in the transition and of less than one year in less advanced countries. In Russia, for example, the total stock of debt (including all levels of government and enterprises) equals around 50 percent of GDP, with a composition of 60 percent foreign currency borrowing, 25 percent domestic currency debt with a maturity of less than one year, and the rest longer-term domestic currency debt. The share of domestic currency short-term debt held by foreign investors is around 30 percent. In Ukraine, total debt equals around 30 percent of GDP, with over 70 percent of this denominated in foreign currency and the remaining domestic currency debt consisting of treasury bills with a maturity of one year or less. This exposure to shifts in debt composition raises parallels with Asia. Indeed, the vulnerability created by the preponderance of short-term debt has been illustrated over the course of recent months, as treasury bill yields spiked upward in countries such as Russia and Ukraine that were judged by the market to be at greatest risk of a crisis. Further development of domestic capital markets is also necessary to lessen exposure to exchange market instability and to reduce the costs of borrowing. Increased government borrowing in domestic currency may be desirable to spur this development, particularly if the increased depth of domestic financial markets encourages increased domestic saving.

External borrowing has clearly been helpful over the course of the transition, both in providing finance for continued increased investment and, particularly at the beginning of the transition, in helping to smooth the fall in consumption associated with the initial declines in output. In many countries, however, structural transformation must be significantly accelerated to provide the increased efficiency and output growth needed to generate the increased domestic saving necessary to service the debt while providing funds for domestic investment. A coherent borrowing strategy is thus crucial to ensure that the use of external resources is consistent with sustainable macroeconomic programs. These steps are particularly important for countries that were already, or are now, on the edge of viable fiscal and external positions.[149]

Transition and Government Revenue

Under central planning, the finances of the government sector were intrinsically linked with those of the enterprise sector. In particular, state-owned enterprises were the main revenue source for the government with their contribution taking the form of profit remittances rather than tax payments. Broadly based privatization programs, which have been completed or are nearing completion in most transition countries, have transferred the ownership of enterprise assets to the private sector and have transformed enterprises into separate taxable entities. Although privatization does not necessarily affect the net worth of the government, the widespread use of voucher and inside privatizations and of non-market-based sale procedures has actually involved a significant net capital transfer from the government to the private sector.[150] Moreover, from a flow point of view, privatization has implied some tax revenue loss because activities conducted by the private sector are more difficult to tax.

[148] See Dirk Willer, "Financial Aspects of Debt Management in Transition Countries," LSE Working Paper (London: London School of Economics and Political Science, August 1996).

[149] See Ishan Kapur and Emmanuel van der Mensbrugghe, "External Borrowing by the Baltics, Russia, and Other Countries of the Former Soviet Union: Developments and Policy Issues," Working Paper 97/72 (Washington: IMF, June 1997); and John Odling-Smee and Basil Zavoico, "External Borrowing in the Baltics, Russia, and Other States of the Former Soviet Union—The Transition to a Market Economy," Paper on Policy Analysis and Assessment (Washington: IMF, 1998).

[150] G.A. Mackenzie, "The Macroeconomic Impact of Privatization," Paper on Policy Analysis and Assessment 97/9 (Washington: IMF, November 1997).

Table 21. Selected Countries in Transition: Main Items in the General Government Revenue Structure, 1996
(In percent of GDP)

	Czech Republic	Hungary	Poland	Slovenia	Slovak Republic
Tax revenue	39.0	36.1	39.7	45.2	40.6
Personal income tax	5.3	5.9	9.2	6.8	5.2
Corporate profit tax	4.1	1.9	3.1	0.9	6.0
Social security contributions[1]	15.9	13.6	10.8	16.6	14.6
VAT/sales tax	7.2	7.7	8.1	13.2	8.4
Excise taxes	4.0	3.3	4.3	3.5	3.7
Trade taxes	1.3	3.7	2.6	3.0	1.7
	Croatia	Estonia	Latvia	Lithuania	Mongolia
Tax revenue	46.2	36.1	32.5	28.2	24.5
Personal income tax	6.5	3.7	5.5	6.7	1.2
Corporate profit tax	1.2	1.7	2.1	1.2	5.5
Social security contributions[1]	15.1	10.8	9.8	7.2	5.4
VAT/sales tax	13.2	10.2	9.8	8.2	5.2
Excise taxes	5.2	3.3	3.2	2.7	1.7
Trade taxes	3.8	—	0.7	0.7	2.6
	Armenia	Belarus	Kazakhstan	Russia	Ukraine
Tax revenue	7.5	38.9	17.3	22.0	37.4
Personal income tax	0.8	5.1	2.2	2.5	3.3
Corporate profit tax	1.5	7.1	2.9	4.3	6.8
Social security contributions[1]	2.3	9.7	9.5	6.6	10.7
VAT/sales tax	1.9	13.8	3.8	6.4	7.8
Excise taxes	1.0	6.1	0.8	2.4	0.8
Trade taxes	. . .	3.3	1.3	0.7	0.6

Sources: IMF, *Goverment Finance Statistics Yearbook* (Washington, various years); national authorities; and IMF staff estimates.
[1]Including contributions paid by government as employer.

Tax Policy Reform

Most transition economies have made considerable progress in designing tax systems suited to a market economy. To replace profit remittances, countries have introduced corporate income taxes; moreover, value-added taxes (VATs) have generally replaced complex turnover taxes, and systems of personal income taxation have been developed. The reform of tax systems is not complete, however. In Russia and the 11 other countries of the former Soviet Union, for instance, VAT systems still suffer from a number of weaknesses.[151] An unfinished agenda of tax policy reform, together with tax administration problems, has contributed to severe revenue collection problems, in Russia and other countries of the former Soviet Union in particular.

In these countries with revenue problems, high priorities for further tax policy reform are to strictly limit tax exemptions, to unify rates within various tax categories, and to eliminate sectoral differences in tax treatment. These objectives require the coverage of the VAT to be extended. Important commodities such as oil and gas will have to be made subject to the full tax regime, and mechanisms need to be put in place to collect the rent associated with natural resources (for example, royalties). The tax status of small private businesses also needs further consideration. Finally, while broadening tax bases, these countries also need to contain marginal tax rates and the overall tax burden on the private sector, so as to lessen the incentives for activity to move into the untaxed informal economy.

Further changes in the structure and composition of taxes are also part of the medium-term reform agenda in countries more advanced in the transition. These countries in general have adopted a revenue mix with a relatively high share of social security contributions and low share of personal income tax revenues in total central government revenues; this mix may have adverse consequences for the cost of labor (Table 21). They also need to reconsider excessively high marginal personal income tax and payroll tax rates. At the same time, these transition countries are introduc-

[151]See Victoria P. Summers and Emil M. Sunley, "An Analysis of Value-Added Taxes in Russia and Other Countries of the Former Soviet Union," Working Paper 95/1 (Washington: IMF, January 1995); and Katherine Baer, Victoria P. Summers, and Emil M. Sunley, "Destination VAT for CIS Trade," *MOCT-MOST: Economic Policy in Transitional Economies*, Vol. 6, (No. 3, 1996), pp. 87–106.

ing tax reforms aimed at harmonizing fiscal regimes (including VAT and trade-related taxes) with EU requirements.

Tax Administration Reform

The reform of tax administration is a key component of institutional fiscal reform in transition countries. These countries face a double challenge in this regard: they have to implement a variety of new taxes, and, with the emergence and expansion of the private sector, they must develop systems for classifying new categories of taxpayers and new forms of economic activity. Tax administration reform refers to a wide range of activities, mechanisms, and specific actions that can be grouped into three broad areas: the organization of tax administration, systems and procedures, and enforcement. As persistent revenue collection problems illustrate, further progress is needed in all three areas, especially in countries less advanced in transition. However, improvements in tax administration are unlikely to have their full effect unless there is also a strengthening of the political will to collect taxes.

Tax administration in transition countries is often not effectively organized. In many countries less advanced in transition, inadequate staffing, poor training, low wages, and lack of equipment have contributed not only to low morale and widespread administrative malpractices, but also to an erosion of tax compliance. One of the most important tasks of the tax administration authorities is to set up internal control and accountability systems to detect incorrect tax assessments and to deter corruption on the part of tax officials.

Moreover, procedures to assess, collect, and record tax payments also need to be strengthened. To efficiently administer a system with a growing number of taxpayers, many of which—particularly small private enterprises—are difficult to tax, governments need to introduce better identification procedures, while at the same time taking steps to provide for self-assessment and withholding of taxes rather than costly administrative assessments. Simplifying tax forms and procedures may further alleviate the burden on both administration and taxpayers. In many cases, improved monitoring and follow-up action against those who fail to file returns or make payments, including the selective use of audits, is needed. Russia and most other countries of the former Soviet Union, for instance, have made only limited progress in adopting modern audit methods.

Finally, tax administration in most transition countries will need to give more attention to enforcement. Among the countries less advanced in transition, few have developed effective measures to tackle noncompliant taxpayers. Such modern enforcement measures as facilitating access to bank deposits, vigorous prosecution of the most egregious cases of tax fraud, appropriation of accounts receivable, and seizure and sale of property in selective cases need to be introduced and applied systematically. The rationalization of interest and penalties on overdue tax payments is also an important component of tax administration reform. In countries where tax arrears are important—for instance, in Kazakhstan, where they are estimated to exceed 2 percent of GDP, and in Russia, where in mid-1997 they amounted to around 6 percent of GDP—accurate and timely aggregate information on the size of arrears is needed.

Deciding on an Appropriate Level of Revenue

Current revenue levels in countries in transition are not necessarily in line with the ability of government to raise revenue in the medium term. Countries more advanced in the transition generally impose a tax burden that in other countries is found to result in distortions and to reduce longer-run growth potential. For countries less advanced in the transition that still face revenue collection problems, there may well be scope for medium-term revenue targets that are somewhat higher than current ratios of revenue to GDP.

A comparison of current ratios of revenue to GDP with the levels predicted from a comparison with similar advanced and developing countries provides a useful guide.[152] Regression analysis for the comparator countries identifies the main determinants of the revenue-to-GDP ratio, with the most important of these being the stage of development as measured by per capita GDP on a purchasing power parity (PPP) basis. The central and eastern European countries collect revenues that surpass the predicted 35 to 40 percent of GDP, suggesting that additional revenue has been raised to accommodate high spending levels (Figure 30). In countries less advanced in the transition, comparison with countries with similar economic characteristics suggests that revenue-to-GDP ratios of 20 to 30 percent are achievable. Current ratios outside that range reveal either significant revenue collection problems (as in Georgia, where the government collects only 10 percent of GDP in revenue) or reform lags and continued high taxation of state enterprises (as in Uzbekistan). Differences in revenue collection within the group of countries less advanced in transition also show a relation to differences in per capita GDP, suggesting that the revenue-to-GDP ratios could increase with gains in per capita income.

Transition and Government Expenditure

The move to a market economy entailed the redefinition of the boundaries between the private and pub-

[152]Luca Barbone and Hana Polackova, "Public Finances and Economic Transition," *MOCT-MOST: Economic Policy for Transitional Economies*, Vol. 6 (No. 3, 1996), pp. 35–61.

lic sectors and has required the finances of the enterprise and banking sectors to be separated from those of the government. Under central planning, state enterprises performed a number of functions, such as providing social benefits and investing in infrastructure, that are considered to be more the responsibility of the public sector in a market economy. At the same time, these enterprises received compensation in the form of explicit subsidies and inputs administratively priced at below market rates.[153] Moreover, state-owned financial institutions conducted a range of operations with fiscal implications.

Much progress has been made in delineating the functions and finances of the enterprise and banking sectors, on the one hand, and of the government on the other. In a number of countries, however, the practice of having public financial institutions, including the central bank, carry out quasi-fiscal operations, such as the provision of credit at below-market interest rates or the financing of the clearance of payment arrears, has not yet been eliminated.[154] Moreover, in most transition countries, while the transfer of social services from enterprises is a feature of reform programs, many enterprises, including privatized and newly established firms, continue to provide some social benefits in line with former practices. While nonwage benefits are also common in market economies, enterprises in transition economies tend to provide them in the form of services based on fixed assets—for example, housing, clinics, and kindergartens—rather than as financial support. Moreover, enterprises provide these benefits on their own account rather than "outsource" them, and thereby engage in activities that are extraneous to their core business operations. Although the types of benefits and the method of provision are still quite different, the share of nonwage benefits in overall labor costs has been reduced in the countries more advanced in transition and, at around 10 percent of the wage bill, is now similar to the practice in a number of advanced economies. In Russia and other countries of the former Soviet Union, in contrast, social benefits still form a much higher share (20 percent and more) of total compensation, reflecting very significant housing-related benefits.[155] In these countries, enterprises continue to receive financial compensation for

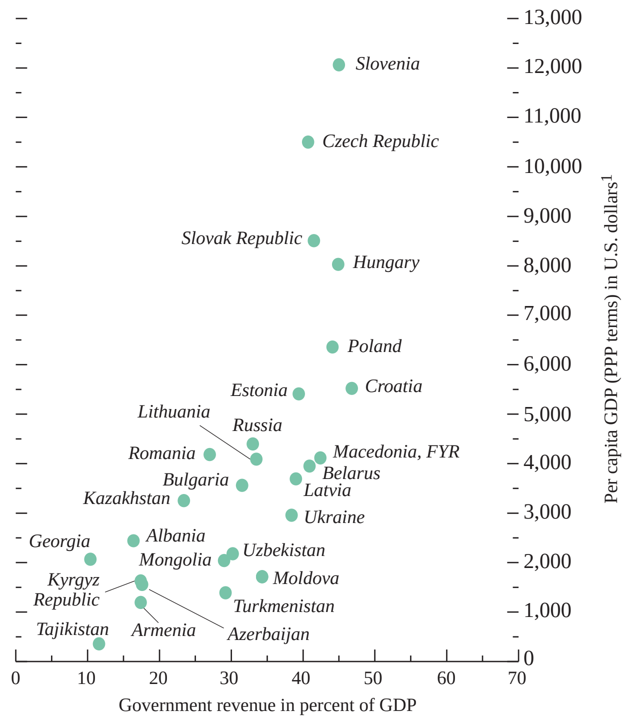
[153]On this issue, see Luca Barbone and Domenico Marchetti, Jr., "Transition and the Fiscal Crisis in Central Europe," *Economics of Transition*, Vol. 3 (March 1995), pp. 59–74; and Vito Tanzi, "The Budget Deficit in Transition: A Cautionary Note," *Staff Papers*, IMF, Vol. 40 (September 1993), pp. 697–707.

[154]For a more general discussion, see G.A. Mackenzie and Peter Stella, *Quasi-Fiscal Operations of Public Financial Institutions*, Occasional Paper 142 (Washington: IMF, October 1996).

[155]See, for instance, Simon Commander and Mark Schankermann, "Enterprise Restructuring and Social Benefits," *Economics of Transition*, Vol. 5 (No. 1, 1997), pp. 1–24; Martin Rein, Barry L. Friedman, and Andreas Wörgötter, eds., *Enterprise and Social Benefits After Communism* (New York and Cambridge: Cambridge University Press, 1997).

Figure 30. Countries in Transition: Government Revenue, 1997

Countries more advanced in transition have relatively high revenue-to-GDP ratios; in countries less advanced in transition, these ratios reflect revenue collection problems and the stage of development.



[1]PPP, purchasing power parity.

social spending from the government in the form of tax concessions and implicit subsidies through deliveries of cheap energy, including tolerance of nonpayment for such deliveries.[156]

The provision of housing, education, and health care services by enterprises is likely to be inefficient and costly, since these activities typically fall outside the core competencies of the industries. To safeguard continued access and to ensure efficient provision of these services, enterprises should spin off the delivery of nonwage benefits, transferring fixed assets where necessary to private providers, the public sector, or, in the case of housing, directly to households. Governments should gradually remove the implicit subsidies on a range of services and utilities and should aim instead at full cost recovery, while targeting social benefits to the less well-off households to ensure that the increase in cost to them is offset. Charging market-based prices will also reduce the waste of energy in housing and social services.[157] For instance, in Lithuania, where full cost recovery was recently achieved, an indirect subsidy program was established to reduce the burden of heating and hot water costs for needy households. When heating bills exceed 15 percent (or hot water bills exceed 5 percent) of household income, the excesses can be deducted and remain unpaid; approximately 30 percent of urban households are estimated to be eligible for this subsidy. In Russia, full cost recovery is now planned by 2003.

Expenditure Adjustment During Transition

Redefining the role of government has also meant reducing the level of government spending and adjusting its composition toward market economy patterns. Aggregate spending as a share of GDP has been reduced in most transition countries. In the countries more advanced in transition, the share of government expenditures in GDP has remained above 40 percent following an initial decline. In some countries less advanced in transition, by contrast, the share of government expenditures in GDP has fallen to very low levels; it is expected to rebound somewhat as revenue collection problems ease. The composition of spending other than on interest payments has also changed: the biggest changes relate to subsidies and capital investment, the shares of which have declined, and to social expenditures, which have gained in importance. The share of military expenditure in total spending fell in central and eastern Europe, but it remained broadly constant in Russia and most other countries of the former Soviet Union.[158]

Subsidies to enterprises and consumers have generally declined, but they remain large in some countries. In Russia and most other countries of the former Soviet Union, national or municipal governments continue to subsidize electricity consumption, as well as residential heat and hot water.[159] In these countries, enterprises also still receive government financial support, often in the form of tax exemptions and tolerated tax arrears. While transfers that promote and facilitate restructuring can be appropriate, government financial assistance often is primarily used to finance current operations and losses and is meant to sustain current employment.[160]

Public investment was sharply reduced in the early years of the transition. In most transition countries, governments decided to postpone investment projects to protect current expenditures, particularly wages of government employees, during what were expected to be temporary overall spending cuts. Moreover, a correction of excessively high levels of government capital formation under central planning was warranted, in any event. However, in countries—several central Asian states and Ukraine, for example—where public investment is now very low, at less than 2 percent of noninterest expenditures (around 1 percent of GDP), there is a considerable need to raise expenditures, particularly on infrastructure, once the shocks of transition have been absorbed.

The share of social expenditures, finally, has risen in most countries since the start of the transition process. Unemployment insurance and various active labor market schemes have been implemented in the face of layoffs resulting from enterprise restructuring. In central and eastern Europe, spending related to these policies increased sharply in the early years of the transition in line with the rise in the unemployment rate, but it stabilized subsequently. In Hungary, the share of expenditures on unemployment and labor market schemes in GDP was around 3 percent in 1995, comparable to what some continental EU countries spend. In Russia and the other countries of the former Soviet Union, such expenditures remain relatively small.

[156]See Hrant Bagratian and Emine Gürgen, "Payment Arrears in the Gas and Electric Power Sectors of the Russian Federation and Ukraine," Working Paper 97/162 (Washington: IMF, December 1997).

[157]See Eric Martinot, *Investments to Improve the Energy Efficiency of Existing Residential Buildings in Countries of the Former Soviet Union*, Studies of Economies in Transformation, No. 24 (Washington: World Bank, 1997).

[158]As a share of GDP, however, and reflecting the decline in the overall expenditure-to-GDP ratio in Russia and other countries of the former Soviet Union, military expenditures fell in both regions; see Sanjeev Gupta, Benedict Clements, and Edgardo Ruggiero, "Worldwide Military Expenditures Continue to Fall, but at a Slower Pace," *IMF Survey*, Vol. 26 (April 21, 1997), pp. 119–20.

[159]As discussed below, data on expenditure composition in Russia and other countries of the former Soviet Union are difficult to interpret because these countries continue to use outdated classification codes.

[160]Gilles Alfandari, Qimiao Fan, and Lev Freinkman, "Government Financial Transfers to Industrial Enterprises and Restructuring," in Simon Commander, Qimiao Fan, and Mark E. Schaffer, eds., *Enterprise Restructuring and Economic Policy in Russia* (Washington: World Bank, 1996), pp. 52–86.

Table 22. Selected Countries in Transition: Registered Unemployment

(Percent of labor force)

	1992	1994	1995	1996	First Half 1997
Albania	24.4	16.1	13.9	11.6	. . .
Armenia	3.0	6.6	6.7	9.3	10.1
Azerbaijan	0.2	0.8	1.0	1.0	1.2
Belarus	0.5	2.1	2.7	3.9	3.8
Bulgaria	15.0	13.1	11.4	12.7	14.3
Croatia	15.3	14.5	14.5	16.4	. . .
Czech Republic	3.1	3.3	3.0	3.1	4.0
Estonia	0.9	1.8	1.8	2.2	2.4
Georgia	0.3	3.8	3.4	3.2	. . .
Hungary	10.7	11.4	10.6	11.0	10.7
Kazakhstan	0.3	0.8	1.5	3.5	4.2
Kyrgyz Republic	0.1	0.4	1.9	4.4	4.0
Latvia	1.1	6.3	6.3	7.0	7.5
Lithuania	0.5	3.6	6.1	7.1	6.0
Macedonia, former Yugoslav Republic of	18.6	20.7	23.7	24.9	. . .
Moldova	0.1	0.9	1.4	1.5	1.4
Mongolia	6.3	8.7	7.6	6.5	. . .
Poland	12.9	16.5	15.2	14.3	12.3
Romania	6.2	11.0	9.9	7.8	6.7
Russia[1]	0.4	1.7	2.8	3.5	3.4
Slovak Republic	11.3	14.6	13.8	12.6	13.0
Slovenia	11.6	14.5	14.0	13.9	14.3
Tajikistan	0.4	1.5	1.8	2.5	2.5
Ukraine	0.3	0.4	0.4	1.1	2.1
Uzbekistan	0.1	0.2	0.3	0.4	0.4
Memorandum					
Russia[2]	4.7	6.9	7.8	9.0	9.6

Sources: OECD; and IMF staff estimates.

[1]Registered unemployment.

[2]Based on Goskomstat's monthly estimates according to International Labor Organization definition (that is, including all persons not having employment but actively seeking work).

Unemployment benefits are small, and registered unemployment is still, except in Armenia, relatively low (Table 22). A number of countries more advanced in transition, Poland in particular, eased pension regulations to mitigate labor market tensions in the initial phases of the transition.[161] Easy eligibility requirements for early retirement and generous benefits gave older workers a strong incentive to leave the work force permanently.

Since only a small share of the unemployed (and underemployed) were eligible for unemployment insurance, transition countries had to strengthen the social safety net in the face of the rising poverty that the dislocation associated with the transition entailed. The incidence of poverty increased on account of both a decline in the average income level and increased inequality in income distribution. Pretransition household incomes were concentrated within a small income range, reflecting income-equalizing policies. The economic decline during transition has moved the "thick" part of the income distribution down, thereby increasing the share of the population that is near or below the poverty line. However, data on poverty during the transition are subject to wide margins of error. Both inadequate income reporting and the concentration of incomes have led to considerable variability in calculated poverty rates. Moreover, the choice of a particular benchmark poverty line significantly affects the poverty headcount and the estimated poverty gap (the average shortfall of household income or expenditure relative to the poverty line) estimates. A recent World Bank study provides such estimates, based upon a relatively high poverty line that reflects the level of development in the countries in transition and the initial compression of their income distributions (Table 23).[162] The increased incidence of poverty in the countries more advanced in transition does not appear to have been associated with an increase in the poverty gap (the average shortfall of household income or expenditure relative to the poverty line), since the new poor are mostly people that have fallen just below the poverty line. At the same time, pockets of deep poverty have emerged in these countries, including among the long-term unemployed and people with irregular employment and income. Poverty has become widespread and deeper in a number of countries less advanced in transition, in the Caucasus and central Asia in particular.

Countries in transition inherited a system of cash and in-kind benefit programs—pensions, family allowances, and social transfers—that was aimed at complementing low wages and redistributing income but was not specifically designed to prevent or alleviate poverty. This system has partially cushioned the effect of the transition on households, but the uniform nature of social transfers meant that they were not targeted to the most vulnerable groups. Pensions and family allowances have helped support beneficiaries' disposable incomes during the transition but have not always become more focused on the poor. Social assistance, the pretransition scheme that was most suited for adaptation to deal with poverty issues, did not become better targeted in a number of transition countries, and therefore failed in these cases to contribute much to the mitigation of increases in poverty. In other instances, however, improvements have been made. In Hungary—where in 1993 more than 90 percent of

[161]See Alain de Crombrugghe, "Wage and Pension Pressure on the Polish Budget," Policy Research Working Paper 1793 (Washington: World Bank, June 1997).

[162]See Branko Milanovic, *Income, Inequality and Poverty During the Transition from Planned to Market Economy* (Washington: World Bank, 1998); the author provides an extensive analysis of the limitations of these estimates. Detailed poverty assessments for a number of transition countries are contained in *Poverty Reduction and the World Bank: Progress in Fiscal 1996 and 1997* (Washington: World Bank, 1997).

Table 23. Selected Countries in Transition: Estimated Poverty Headcount and Poverty Deficit, 1993–95[1]

Country	Poverty Headcount (in percent of population)	Average Shortfall (as percent of poverty line)[2]	Total Number of Poor (in millions)	Total Poverty Deficit (in percent of GDP)[3]
Belarus	22.0	26.0	2.3	1.2
Bulgaria	15.0	26.0	1.3	1.1
Czech Republic	<1.0	26.0	—	—
Estonia	37.0	37.0	0.6	4.2
Hungary	2.0	33.0	0.2	0.1
Kazakhstan	62.0	38.0	10.6	8.2
Kyrgyz Republic	86.0	67.0	3.9	57.7
Latvia	22.0	28.0	0.6	2.3
Lithuania	30.0	34.0	1.1	2.9
Moldova	66.0	43.0	2.9	7.0
Poland	14.0	27.0	5.3	0.9
Romania	39.0	28.0	8.9	2.4
Russia	44.0	38.0	66.1	3.3
Slovak Republic	<1.0	20.0	—	—
Slovenia	<1.0	33.0	—	—
Turkmenistan	57.0	39.0	2.2	6.7
Ukraine	63.0	47.0	32.7	6.9
Uzbekistan	39.0	32.0	8.3	4.4
Total	40.0	35.0	147.1	2.8

Source: Branko Milanovic, *Income, Inequality, and Poverty During the Transition from Planned to Market Economy* (Washington: World Bank, 1998).

[1]The estimates shown are subject to a number of qualifications arising partly from data deficiencies; see text and source.

[2]Based upon a poverty line of 120 purchasing power parity 1993 U.S. dollars per capita per month.

[3]Income transfers needed to bring all the poor up to the poverty level.

households received one or more transfers—starting from 1995, the cash social transfers system was modified, including the application of an income cap on family allowances and greater emphasis on social assistance.[163] In Georgia, the system of family allowances was replaced by a system of categorically targeted benefits; and in Ukraine, family allowances have been made means-tested, and targeted subsidies for communal services have been introduced.

Temporary provision of social benefits on a larger scale than will be needed following the transition has been appropriate, and has helped to alleviate the social consequences of declining real incomes and enterprise restructuring. Such spending, combined with the elimination of open-ended subsidies to state enterprises, has also speeded up the overall transformation process by stimulating labor reallocation.[164] In fact, countries less advanced in transition have avoided sharp increases in expenditures related to labor market adjustment only by delaying the enterprise restructuring process and maintaining high levels of subsidies. Countries more advanced in transition, by contrast, by introducing measures (early retirement, for instance) that had more permanent effects and created long-term entitlements, in some cases chose the wrong social spending instruments.

Institutional Arrangements for Expenditure Management

The adjustment of expenditures to the priorities of a market economy has to be supported by institutional reform. The establishment of appropriate institutional arrangements for sound expenditure management is a key component of the fiscal reform effort in transition countries. With a market-oriented legal framework guiding the budgetary decision-making process now in place in most cases, the main priority is the strengthening of budget preparation and execution procedures.[165] The governments of a number of transition countries still fail to honor payment obligations on time, including wages and pensions, or end up sequestering or

[163]For a detailed analysis of the Hungarian case, see Christiaan Grootaert, "Poverty and Social Transfers in Hungary," Policy Research Working Paper 1770 (Washington: World Bank, May 1997).

[164]See Bankim Chadha and Fabrizio Coricelli, "Fiscal Constraints and the Speed of Transition," *Journal of Development Economics,* Vol. 52 (February 1997), pp. 221–49; and Fabrizio Coricelli, "Fiscal Constraints, Reform Strategies, and the Speed of Transition: The Case of Central-Eastern Europe," CEPR Discussion Paper 1339 (London: Centre for Economic Policy Research, March 1996).

[165]For a discussion of these issues with a special focus on Russia, see World Bank, *Fiscal Management in Russia* (Washington, 1996).

cash-rationing expenditures. In Russia, where an effort was made to pay off pension and wage arrears, overdue payments to suppliers still amount to around 3 percent of GDP. In Ukraine, arrears on wages, pensions, and benefits are in the order of 4 percent of GDP. Eliminating these practices and settling outstanding arrears through cash payment and securitization should be given a high priority in these countries, and improving expenditure management can make an important contribution in this area.

Well-established practices indicate that the expenditure side of the budget preparation process should cover all government expenditures, ensure consistency of budgeted expenditures with realistic macroeconomic and revenue forecasts, and prioritize spending. In many transition countries, extrabudgetary funds still account for a large share of government expenditure—around 20 percent in Russia in 1996, for instance. Moreover, transition countries have tended to budget expenditures linked to inflation, such as wages and social transfers, on the basis of ad hoc inflation forecasts. Finally, expenditure allocation in these countries is based largely on renewal of appropriations from previous budgets, rather than on explicit prioritization. Underbudgeting and lack of expenditure prioritization have led to disorderly expenditure compression during budget execution and have delayed the adjustment of the composition of spending to the priorities of a market economy.[166]

The transition has generally led to a strengthening of the role of the legislature in the budget preparation process, because budgets have become subject to approval by parliaments. However, budget adoption procedures at the parliamentary stage in a number of countries need further strengthening. In some cases, the complexity of the rules and the large number of stages of discussion—four in the case of Russia—contribute to delays in approval. The absence of effective procedures to resolve protracted conflicts between executive and legislative branches has also resulted in delays (in Ukraine in 1997 and in Romania, this year, for instance). Other steps that could improve interaction between parliament and government during budget adoption include limiting legislative budget initiatives, and enhancing the analytical expertise of parliament.

Sound expenditure management does not end with budget preparation. The budget must also be implemented according to schedule following the approved appropriations, with transparent and efficient adjustments to new developments throughout the year. For that purpose, most countries have created a treasury system and have taken steps to centralize budgetary payments through this system. A number of countries, Russia and other countries of the former Soviet Union in particular, have not yet been able to establish a treasury function that performs all basic treasury operations satisfactorily. In other countries, treasury systems in general are still not fully effective in cash and debt management, as recurrent episodes of cash rationing and payments arrears illustrate, and they still lack the capacity to generate timely, comprehensive, and reliable fiscal data. Moreover, after budget execution, an external audit or evaluation stage is advisable; a common weakness of transition economies is the failure to develop such an audit function.

Agenda for Further Expenditure Reform

Expenditure reform in countries in transition is far from complete. In the countries less advanced in transition, the medium-term reform agenda should focus on the phasing out of remaining subsidies and on improvements in social expenditure programs. Even in the advanced transition countries, which have eliminated state support to the enterprise sector and broadly absorbed the extra social costs of the transition, further reforms are needed. These countries appear to be spending more than long-run revenue-generating capacities can sustain and more than efficiency considerations warrant. In addition, these countries still allocate expenditures in ways that are not entirely consistent with the tasks of government in a market economy, and need to improve the quality of individual spending programs.

Data on comparable market economies provide a benchmark to assess these issues; as the countries more advanced in transition aspire to EU membership, comparison with the advanced western European economies appears particularly relevant. The countries more advanced in transition in central and eastern Europe have already adopted spending programs similar to those in western Europe that involve possibly unsustainable levels of expenditure, such as current levels of government spending close to 50 percent of GDP in Hungary. The result is either government deficits that raise issues of financial sustainability, or large tax burdens that hinder efficiency and thereby reduce potential growth. Reducing the overall level of government expenditures in the medium term by improving the cost-effectiveness of major programs and projects so as to safeguard sustainability is an important policy objective for these countries.

A medium-term strategy for fiscal reform must involve assessments of the efficiency, as well as the sustainability, of overall government spending. Evidence for this can be obtained from studies that examine the efficiency of government expenditures relative to the services delivered by the government; a country is deemed to be inefficient if there are other countries that provide more output across all categories of government services but at lower levels of government expenditure. In an illustrative test covering four central

[166]See the evidence in Adrienne Cheasty and Jeffrey M. Davis, "Fiscal Transition in Countries of the Former Soviet Union: An Interim Assessment," *MOCT-MOST: Economic Policy in Transitional Economies*, Vol. 6 (No. 3, 1996), pp. 7–34.

Table 24. Selected Countries in Transition: Main Items in the General Government Expenditure Structure, 1996
(In percent of GDP)

	Czech Republic	Hungary	Poland	Slovenia	Slovak Republic
Total expenditure	43.9	49.9	47.5	44.9	48.3
Wages	4.1	. . .	9.4	. . .	. . .
Social security transfers	12.2	14.4	20.8	20.2	14.5
Subsidies	1.8	3.9	1.7	3.2	3.5
Interest expenditure	1.0	8.5	4.2	1.2	2.2
Capital expenditure	6.7	. . .	2.8	2.5	7.3
	Croatia	Estonia	Latvia	Lithuania	Mongolia
Total expenditure	47.4	40.5	37.8	34.7	39.6
Wages	11.8	17.1	8.3	8.5	13.0
Social security transfers	13.5	11.0	16.1	8.8	5.2
Subsidies	2.0	0.9	0.4	0.8	—
Interest expenditure	1.2	0.3	1.8	1.0	0.7
Capital expenditure	7.5	4.6	2.3	2.8	4.7
	Armenia	Belarus	Kazakhstan	Russia	Ukraine
Total expenditure	26.5	42.5	25.9	41.6	39.9
Wages	2.9	8.4	6.3	6.2	. . .
Social security transfers	2.3	1.7	. . .	. . .	5.1
Subsidies	0.1	3.0	3.9	7.7	4.3
Interest expenditure	2.6	0.7	0.5	5.6	1.6
Capital expenditure	4.1	1.2	1.5	4.0	1.3

Sources: IMF, *Government Finance Statistics Yearbook* (Washington, various years); national authorities; and IMF staff estimates.

and eastern European transition countries and a number of OECD countries, it was found that, for each of the transition countries, between 7 and 15 OECD countries spent less and reached better results on all of the output indicators selected.[167] These results suggest that reduction in government spending need not result in a reduction of the range, quantity, or quality of government services.

In addition to adjusting overall spending, countries more advanced in transition also need to achieve a better spending mix (Table 24). A distinctive feature of the functional composition of government spending in these countries is the high share of social expenditures, including social security and welfare (unilateral transfers) expenditures and spending on health and education. In 1996, for instance, social expenditures absorbed up to 50 percent of total noninterest spending in the Czech Republic and Slovenia.[168] The share of social security and welfare spending, in particular, exceeds what structural characteristics shared with comparator countries predict, and it reflects maintained expenditures under traditional programs and the additional outlays for new unemployment and labor market schemes. Health care and educational spending also take up a significant part of noninterest expenditures. The large share of transfers to households in expenditures as classified by economic type largely reflects social security systems, and it further illustrates the importance of these systems in central and eastern Europe. In countries such as Poland and Slovenia, the share of capital expenditures, by contrast, has fallen below what could cover medium-term investment needs, for infrastructural improvements especially.

Further reforms are still needed in key areas of social spending. Spending on social security and welfare needs to be made more cost-effective by improved design and targeting of the programs. In the health and education sectors, inefficiencies owing to overstaffing and excess physical capacity need to be addressed. However, there is no contradiction between streamlining spending on social programs and improving their quality and scope. Indeed, reducing the incidence of poverty, especially among the elderly, and improving citizen health and educational levels are important social objectives; assisting workers in adapting their skills to the needs of a market economy is critical for

[167]The output indicators used were the government services of patents, university entrants, infant mortality, life expectancy, the old-age demographic dependency ratio, and the number of telephone mainlines. See Barbara Fakin and Alain de Crombrugghe, "Fiscal Adjustments in Transition Economies: Social Transfers and the Efficiency of Public Spending—A Comparison with OECD Countries," Policy Research Working Paper 1803 (Washington: World Bank, July 1997).

[168]Interest payments account for a significant share of total government expenditures in some of the transition countries; in Hungary, for instance, they amounted to almost 30 percent of central government spending in 1996.

economic growth.[169] Moreover, the old system, while inefficient and costly, provided wide access to relatively good-quality basic education and health care, the preservation of which would be worthwhile.[170] In countries less advanced in the transition, the growth in informal sector activities, which reduces the revenue basis (payroll taxes) of social protection programs and makes targeting benefits more difficult, creates additional challenges.[171] In addition to pension reform (Box 10), strengthening the social safety net and improving the efficiency of health care and education are among the main priorities.

Social safety nets need to be redesigned to address the key challenges of poverty. While the resumption of growth and stabilization of income distribution are expected to bring back above the poverty line much of the population that is now slightly below it, some pockets of deep poverty will remain even in relatively advanced transition countries, and poverty will remain deeper and more widespread in a number of the less advanced countries. Financial and administrative constraints, however, seriously limit the policy options. The World Bank study on poverty during the transition referred to above suggests that to bring all the poor up to the poverty level, assuming perfect targeting—that is, assuming that transfers are received only by the poor and in the exact amounts needed to bring them up to the poverty line—would require income transfers of less than 1 percent of GDP in the more advanced transition countries of central and Eastern Europe, but of more than 3 percent in Russia and most other countries of the former Soviet Union. Taking into account the additional outlays needed because of imperfect targeting, most countries in transition will have to opt for schemes that can realistically aim only at alleviating poverty. The limited capability of local government to implement social transfer schemes also puts a premium on simplicity. Given these constraints, governments may choose to maintain the traditional benefit programs such as family allowances and minimum pensions, or instead to move to a single means-tested system.[172] Categorical benefits can be efficient instruments for combating poverty if there is a strong correlation between poverty and observable characteristics such as family size and age, and if substantial informal income sources make the assessment of household incomes difficult.

Countries in transition inherited health and education systems that, while providing wide access to good-quality provision, suffered from key structural problems. Decision making, administrative responsibilities, and financing were all centralized, and performance measures were generally based on inputs such as hospital space per person and the number of doctors and teachers. Moreover, the health care system was not well equipped to deal with the growing role of noncommunicable diseases, lifestyle-related health problems, or health problems related to stresses of the transition, which resulted in a marked decline in the life expectancy of men (Table 25).[173] In education, the old curriculum—narrowly specialized and focused on preparation for jobs in heavy industry and manufacturing—needed a

Table 25. Selected Countries in Transition: Life Expectancy at Birth

(In years)

Country	1990	1993	1994	1995
Azerbaijan				
Male	67.0	65.2	65.2	63.4
Female	74.8	73.9	73.9	73.5
Bulgaria				
Male	68.4	67.7	67.2	67.1
Female	75.2	75.1	74.8	74.9
Czech Republic				
Male	67.5	68.9	69.5	70.0
Female	76.0	76.6	76.6	76.9
Hungary				
Male	65.1	64.5	64.8	65.3
Female	73.7	73.8	74.2	74.5
Latvia				
Male	64.2	61.6	60.7	60.8
Female	74.6	73.8	72.9	73.1
Poland				
Male	66.5	67.4	67.5	67.6
Female	75.5	76.0	76.1	76.4
Romania				
Male	66.6	65.9	65.7	. . .
Female	73.1	73.3	73.4	. . .
Russia				
Male	63.8	58.9	57.6	58.3
Female	74.3	71.9	71.2	71.7

Source: European Bank for Reconstruction and Development, *Transition Report* (London, 1997).

[169]See Philip Gerson, "The Impact of Fiscal Policy Variables on Output Growth," Working Paper 98/1 (Washington: IMF, January 1998).

[170]A detailed assessment of the state of the social sector in countries in transition is offered in United Nations Development Program, *Human Development Under Transition: Summaries of National Human Development Reports, Europe & CIS* (New York, 1996 and 1997), and in the underlying individual country reports.

[171]Ke-young Chu and Sanjeev Gupta, "Social Protection in Transition Countries: Emerging Issues," *MOCT-MOST: Economic Policy in Transitional Economies*, Vol. 6 (No. 3, 1996), pp. 107–23.

[172]In Russia and most other countries of the former Soviet Union, practically all social transfers are still categorical. In the Kyrgyz Republic, by contrast, the government at the beginning of 1995 combined child allowances, bread compensation, and social pensions into a single means-tested cash payment.

[173]See Ellen Goldstein and others, "Trends in Health Status, Services, and Finance: The Transition in Central and Eastern Europe," Vols. 1 and 2, Technical Papers 341 and 348 (Washington: World Bank, 1996).

Box 10. Pension Reform in Countries in Transition

The reform of public pension systems is a key component of social spending reform in countries in transition. Pension systems in transition countries have come under increasing pressures as the transformation process has led to an increase in the ratio of pensioners to contributors and has reduced tax compliance. Initial attempts to cope by cutting benefits and raising payroll tax rates eroded the systems' ability to provide adequate social protection and created significant labor market distortions and incentives for activity to move to the informal sector. A broad consensus has developed about the need for pension reform, but measures taken and approaches for reform differ significantly across countries.[1]

Pension systems in the countries in transition are still based largely on the public pay-as-you-go (PAYG) defined-benefit systems inherited from the pretransition period. They are financed mainly through social security contributions from the working population, in some cases supplemented by budgetary transfers, and are administered by extrabudgetary pension funds. The contribution methods, characterized by narrow contribution bases and high contribution rates, are very distortionary. Moreover, benefit eligibility rules are broad, with special regimes for certain occupations and other groups; the statutory retirement age is typically still 60 for men and 55 for women. Benefits are based on complicated formulas and are only weakly linked to contributions. The lack of clear relation between years of contribution and pension benefits, loose eligibility criteria, and low retirement ages add to the distortionary nature of the current pension systems.

System dependency ratios—defined as the ratio of pensioners to working population—were already high at the beginning of the transition, and they increased further (*see table* on public pension systems) as employment fell, as the incidence of early retirement increased, and, in a few countries, as populations aged.[2] In some central and eastern European countries (Poland, for instance), governments intentionally used early retirement and disability pensions as a safety net to prevent a sharp increase in unemployment, adding to the financial pressures. At the same time, financial weaknesses in the enterprise sector, a rise in private and informal sector activities, and an inefficient collection system resulted in a decline in contributions. Payroll tax compliance declined, and, in countries such as Azerbaijan, Georgia, the Kyrgyz Republic, and Moldova, by 1996 the effective pension contribution rate had fallen below half the statutory rate. In a number of countries, arrears in the collection of contributions, including from budgetary organizations, emerged.

Public Pension Systems in Countries in Transition

(In percent)

	System Dependency Ratio[1]			Average Replacement Rate[2]		
	1990	1993	1996	1990	1993	1996
Eastern European countries						
Bulgaria	55.0	80.0	74.4	42.8	40.2	31.4
Croatia	31.0	43.0	54.3	73.0	62.0	35.4
Czech Republic[3]	42.0	51.0	61.0	47.6	43.4	47.8
Hungary	47.0	66.0	76.9	49.7	47.3	41.4
Poland	40.0	53.0	61.3	59.0	76.8	61.3
Romania[3]	34.0	49.0	52.3	41.9	26.0	29.7
Slovak Republic	39.0	53.0	46.1	48.3	44.0	42.0
Baltics, Russia, and other countries of the former Soviet Union						
Armenia	33.8	43.7	44.1	44.6	30.7	24.3
Azerbaijan	38.8	42.9	41.6	42.3	21.2	29.2
Belarus	46.1	54.0	71.0	40.1	38.0	40.9
Estonia	45.3	47.9	55.9	. . .	. . .	29.4
Georgia	34.6	37.3	54.9	. . .	. . .	36.4
Kazakhstan	31.9	43.7	57.1	38.5	39.3	34.0
Kyrgyz Republic	34.6	38.0	34.0	44.8	38.4	48.5
Latvia	42.7	53.1	54.9	31.2	33.3	38.6
Lithuania	47.4	50.2	53.8	36.3	28.4	30.8
Moldova	34.6	46.9	50.2	38.6	32.1	40.1
Russia	44.9	52.4	57.0	38.0	24.5	28.4
Tajikistan	27.3	32.9	27.0	47.8	45.9	23.7
Turkmenistan	25.4	28.0	25.3	41.1	47.5	53.3
Ukraine	51.4	60.5	65.3	41.6	26.9	32.7
Uzbekistan	29.9	33.1	29.2	45.1	29.9	40.9
Major advanced economies[4]	**. . .**	**39.2**	**. . .**	**. . .**	**. . .**	**37.5**

Sources: Andrews and Rashid, "The Financing of Pension Systems in Central and Eastern Europe"; Castello Branco, "Pension Reform in the Baltics, Russia, and Other Countries of the Former Soviet Union"; The Vienna Institute for Comparative Economic Studies; and IMF staff estimates.

[1]Pensioners as a percent of the number of people employed.

[2]The average pension in terms of the average wage.

[3]The system dependency ratios for the Czech Republic and Romania reflect data for 1995.

[4]Major advanced economies include the United States, Japan, Germany, France, Italy, the United Kingdom, and Canada; for the system dependency ratio, unweighted average of selected OECD countries.

[1]This box summarizes findings in Marta de Castello Branco, "Pension Reform in the Baltics, Russia, and Other Countries of the Former Soviet Union," Working Paper 98/11 (Washington: IMF, January 1998). An analysis of financial pressures on pension systems in the early years of the transition, with a focus on central and eastern Europe, is offered in Emily S. Andrews and Mansoora Rashid, "The Financing of Pension Systems in Central and Eastern Europe: An Overview of Major Trends and Their Determinants," World Bank, Technical Paper 339 (Washington, October 1996).

[2]Ideally, the system dependency ratio should be measured as the ratio of pensioners to contributors, but this is not always possible owing to the lack of data. If so measured, the ratios in the first table would be even higher.

With the declining number of contributors and weakening tax compliance putting downward pressure on revenues, most countries initially responded by reducing the generosity of benefits or by raising the contribution rate.[3] Average replacement rates—defined as the average pension in terms of the average wage—fell by more than 10 percentage points in Albania, Croatia, and Romania during 1991–93, and benefit levels were also compressed in Russia and a number of other countries of the former Soviet Union in the early years of the transition.[4] In the latter group of countries, in some cases the benefit structure has been flattened, and the average pension reduced to a little above the poverty line, eroding the income protecting functions of the pension systems and turning them into essentially category-based social safety nets. Following significant increases, payroll tax rates are now in general in excess of 30 percent, and they were as high as 52 percent in Ukraine in 1996. Reflecting differences in old-age dependency ratios, income levels, initial systems, and policy responses, substantial variations across countries emerged in the ratio of public pension payments to GDP. In 1996, this ratio was around 10 percent in Hungary and Latvia and as high as 14 percent in Poland, but only 4½ percent in Russia and even less in the Caucasian and central Asian countries, compared with an average of around 15 percent in the western European economies (*see table* on public pension expenditure).

Reduced benefits, higher contribution rates, and, in a few cases, substantial budget transfers notwithstanding, pension funds began to run deficits across the region. In Russia and other countries of the former Soviet Union, these were reflected in an accumulation of pension arrears—of up to 3 percent of GDP in Moldova in 1996, for instance. The typical short-run responses to financial pressures in the form of benefit compression and higher contribution rates have clearly not restored the financial viability of the system. Moreover, the transition countries, except Albania and some countries in the Caucasus and central Asia, face the prospect of aging populations, with people aged over 60 expected to exceed 25 percent of the population in the Baltics, Bulgaria, Hungary, Russia, and Ukraine by 2030. While population aging has not yet had major budgetary implications it will add further strains to the financial positions of pension systems.

In response to these continuing financial pressures, most central and eastern European countries, the Baltics, Russia, and a number of other countries of the former Soviet Union have implemented piecemeal reform measures, which aim to restore the viability of the existing PAYG systems without altering their basic structure. This approach involves measures to change eligibility criteria and the composition of benefits on the one hand, and to improve collection and tax compliance on the other. Measures include increasing the statutory retirement age

Countries in Transition: Public Pension Expenditure, 1993 and 1996

(In percent of GDP)

	1993	1996
Eastern European countries		
Albania	6.5	6.8
Bulgaria	14.1	9.5
Croatia	6.2	10.2
Czech Republic	7.3	8.4
Hungary	10.6	9.7
Macedonia, former Yugoslav Republic of	15.6	11.2
Poland	13.4	14.4
Romania	6.2	5.8
Slovak Republic	9.4	8.3
Baltics, Russia, and other countries of the former Soviet Union		
Armenia	2.5	3.1
Azerbaijan	6.7	2.5
Belarus	7.6	8.4
Estonia	6.4	7.6
Georgia	. . .	1.7
Kazakhstan	4.4	5.3
Kyrgyz Republic	. . .	7.7
Latvia	9.5	10.8
Lithuania	4.8	6.2
Moldova	. . .	8.1
Russia	6.1	4.5
Tajikistan	6.9	3.0
Turkmenistan	2.3	. . .
Ukraine	8.3	8.7
Uzbekistan	10.0	6.4
Memorandum		
France	14.4	. . .
Germany	14.3	. . .
Italy	17.1	. . .
Spain	11.2	. . .
United States	. . .	4.6

Sources: Andrews and Rashid, "The Financing of Pension Systems in Central and Eastern Europe"; Castello Branco, "Pension Reform in the Baltics, Russia, and Other Countries of the Former Soviet Union"; Eurostat; and IMF staff estimates.

[3]In a number of countries, including in the former Yugoslav Republic of Macedonia during 1992–93 and in Poland during 1991–92, the average replacement rate rose, compounding the financing problems of the pension system. Whereas in the former Yugoslav Republic of Macedonia the increase in the replacement rate reflected the indexation rules and the widespread use of early retirement options by relatively well-paid workers, in Poland it was more the result of new policy measures.

[4]The reduction in replacement rates in these countries was mainly the result of high inflation combined with ad hoc and imperfect indexation of benefits. Inflation adjustments of pensions generally aimed to protect the real value of the basic pension; pension supplements fared less well with inflation, leading to compression in the distribution of pensions.

Box 10 ***(concluded)***

or introducing actuarial provisions in the calculation of pension benefits to reduce the incentives for early retirement; reducing or even eliminating benefits for working pensioners and the eligibility for privileged early retirement; reforming the contribution base; and improving compliance.

A few countries, however, have gone beyond piecemeal reform with steps to replace the current PAYG public pension systems by so-called multipillar systems, as promoted by the World Bank.[5] A scaled-down version of the PAYG system is maintained as the first pillar; its focus is on redistribution and the provision of a social safety net for the old. The second pillar is a compulsory, privately managed, fully funded scheme aimed at fostering saving for retirement. The third pillar consists of voluntary private schemes intended for those who wish to save more for retirement than is provided for by the compulsory schemes. Although a number of countries are considering systemic pension reform and are in some cases preparing the introduction of private pension funds, only Hungary, Kazakhstan, Latvia, and Poland have thus far taken concrete steps to shift to a multipillar system.[6]

The Kazakh reform plan, which became operational in January 1998, envisages a transition toward a new system, based on the Chilean model, in which the first pillar will play a minimal role; all current and new workers will immediately participate in the funded system of individual accounts. In Hungary, Latvia, and Poland, the first pillar retains a more important role and continues to provide benefits partially linked to contributions. These three countries are also taking a more gradual approach toward introducing the privately managed pillars and, in Hungary and Poland, offer those currently in the workforce and within a certain age range the option to continue participation under the old system.[7] The legislative work for the pension reform is complete in Hungary, and the new pension system is being introduced; in Poland, some laws regulating the private pillars still need to be approved, and the reforms are scheduled to take effect at the beginning of 1999.

Under any reform approach, a number of piecemeal reform measures are needed to address the contribution and compliance problems of the existing PAYG schemes as well as the longer-term threats to their financial sustainability arising from population aging. In a number of transition countries, the immediate priority is ensuring that the public PAYG schemes fulfil the basic safety net functions of the first pillar. Longer-term viability is a common concern for all transition countries. Reform measures include introducing rules or incentives to raise the effective retirement age; tightening eligibility criteria for early retirement and disability; and eliminating tax exemptions and extending the payroll tax to nonwage compensation. The specific mix of measures will depend on the conditions in individual countries. For instance, in the central and eastern European countries where early retirement and disability pensions were used to prevent a sharp increase in unemployment at the outset of the transition, a gradual easing of the unemployment pressures will at the same time increase the number of contributors and reduce the incentives to have generous eligibility criteria and benefits.

In most countries, and especially in the countries with aging populations, even following reforms, the public PAYG systems alone may not be in a position to provide adequate benefits in the future. Countries are therefore likely to consider building a second, private pension pillar to supplement the public system, the first pillar. As they embark on such systemic reform, the key issues are the relative sizes and functions of the public and private pillars; and the speed of transition to the new system. Systems with an emphasis on the private pillar, as in Kazakhstan, offer less scope for redistribution and require a sound financial system. Important factors in deciding the speed of transition are the prospects for restoring the financial balances of the public PAYG systems and the fiscal costs of financing the transition from a PAYG to a funded scheme. Fiscal costs, which as such lead to an increase in the fiscal deficit as conventionally measured, arise as governments continue to provide benefits to existing and future pensioners but have to give up (partially or totally) the payroll taxes that support these benefits.[8] The choices depend on the specific circumstances of each country, including the stage of progress with overall reform, financial sector reform in particular. Countries must have at least fairly established financial markets before a private pillar can be put in place, and considerable regulation and supervision to avoid fraud and excessive risk taking are needed. Countries more advanced in transition have already made considerable progress toward establishing the preconditions for the private provision of pensions, and in some case may move toward having the private sector provide a relatively large share of pensions in the medium term. In countries less advanced in transition, a priority is to intensify efforts to develop the legal and financial market environment necessary for the future introduction of privately managed pension funds.

[5]For a discussion, see Richard Hemming, "Should Public Pensions Be Funded," Working Paper 98/35 (Washington: IMF, March 1998).

[6]Countries that are preparing comprehensive programs, and in some cases already have established private pension funds, include Azerbaijan, Croatia, the Czech Republic, Estonia, the former Yugoslav Republic of Macedonia, Georgia, Lithuania, Romania, Russia, and Slovenia.

[7]The decision about voluntary versus mandatory switching has not yet been made in Latvia.

[8]An increase in the budget deficit associated with this transitory cost, however, does not in principle imply a relaxation of the fiscal stance.

complete overhaul.[174] While progress has been made toward putting the organization and financing of health and education on a better footing, little has been achieved in terms of greater efficiency of resource allocation and usage. As a result, government spending on health and education remains high.

Most countries have taken steps toward organizational and financial reform in the public health and education sectors. The role of the central government administration has been reduced and redefined, and local authorities have assumed more responsibilities. On the financing side, governments are adopting a range of alternative funding strategies, including the transfer of assets, provision to the private sector, or both. In the area of health care financing more specifically, countries have moved toward a mixed system of financing that is based on public health insurance funded largely through a combination of payroll taxes and transfers from general revenues. In Russia, for instance, employers make income-based contributions to health insurance funds for their employees, while local governments make contributions to these funds for the nonworking population. The public health costs of the state and municipal health systems continue to be financed directly from the budget levels of the government. Financing reforms have made it possible to maintain or even increase spending on health and education as a percentage of total noninterest expenditures.[175] In Russia, for example, total spending on health in real terms has returned to pretransition levels following adoption of new financing mechanisms.

Organizational and financial changes, however, have not necessarily brought about significant efficiency gains. In most countries, resources are still not used effectively, and problems of overstaffing, partly owing to government attempts to safeguard employment, and excess infrastructural capacity persist.[176] In almost all transition countries, the shares of public health and education—the two sectors that typically account for the largest share of government employment—in total employment has increased during the transition (Table 26), even while expenditure on wages, supplies and materials, and maintenance and capital programs fell in real terms. Steps to address overemployment and inefficiency problems, while strengthening quality by avoiding relative wage erosion vis-à-vis the private sector, deserve high priority.

[174]Most transition countries by now have implemented major curriculum reforms in response to increased student demand for training in market-oriented skills and for higher and general secondary education.

[175]The share of education in total noninterest expenditures in Bulgaria rose from 8.2 percent in 1990 to 10.6 percent in 1996; in Estonia, from 12.8 percent in 1991 to 16.9 percent in 1996; and in Russia, from 8.2 percent in 1992 to 12.8 percent in 1996.

[176]Mark A. Horton, "Health and Education Expenditures in Russia, the Baltic States, and the Other Countries of the Former Soviet Union," Working Paper 96/126 (Washington: IMF, November 1996).

Table 26. Selected Countries in Transition: Shares of Education and Health in Total Employment
(In percent)

	1990	1993	1994	1995	1996
Belarus					
Education	9.9	10.2	10.5	11.1	11.5
Health	5.2	5.8	6.1	6.5	6.9
Czech Republic					
Education	5.9	6.7	6.6	6.4	6.4
Health	5.2	5.4	5.3	5.2	5.3
Kazakhstan					
Education	11.4	12.1	12.0	11.9	10.4
Health	5.8	6.2	6.5	6.4	5.9
Latvia					
Education	7.2	7.6	7.6	8.7	8.8
Health	4.8	6.4	6.1	6.2	6.1
Romania					
Education	3.8	4.3	4.4	4.6	. . .
Health	3.0	3.1	3.3	3.5	. . .
Russia					
Education	9.6	10.2	10.8	11.0	11.2
Health	5.6	6.0	6.4	6.7	7.0
Ukraine					
Education	9.3	9.6	9.9	9.5	9.2
Health	5.9	6.4	6.5	6.4	6.4

Sources: National authorities; and IMF staff estimates.

Intergovernmental Fiscal Relations

In the unified government structure under central planning, subnational governments were mere administrative branches of central government. Countries in transition have generally moved toward decentralization. In most cases, a two-tier structure has been introduced, with a central government and a large number of relatively small local governments, a structure also found in many western European countries of a nonfederal nature. In some countries, three tiers are emerging. In Poland, for instance, the government is planning to create a new middle tier of government, based on about 320 governmental units and loosely modeled on the concept of U.S. counties. Decentralization has to be accompanied by appropriately designed systems of intergovernmental fiscal relations.[177] In some countries, Georgia and Ukraine for instance, local governments still act mainly as spending agents of the central government with limited autonomy, and they are predomi-

[177]For an overview, see Richard M. Bird, Caroline L. Freund, and Christine I. Wallich, "Decentralizing Fiscal Systems in Transition Economies," *Finance and Development*, Vol. 32 (September 1995), pp. 31–34.

nantly financed directly from the central government under a system of so-called administrative decentralization. In most transition countries, however, local governments have been given the power to spend and to raise taxes autonomously within legally defined criteria. Russia, in fact, is taking on the character of a fiscal federation, with its regional authorities having extensive fiscal autonomy. The share of subnational spending in total government spending, on average about 30 percent among the transition countries, ranges from 15 percent in Croatia to almost 50 percent in Russia.

Efficiency gains from decentralization depend on a clear, consistent, and stable assignment of expenditures to each level of government.[178] A principle that has become widely accepted, and that is established in the Maastricht Treaty of the EU, is that of subsidiarity, which broadly states the presumption that government functions should be performed at the most decentralized level consistent with efficient performance. In practice, however, in the transition countries, the transfer of expenditure authority to subnational governments has often proceeded by trial and error. In some cases, services that may be presumed to benefit the entire country and to be most appropriately provided by the central government have been transferred to subnational governments—social safety net spending in Russia and Ukraine, for instance—while the provision of some local public services also sometimes remains the responsibility of central government agencies.

Subnational governments require revenue sources to finance their expenditures, whether transfers, shares of general tax revenues, or own tax streams. In the transition countries, central governments have tended to limit the own and shared tax resources of subnational governments and to withhold the right, when local taxes are raised, either to set the tax rate or to define the tax base. The taxes specifically assigned to subnational governments are, in addition to property taxes, a number of minor "nuisance" taxes; these raise only a small proportion of the total revenue of local governments—around 9 percent in Estonia and 6 percent in Hungary, for instance.[179] Own local tax revenue is complemented by shared taxes, often the personal income tax. While tax sharing could offer the advantage of simplicity and, if shares are transparent and fixed, guarantee subnational governments some degree of revenue certainty, in many cases tax shares change from year to year, varying among regions, and are negotiated by each locality with the center.

Since subnational governments' own and shared tax revenues rarely permit them to meet their expenditure needs, transfers from the central government are needed to narrow the gap, which can be as large, in the case of Hungary, as almost two-thirds of the recurrent expenditures of the local governments. A well-designed transfer system would enable the central government to set standards in the provision of basic public services and thereby achieve a high degree of equity. In most transition economies, however—the Czech Republic, Slovak Republic, and Poland are among the exceptions—fiscal flows among the various levels of government remain discretionary and negotiated, with transfers largely unconditional and determined ad hoc by the central government, often changing with each annual budget.

Combined tax revenues of and transfers to subnational governments have often been insufficient to cover assigned expenditures, reflecting attempts by the central government to shift the burden of fiscal adjustment to lower levels. In many cases, the financial positions of local governments have worsened, sometimes leading to expenditure arrears or the withholding of contributions to the federal budget. Local and regional governments in a number of countries have also been borrowing from domestic financial institutions and issuing Eurobonds in international financial markets.[180] Issuers of Eurobonds include the cities of Prague in 1994 and Tallinn in 1996, and several Russian cities and subnational authorities in 1997;[181] more than 20 other cities and authorities in Russia are reported to have expressed interest in issuing Eurobonds. With fiscal discipline at the subnational level often weak, there is a significant risk that the public sector will borrow for inappropriate reasons—to prop up uncompetitive local enterprises or to continue with unsustainable expenditures, for example. In cases of external borrowing, the potential effects of a default by local governments could force the central government to consider a bailout, even in the absence of a guarantee. Even with domestic borrowing, the sum of borrowing by various subnational authorities and the central government may compromise macroeconomic stability. There is therefore a strong case for regulation and strong institutional safeguards, for external borrowing in particular. In countries with more unitary government, administrative controls that either prevent subnational authorities from borrowing or allow them to borrow only for investment purposes following approval may be appropriate. In countries of a more federal nature, a

[178]For an overview of the principles that should guide expenditure and revenue assignment, see Teresa Ter-Minassian, ed., *Fiscal Federalism in Theory and Practice* (Washington: IMF, 1997).

[179]The property tax is the only significant tax that tax reforms have specifically assigned to subnational governments. Much needs to be done, however, if the property tax is to fulfill its potential in the transition economies. Much of the housing stock remains publicly or communally owned, and housing markets that would allow a proper valuation are only beginning to emerge.

[180]In other transition countries—Armenia and Kazakhstan, for example—borrowing by subnational governments is not allowed.

[181]Prague was, however, not given permission by the Czech Ministry of Finance to issue Eurobonds in 1996–97.

rules-based approach for domestic borrowing may be considered.

The creation of intergovernmental finance systems in the transition economies offers potential economic benefits. But weaknesses in the design of existing systems, including an overdependence on transfers and a lack of transparency, represent risks to financial stability, regional equity, and the provision of essential services. Reforms should include increasing subnational governments' own revenue sources, introducing clear and stable assignments of expenditures, and tax-sharing and transfer arrangements, and, throughout the entire process, ensuring that the system provides adequate funding for key government functions such as health, education, and social welfare.

Legal Reform, Transparency, and Accountability

Institutional reform in the fiscal area goes beyond establishing the appropriate institutional arrangements for debt management, tax administration, expenditure management, and intergovernmental fiscal relations. In particular, there is a widespread need to put in place and implement legal frameworks that cover the financial operations of government at all levels to ensure that the rule of law applies to every government financial transaction.

The new institutional arrangements and the overall legal framework will be ineffective if they are not characterized by accountability and transparency at all stages (see also Annex I). To improve accountability, internal and external ex post audits and budget evaluation need to be developed. More transparency requires governments to move away from a tradition of secrecy and to replace data systems oriented to central planning. Fiscal statistics in a number of transition countries are still inadequate in major respects, since they continue to refer to reporting procedures and classification codes from the era of central planning. The most serious shortcoming is the incomplete coverage of fiscal reporting that documents the execution of the budget: it often excludes significant portions of government activity and does not properly cover financing flows and outstanding domestic and foreign debt. Another important problem is that classification codes do not accurately distinguish the different economic characteristics of transactions.[182] Fiscal reporting also suffers from other weaknesses that are related to the use of cash-based recording and incomplete coverage of arrears and noncash transactions, the recording of privatization transactions, and quasi-fiscal operations. Extra-budgetary funds present a particular challenge to clarity in fiscal accounts: these remain quite large, but data on these funds remain incomplete. Public finance statistics in the countries more advanced in transition now appear to be of reasonable quality, frequency, and reliability. A majority of them—Croatia, Hungary, Latvia, Lithuania, Poland, and Slovenia—have subscribed to the IMF's Special Data Dissemination Standard (SDDS), and their fiscal data, in general, meet its specifications for data coverage, periodicity, and timeliness.

A coherent and comprehensive legal framework need not restrict the conduct of fiscal policy. Countries can, however, adopt fiscal policy rules, such as for the budget deficit or debt, requiring not to exceed a numerical ceiling or to meet a target. In the Czech and Slovak Republics, for instance, central bank credit is limited to a proportion of government revenue in preceding years. In a number of countries, restrictions have been imposed on borrowing by subnational governments: for instance, in Estonia and (following approval of new legislation) in Russia, local governments face ceilings on both the stock of debt and on new borrowing. While transition countries may benefit from borrowing rules, such as restrictions on government access to central bank financing or on overall domestic government borrowing, by subnational governments in particular, they appear to lack both the long track record of fiscal discipline and the stability of expenditure and revenue patterns that would make the adoption of broader fiscal rules most effective.

Steps to improve the management of public resources through institutional and legal reform can be seen as part of a broader range of efforts to promote good governance.[183] For instance, tax administration reform can reduce tax fraud and eliminate ad hoc decision making and preferential treatment, while audits of government accounts and the publication of financial information about the government can deter the misuse of government resources. While progress toward improving governance has been made, much remains to be done, especially in the countries less advanced in transition. In the absence of a more systematic assessment of the quality of public institutions and services, surveys of businessmen and regional analysts have been used to derive subjective indicators of such progress. These surveys indicate that countries less advanced in transition are still perceived as having relatively unfair taxes, onerous regulations, and poor provision of public goods and services.[184] Further analy-

[182]Marie Montanjees, "Government Finance Statistics in the Countries of the Former Soviet Union: Compilation and Methodological Issues," Working Paper 95/2 (Washington: IMF, January 1995).

[183]Another important economic dimension of good governance involves the development and maintenance of a transparent and stable regulatory environment. By liberalizing prices, eliminating trade restrictions of various kinds, and privatizing state enterprises, countries in transition have made progress toward reducing discretionary government interference in the economy and the associated scope for rent seeking.

[184]See, for instance, European Bank for Reconstruction and Development, *Transition Report 1997* (London, 1997); and Boris Shor, "Nations in Transit, 1997: Freedom House Rankings," *Transition,* Vol. 8 (June 1997), pp. 4–6.

sis on the basis of these indicators suggests that governance problems result in slower economic growth, less foreign direct investment, and a higher share of informal and untaxed activity.[185]

* * *

Fiscal policy contributed greatly to the initial macroeconomic stabilization in the transition countries. While in a number of transition countries, including Russia and some other countries of the former Soviet Union, further efforts are still needed to eliminate excessive deficits that put the achievements of stabilization at risk, the focus of fiscal policy in countries in transition is now shifting toward safeguarding the sustainability of fiscal programs and improving the performance and quality of public services; such second-generation reforms are crucial for enhancing efficiency and thus providing for productivity gains that lead to increased output and improved quality of life. Sustainability and improvement in the quality of public services, however, cannot be achieved unless governments secure stable and adequate revenues; persistent tax collection and administration problems in countries less advanced in the transition therefore need immediate and forceful policy response. In countries more advanced in transition, reforms to improve the cost-effectiveness of the social security and welfare systems and thereby downsize the overall level of government spending have a high place on the agenda. Major restructuring of the public health and educational sectors should be given equal prominence for all the countries in transition, as should improving transparency and accountability of government activities and promoting good governance.

[185]See Aymo Brunetti, Gregory Kisunko, and Beatrice Weder, "Institutions in Transition: Reliability of Rules and Economic Performance in Former Socialist Countries," Policy Research Working Paper 1809 (Washington: World Bank, August 1997); and Simon Johnson, Daniel Kaufman, and Andrei Shleifer, "The Unofficial Economy in Transition," *Brookings Papers on Economic Activity*: *2* (1997), pp. 159–239.