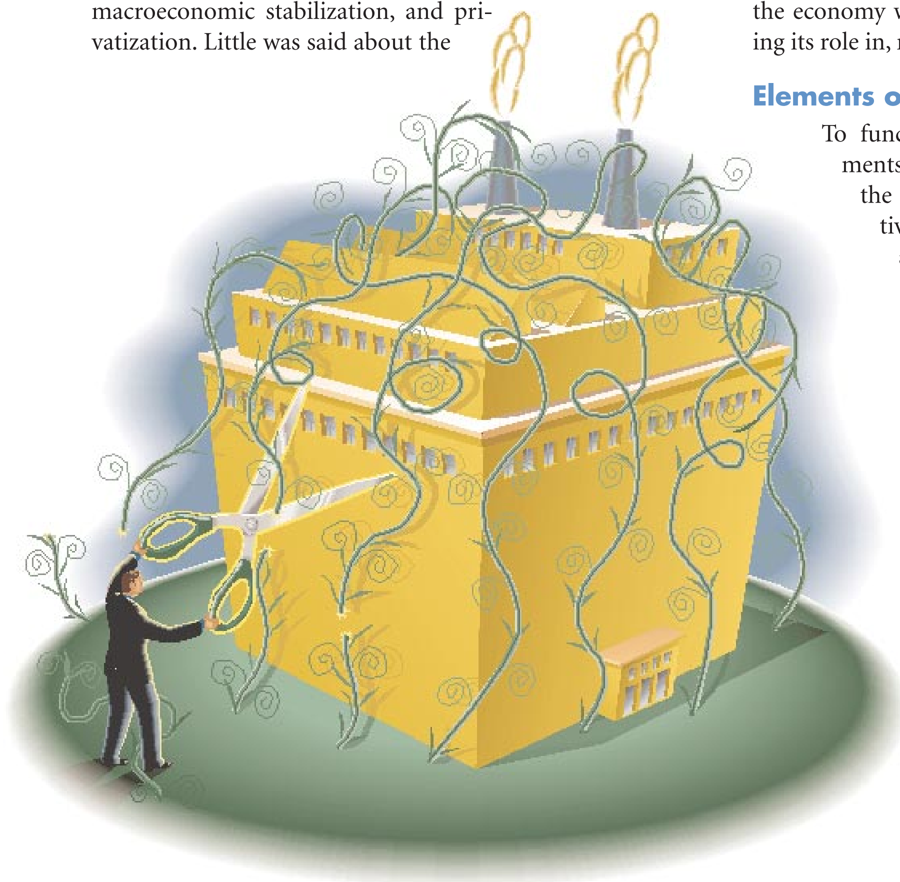
Transition and the Changing Role of Government

Over the past decade, many centrally planned economies have set out to transform themselves into market economies. To be successful, they need to develop the necessary institutions and ensure a proper role for government.

Vito Tanzi

WHILE much has been written about the economic changes that must take place for centrally planned countries to become market economies, less has been written about how the economic role of the state must change. In "shock therapy," advocated by some economists at the start of the transition, the main ingredients for success were assumed to be price liberalization, macroeconomic stabilization, and privatization. Little was said about the role of the government in the new environment. A complete transformation of the economy, the institutions, and economic processes requires, in addition, that

- profitability be the guiding criterion for most investment decisions;
- activities deemed socially desirable be financed by the government; and
- the government effectively perform its core functions in the economy while withdrawing from, or drastically reducing its role in, many secondary activities.



Elements of a market economy

To function well, market economies need governments that can establish and enforce the "rules of the game," promote widely shared social objectives, raise revenues to finance public sector activities, spend the revenues productively, enforce contracts and protect property, and produce public goods. They also need a pared-down set of regulations that are clear and leave little margin for interpretation or discretion. While the guiding principle under central planning was that nothing was permitted unless explicitly authorized, the guiding principle in a market economy should be that everything is permitted unless expressly forbidden.

The transformation to a market economy is not complete until functioning fiscal institutions and reasonable and affordable expenditure programs, including basic social safety nets for the unemployed, the sick, and the elderly, are in place. Spending programs must be financed from public revenues generated—through taxation—without imposing excessive burdens on the private

Progress in transition, 1998

	Private sector share of GDP (percent, mid-1998) [1]	Enterprises [2]		Markets and trade [2]	Financial institutions [2]
		Large-scale privatization	Small-scale privatization	Price liberalization	Banking reform and interest rate liberalization
Albania	75	2	4	3	2
Armenia	60	3	3	3	2+
Azerbaijan	45	2	3	3	2
Belarus	20	1	2	2	1
Bulgaria	50	3	3	3	3–
Croatia	55	3	4+	3	3–
Czech Republic	75	4	4+	3	3
Estonia	70	4	4+	3	3+
Georgia	60	3+	4	3	2+
Hungary	80	4	4+	3+	4
Kazakhstan	55	3	4	3	2+
Kyrgyz Republic	60	3	4	3	3–
Latvia	60	3	4	3	3–
Lithuania	70	3	4	3	3
Moldova	45	3	3+	3	2+
Poland	65	3+	4+	3+	3+
Romania	60	3–	3+	3	2+
Russian Federation	70	3+	4	3–	2
Slovak Republic	75	4	4+	3	3–
Tajikistan	30	2	2+	3	1
Turkmenistan	25	2–	2	2	1
Ukraine	55	2+	3+	3	2
Uzbekistan	45	3–	3	2	2–

Source: European Bank for Reconstruction and Development, *Transition Report, 1998*, Table 2.1.

[1] Private sector shares of GDP represent rough EBRD estimates, based on available statistics from both official (government) and unofficial sources. The underlying concept of private sector value added includes income generated by the activity of private registered companies, as well as by private entities engaged in informal activity, in those cases where reliable information on informal activity is available.

[2] The numerical indicators range from 1 to 4, with 1 representing the least progress. They are intended to represent cumulative progress in the movement from a centrally planned economy to a market economy in each dimension, rather than the rate of change in the course of the year.

sector. Because the level of taxation of a country depends on, among other criteria, the extent of its economic development and the sophistication of its tax systems and administration, these constraints must be considered in discussions of public spending.

Finally, because the optimal role for government derives not just from economic considerations but also from the interplay of political and economic forces, the views of the executive branch of government should broadly match those of the legislative branch. If the two sides are miles apart on what the government should do, as they have been in Russia and some other countries, neither an optimal government role nor rational policies are likely to emerge.

Institutions in a market economy

To perform their tasks, governments in market economies need some well-developed institutions run by competent individuals and guided by appropriate incentives. The objectives of the managers must not diverge from those of the institutions, which must in turn be consistent with the public interest. Such institutions do not materialize magically. They need to be created and continually reformed. In industrial countries, it took centuries for these institutions to evolve.

When the necessary public institutions do not exist or, if they do exist, when the incentives for their managers are perverse, the government can easily become an impediment to economic activity because it ends up being used by individuals for their own ends. This is what normally happens in a corrupt system, where parts of the government apparatus are privatized for the gains of individuals or special interest groups. In such a system, the achievement of social objectives is difficult and some of the government's actions may appear predatory, such as when state employees extract bribes from citizens who need permits or authorizations.

Pre-transition environment

At the beginning of the transition, the share of GDP derived from private sector activities was small in all transition countries. It ranged from less than 1 percent in the former Czechoslovakia and Russia to almost 20 percent in Poland, compared with about 80 percent in the United States. Economic production occurred overwhelmingly in the public sector because few productive assets could be privately owned and few private activities were allowed. Prices and genuine economic profits did not play much of a role in resource allocation because the use of resources was determined by political decisions made within the planning office.

The transition countries did not need market-type tax systems to raise public revenues because the government decided how to use total output and could simply appropriate production for its own needs. Taxes were mostly transfers from some activities to others. The primary function of tax

administrators was to ensure that funds were transferred to the government books and accounted for. There was no budget office, no budget law, and no treasury.

Tax revenues were obtained from three major sources—turnover taxes, taxes on enterprises, and payroll taxes—which generated large revenues (at times up to 50 percent of GDP). Under this system, most taxes were hidden, so that individuals were largely unaware that, indirectly, they were paying high taxes. Taxes were collected on the basis of negotiations with government officials. The government was free to change the rates and changed them often; when it needed extra revenue, it negotiated to raise more taxes. An enterprise in difficulty might negotiate to lower its taxes.

Particular characteristics of central planning made tax collection relatively simple: (1) the authorities' knowledge—available from the plan—of quantities of goods produced and of the prices at which they would be sold; (2) the role of the central bank in processing payments and imposing restrictions on how payments were to be settled; and (3) the concentration of economic activities in a few large enterprises. Well-defined or fixed rules of law that individuals or enterprises could appeal to when they disagreed with the actions of the government did not exist.

Progress in general reforms

How much progress have the former socialist countries made in transforming their economies? Evaluating them on the basis of the shock-therapy approach gives the impression that progress has been considerable. In general, the Eastern European and Baltic countries have progressed rapidly, while the other countries have been less successful in establishing fiscal institutions, controlling fiscal imbalances, and redefining the role of the state. But even within these groups, the differences are significant (see table). In some countries, one senses that the old system is largely gone but that nothing has taken its place, leaving an institutional vacuum.

Privatization. The private sector share in GDP, almost insignificant 10 years ago, has risen dramatically in many transition countries, reaching 70 percent or more in Albania, the Czech Republic, Estonia, Hungary, Lithuania, Russia, and the Slovak Republic. Only in Belarus, Tajikistan, and Turkmenistan does it remain at 30 percent or lower. While impressive, these percentages reflect privatization of ownership but not necessarily of management. In many countries, either the prereform managers are still running the enterprises or the new managers behave as if the enterprises were still owned by the state.

One intriguing aspect of the privatization experience in these countries is that, as state ownership has declined, the rise in fiscal proceeds from privatization has not been commensurate. Although the state owned almost everything before the transition, the revenues it collected from the sale of its assets were minuscule. In Russia, for example, assets valued at $50–60 billion were reportedly bought for $1.5 billion.

There are several reasons for the low revenues. Privatization was tantamount to a fire sale to which only a privileged few were invited, and they used their positions or connections to amass enormous wealth. Thus, although constituting a fundamental step toward a market economy, privatization became an obstacle to the protection of private property—another prerequisite of a market economy.

Nomenklatura privatization—the purchase of state enterprises by former high officials of the communist party—and other similar developments, such as the purchase at low prices of valuable assets of state enterprises, have contributed to the dramatic changes in the distribution of income in these countries. Before the transition, they had some of the most even income distributions in the world, a source of pride for their leaders. Within a few years, however, some of the richest men and women in the world—some of whom also acquired substantial political power—were living a life of conspicuous consumption. More worrisome is the increase in inequality that has occurred, not because individuals who rose higher on the income scale created wealth but because they raided the government's wealth.

It is easy to guess the reaction of these countries' populations to the economic changes that created these new circumstances and to understand why the market economy, which is identified with these changes, is blamed. Many of the measures necessary to make a market economy vibrant and efficient will be seen as protecting the ill-gotten wealth of the new upper class and will encounter difficulty in the political process. It should not be surprising if privatization is not universally accepted as a sign of progress.

Price liberalization. The transition countries as a group have gone far toward liberalizing and stabilizing prices (see table). Although Belarus, Tajikistan, and Uzbekistan show little progress, most countries show some, and a few—Hungary and Poland—show a great deal. However, freeing prices on some goods does not ensure increased efficiency if prices remain controlled in large and vital sectors such as energy.

Fiscal reforms. Most transition economies have implemented major fiscal reforms in the 1990s, some more successfully than others. Because a tax culture never developed in the centrally planned economies, people reacted with hostility to the introduction of an explicit tax system.

The economic reforms that took place in these countries at the beginning of the transition had a damaging impact on the existing public finances.

• They destroyed the plan, thus eliminating the information (good or bad) on quantities of goods produced and on prices. The government had to rely on other sources, including taxpayers' declarations, for this information. Tax evasion increased.

• They increased dramatically the number of producers and thus the number of potential taxpayers, as private sector activities came into existence. Tax administrations that had been used to dealing with relatively few, friendly enterprises had to deal with hundreds of thousands, or even millions, of unfriendly taxpayers. Large state enterprises, which had

provided the bulk of tax revenue, declined in importance, while new small and difficult-to-tax private producers emerged as the most dynamic sector of the economy. They required both close attention from tax authorities, because of their propensity to evade taxes, and protection from unscrupulous tax officials.

• They removed the restrictions on payment methods that had existed under central planning (when all payments were channeled through the central bank). Unfortunately, tax arrears and payments in the form of barter have grown, creating major difficulties for the new system.

Because of these changes, among others, the old systems could not easily be reformed. Totally new systems were needed, and they required not just new tax laws but also new fiscal institutions, new skills, technical knowledge, and political capital. Few of the transition economies have been able to meet these requirements of a market-oriented system.

Many countries attempted to patch up the old institutions to make them behave like new ones. The poorly paid personnel of these institutions, schooled in the old ways, were often the main obstacle to change, and those who were put in charge of these institutions often had limited knowledge of how tax administrations should work in market economies. Their incentive was to maintain the old system. It would have been far better to create, from scratch, new institutions.

Many governments have failed to accept or understand that, in a market economy, a tax system should be based on laws that establish tax rates and rules for objectively defining the tax bases and should have one paramount objective—to raise revenue as efficiently and equitably as possible. Rather, these governments view the tax system as a tool that should do many things—keep failing enterprises alive, sustain employment by allowing loss-making enterprises to pay wages instead of taxes, stimulate economic activity, and so on. In some ways, the tax system replaced the plan as the key instrument for economic and social policy. Thus, in some of these countries, taxes have continued to be soft and discretionary, and key ministers have continued to spend more time dealing with individual taxpayers' tax problems than reforming the tax system. This may have sharply increased the tax burden on segments of the economy that are not able to receive preferential treatment.

In many of these countries, especially the larger ones, public spending has remained very high as a share of GDP. Once made, spending plans may be difficult to revise, especially downward. This is particularly true of pensions, health benefits, and public employment, which involve long-term commitments. One reason for many countries' high ratios of spending to GDP is that they have experienced declines in output. Another is that they have not yet formulated policies for shrinking the role of the state. The government remains engaged in far too many activities.

Vito Tanzi is Director of the IMF's Fiscal Affairs Department.

Conclusion

Major changes will need to occur to complete the transition. Changes can be either superficial—essentially those envisaged by the shock-therapy approach—or deep, including creation of new institutions, changes in incentives, changes in processes, and transformation of the role of government. These deep changes are much more difficult and time-consuming because they involve structural reforms and require a major modification of attitudes, incentives, and relationships.

Once a country has made the transition to a market economy, the role of government is dramatically different. It operates not through direct controls but mostly through the tax system, the budget, and a few essential regulations. The tax system must be totally reformed to make it efficient and equitable and capable of raising reasonable revenues. Expenditure policies must be brought in line with the reduced public resources. The new regulations will play a role in setting the rules of the game, regulating private pensions, and enforcing competition. Most permits, authorizations, and other mechanisms that are known to promote bribery must be eliminated, because they lead to the corruption that is widespread in many transition economies.

Given the decline in income equality in these countries and their experiences with privatization, it is likely that their governments will be asked to play a more positive role in income redistribution. Policymakers should work hard to harmonize the concept of the role of the state that seems to prevail in many of their legislatures with one that is feasible, given the existing macroeconomic conditions and level of institutional and economic development.

There must be a fuller realization that, while large fiscal deficits are often a macroeconomic problem, they become a more fundamental problem when they force governments to renege on their legal contracts by sequestering or freezing payments across the board. These actions are a corruption of the budgetary process and the market economy. When a public employee is not paid or when pensioners do not receive pensions to which they are legally entitled, something is fundamentally wrong with the whole political budgetary proc F&D

Suggestions for further reading:

Lajos Bokros and Jean-Jacques Dethier, eds., 1998, Public Finance Reform During the Transition: The Experience of Hungary *(Washington: World Bank).*

Adrienne Cheasty and Jeffrey Davis, 1996, "Fiscal Transition in Countries of the Former Soviet Union: An Interim Assessment," MOCT-MOST: Economic Policy in Transitional Economies *(Netherlands), Vol. 6, pp. 7–34.*

European Bank for Reconstruction and Development, 1998, Transition Report*, 1998 (London).*

Vito Tanzi, 1992, Fiscal Policies in Economies in Transition