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Mobilization of Savings in Eastern European Countries:
The Role of the State *

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Abstract

As the countries of Eastern and Central Europe transform their economies from centrally-planned to market-oriented, the question of the role that the governments should play in mobilizing savings to ensure a high growth rate must be addressed. This paper argues that the issue of a good allocation of savings must precede that of mobilization. Much evidence suggests that major distortions have, in the past, dramatically reduced the productivity of investment. The paper discusses some of the institutional changes that will be necessary to ensure a better allocation of savings.

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Summary

Most Eastern Europeans currently wish to convert their centrally planned economies to market-oriented ones with only limited governmental intervention. Little discussion is taking place about the specific role that the state should play during the transition stage and in the final stage. Furthermore, there is little theory to guide policymakers in determining the role of the state during the period of transition. The paper discusses this special role.

Section II starts with a discussion of the initial conditions in Eastern Europe. Among the favorable conditions in the region are the following: (a) the closeness of well-developed markets; (b) the high education level of these countries' citizens; (c) the initial, relatively even income distribution; and (d) the strong desire of Eastern European countries to emulate Western European countries. Among the unfavorable conditions are the following: (a) the current unstable international situation; (b) the precarious economic conditions in Eastern European countries; (c) their large distortions in resource allocation (shown by the paper's presentation of several indirect indices of distortions); (d) the current confused situation regarding ownership of the factors of production; (e) the lack of understanding among Eastern Europeans of how a market economy operates; (f) the relative underdevelopment of fiscal and monetary institutions; and, possibly, (g) the poor work habits acquired in past years.

In Section III, the paper briefly discusses transitional issues, such as privatization and price liberalization. Finally, it addresses the issue of the role of the state in the mobilization of savings. It discusses, first, the various ways in which the state can influence the mobilization of savings. In this process, it highlights the role of financial and fiscal institutions. Since these institutions are very primitive in Eastern Europe, their development is an essential step in its economic transformation. A particularly troublesome transitional problem is posed by the tax system. The paper argues that the existing tax system, while highly productive, could be severely disrupted by the change to a market economy. The existing institutions used for tax administration must be completely replaced if Eastern European governments are to have the resources needed to pursue their essential roles.

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I. Introduction

Over the past 100 years views about the role of the state have spread across a spectrum which included the Stalinist interpretation of the Marxist view on one extreme and the Smithian view on the other. In the former view, at least in its practical implementation in centrally-planned economies, the role of the state is overwhelming. It is the state that determines the allocation of resources, the distribution of income and consumption, the levels of saving and investment, and the relative prices of goods and services. It is also largely the state that determines the allocation of jobs and the places where people live and work. In the Smithian view, first advanced by Adam Smith two centuries ago and subsequently amended to take account of market failures arising from externalities, public goods, and so forth, it is the private sector that largely determines the allocation of resources and the distribution of income. The state is largely a spectator that steps in to correct the actions of the private sector when the latter commits errors of commission or omission.

These two polar views have probably never been applied in their extreme versions. Centrally-planned economies have been closer to the Stalinist-Marxist conception while the Western democracies have been closer to the view associated with Adam Smith. There have also been substantial differences within the groups of countries. For example, there has been a great distance between, say, North Korea and Romania on one hand and Hungary and Yugoslavia on the other hand and between the United States and Sweden.

There was a time when the possibility of convergence was seriously discussed. According to this hypothesis, which seemed to be popular in the 1960s, the centrally-planned countries would become less Marxist while the Western democracies would become more concerned with income distribution, poverty, and market failures in general, and would thus require more public sector intervention. This process of convergence would reduce the differences among countries and would result in a "third way," that is, the way of mixed economies in which the government would play a larger role than it now plays in Western democracies. This convergence hypothesis lost its appeal in the 1970s when a wave of conservatism affected the thinking in the Western world while serious economic problems began to develop in the centrally-planned economies. Today this kind of third way seems to have lost its appeal. As Vaclav Klaus, the Minister of Finance of Czechoslovakia, has recently put it, for East European countries the "third way is the direct way to the third world."

The prevalent current desire among Eastern Europeans is to convert their economies to market economies with limited governmental intervention as soon as possible. ^{1/} However, little discussion is

^{1/} Throughout the paper the term East European countries will cover former socialist countries of Eastern and Central Europe.

taking place about the specific role of the state both in the transition stage and in the final stage. One reason is that the state is so largely discredited in most of these countries that the idea of assigning a specific role to it sounds strange. Another is the fact that, in several of these countries, the new governments are likely to incorporate, at political levels or among civil servants, many individuals who were closely associated with the previous regimes. There will be inevitable skepticism on whether these individuals will see the role of the state in the same way as the policymakers of Western countries. A third problem is that the population at large may be in favor of a market economy in the abstract but it may resist many of the changes that would make such an economy a reality.

While we have fairly clear views about the theoretical role of the state in a market economy (in spite of continuing disagreement about specific policies), there is very little to guide us as to the role of the state in a period of transition which, under the best of circumstances, can stretch for several years. In this paper we shall focus on this special role.

II. Initial Conditions in East European Countries

Before discussing the major issues in transition it may be worthwhile to outline briefly some of the more important initial conditions that will affect or limit the actions of the government and that will largely influence the cost of transition and the final outcome. We shall distinguish the favorable from the unfavorable initial conditions.

Favorable conditions

Some conditions will help these countries in making the transition to a market economy.

First, is the vicinity to well developed markets. The fact that these countries are next door to one of the most advanced economic areas in the world (the countries of the European Community) will undoubtedly be beneficial to them. The West European countries will provide large and growing markets, financial capital, technology, and a ready reference point for making many institutional changes. This, however, may be a two-edged weapon since Western Europe may also become a magnet for the more skilled and the more enterprising individuals from East Europe.

Second, the citizens of most of the East European countries have obtained a good level of education. In this sense these countries are somewhat different from the middle-income developing countries with similar per capita incomes. Literacy rates are high and high levels of formal schooling are common. This fact should facilitate the transfer

of technology from more advanced countries and the diffusion of the new technologies and techniques once they are imported.

Third, these countries are characterized by relatively even income distributions. Their Gini coefficients, at reported values of around 24, compare favorably with the lowest coefficients among Western countries; they are at, say, the level of Sweden. Thus, the role of the state will not require policies that redistribute income across income classes, although it will be expected to play some role in redistributing income across regions. Rather, the state should try to bring about income and wage differentials that are functional, that is, that reflect particular requirements of the economy while preventing a deterioration of the existing distribution which may accompany the introduction of a market economy. ^{1/} This will be one of the major challenges facing the new governments.

Fourth, one must list the strong desire for change now felt by the citizens of these countries. After having been told over many years that their rates of growth were higher than those of comparable countries in the West, the populations of these countries have come to realize that their standard of living is in fact only a fraction of that in Western Europe. In some cases there are no historical or fundamental reasons for these differences (for example, between Austria on one hand and Hungary and Czechoslovakia on the other). This realization might induce the populations of the East European countries to support policies that would accelerate the rates of growth of their countries.

Unfavorable conditions

Against these favorable conditions, however, one finds many unfavorable ones that will create major obstacles to change and that will complicate the task of policymakers.

First, it is unfortunate that the great transformation in Eastern Europe is occurring at a time when the international economic environment is deteriorating with slowdown in economic activity in some important countries (e.g., the United States and the United Kingdom) and with significant increases in interest rates, oil prices, and inflation. Also, the situation in the Middle East is having serious economic effects, especially on some of these countries (Romania and Bulgaria). The breakdown of the commercial arrangements with the Soviet Union and this country's current difficulties, are creating additional difficulties. Clearly the transition would have been easier in the environment that prevailed two or three years ago.

^{1/} At the moment wage differentials are too low to promote efficiency. The difference between the lowest and the highest paid is about 1 to 3.

Second, when they entered the current period of transition, most of these countries were already facing major macroeconomic imbalances with growing foreign debt, balance of payment difficulties, negative rates of growth, and growing scarcities and inflation. As we have learned from adjustment programs in developing countries, periods of crisis are not the best to bring fundamental economic and social changes.

Third, the East European countries are characterized by very large distortions in resource allocation. There are many indications of these distortions. For example, incremental capital output ratios (ICORs) have been incredibly high over the past 15 years. ^{1/} Investment-to-GDP ratios among the highest in the world have led to very low or even to negative growth rates. In commenting on this fact Leontieff has referred to the "input-input sector" where resources go in but nothing comes out. This fact is very important for the question of mobilization of savings since there is no point to such mobilization if the end result will be highly misallocated resources. The energy inputs have been disproportionate to output growth. The energy elasticity of the growth in GDP has been several times that of the OECD countries and the energy input per, say, \$1,000,000 of output for the centrally-planned economies of Eastern Europe has been close to three times as high as in the OECD countries. Ton/km of surface transport, per million dollars of GDP produced, has been four to eleven times the average of OECD countries (see Thumm, 1990). Central planning is easier when much of the production of a product takes place in one large enterprise, so that one-plant monopolies were encouraged. But this implies that goods have to be transported over longer distances than if several enterprises existed.

Table 1 provides some relevant statistics on the relationship between some inputs and growth in real GDP. In analyzing this table it should be recalled that there is now much evidence that the growth rates in socialist economies were highly inflated so that the change in real GDP for the three East European countries reported in the table is overestimated.

Another index of distortion is the ratio of inventories to GDP. All evidence indicates that firms in centrally-planned economies operate with extremely large stocks of material inputs. ^{2/} According to Thumm (op. cit., p. 7), the ratio of inventories to GDP in centrally-planned economies is ten to twenty times that in OECD countries. These high ratios are the result of many factors including very low interest rates, uncertainty in getting needed inputs, etc. They thus play a role similar to precautionary balances for the individuals' demand for money.

^{1/} As high as 15 to 30.

^{2/} On the other hand, stocks of finished products are very low compared to market economies (see Kornai, 1982, p. 137).

Table 1. Structural Change in the Use of Material Inputs
(Percentage Changes, 1970-85)

Country	Use of		Cement Production	Goods Transported	Real GDP
	Primary Energy	Steel			
Belgium	7.1	-24.5	-17.6	-2.2	42.7
Denmark	-2.7	-15.6	-33.2	20.1	40.8
France	30.3	-34.8	-23.4	-14.5	51.6
Germany	13.4	-26.3	-32.8	4.4	38.4
Sweden	26.4	-37.9	-41.2	-21.4	32.7
United Kingdom	-23.	-43.5	-28.7	-18.2	32.4
Austria	32.1	-33.9	-6.0	21.3	54.3
Finland	39.6	14.8	-11.2	12.2	65.7
Japan	37.3	-2.3	27.4	7.5	90.2
Norway	51.1	-21.6	-40.3	34.7	87.5
Italy (1980-85)	5.4	-9.8	-11.2	4.8	8.2
Italy (1970-85)	53.4	38.3	40.3	60.8	56.7
Bulgaria	74.9	24.9	42.3	77.5	37.3
Czechoslovakia	31.5	22.5	37.3	62.9	33.9
USSR	76.3	33.5	35.9	70.2	47.7

Source: M. Jaenicke et al., "Structural Change and Environmental Impact," in *Intereconomics*, January-February 1989. Adapted by Emilio Gerelli and Gilberto Muraro, "Verso Un'Economia Immateriale" in *Rivista di Diritto Finanziario* (1990), p. 175.

These distortions indicate that the question of allocation of saving and resources is far more important than the question of mobilization of saving. These economies have been mobilizing too much saving, and misallocating it, over past years. The role of the state over future years must be one that removes, or at least dramatically reduces, these distortions by changing the incentive mechanisms that brought them about. Mobilization of savings must be accompanied by a better use of those savings.

The fourth factor is ownership of the factors of production (enterprises, land, buildings, etc.). The common view is that these factors of production are owned by the public sector and that privatization is a sine qua non for moving to a market economy. Unfortunately the situation is complex. First, property rights are often not clearly identified. In most of these countries former owners have stepped forward to establish claims that antecede the takeover by the communist parties. As a Western-type legal system comes into being, these claims will acquire more legitimacy in the courts. Anyway, the existence of these claims will discourage potential buyers. ^{1/} Second, for many socialized assets, claims by workers' councils, cooperatives, or by other groups contrast with the claims by the central government. ^{2/} Therefore, the statement that enterprises or other assets are "publicly owned" is often not very informative. Some economists have argued that the state might have to renationalize these assets as a step toward their privatization. The establishment of clear property rights and the privatization of many of these assets are essential steps toward the creation of a market economy. And a market economy is a necessary condition for an efficient use of savings. An important role for the state is, thus, the establishment of clear rules of the game which will allow these steps to take place.

Fifth, is the lack of understanding of how a market economy operates. Some concepts that in the West are taken for granted are alien to the average person in these countries. In a country I visited recently, some high level civil servants could not understand how a market economy could function without a "price office" that would set prices. In some countries even the language can be a barrier with, for example, a "market-clearing price" being translated as a "saturation price." The concept of profit, as a very useful index for the allocation of resources and for determining individuals' incomes, is likely to be seen with a high degree of suspicion. It is unlikely that the average person will accept the fact that the owner of a new successful private activity is entitled to a high income and a high standard of living. These attitudes have implications for the role that

^{1/} In the U.S. housing market a similar problem is dealt with by buying a special insurance against the possibility that the deed is an invalid one.

^{2/} In many of these countries the power of workers' councils will be a major obstacle to privatization.

the public sector will be allowed to play. The more accepted and understood are the institutions of a market economy, the more limited need be the role of the state. 1/ Furthermore, many of the rules of a market economy are unwritten ones so that they do not require specific regulations. 2/ They have become accepted norms in Western economies only over a period of time. They will need to be created and enforced, perhaps as formal regulations, in economies in transition.

Sixth, is the relative underdevelopment of fiscal and monetary institutions. A tax system of the type that exists in market economies is almost nonexistent in most centrally-planned economies. The same is true for the banking system. Thus fiscal and monetary policy, as it is understood in the West, cannot be efficiently pursued. The creation of fiscal and monetary institutions will require important legal and accounting reforms which will take time to implement. However, these reforms are essential if the state wants to play a proper and constructive role. Furthermore, the creation of a tax system requires much more than the writing of tax laws. It requires the creation of the relevant administrative set-up, the education of the taxpayers, etc.. Until those institutions are fully functional the ability of the government to mobilize savings will be limited.

Finally, while in these countries the general level of education may be high, the contribution of human capital to production depends not just on the knowledge of the workers but also on their attitudes toward work. Although it is difficult to determine how important this problem is, various commentators have called attention to the poor work habits and attitudes developed by workers under the previous system. 3/ The lack of motivation to work hard, the inexistence of arm's length relationships in contracts and in economic relationships in general, and other factors may become significant negative influences in the new economic relations that these countries are in the process of setting up.

In conclusion, all of these factors, whether positive or negative, will influence the role of the government and the success of that

1/ On this issue I have some difficulty with Kornai's view that "there is no need to make the tax system progressive" (Kornai, 1990, p. 122) although I agree with him that a country should not end up with "Hungarian wages minus Swedish taxes" (ibid, p. 117).

2/ For example, many contacts are implicit rather than explicit but they still need to be observed.

3/ For example, the need to stand in line for hours to obtain scarce goods has made shopping during working hours an accepted practice. It has been reported that East German workers who migrated to the West have found strange the fact that they could not shop during working hours.

role. ^{1/} The government must have a clear sense of direction in uncharted waters, must be able to surmount political obstacles to enact the correct legislation, and it must set up the right institutions to make sure that the enacted laws become effective economic instruments. Laws are easy to write. Institutions are much more difficult to develop.

III. Transitional Issues

In the previous section we discussed some of the initial conditions which characterize the East European countries as they begin the process of transformation of their economies from centrally-planned to market economies. In this section we want to outline as briefly as possible some of the major issues to be faced by the government during the period of transition. This period starts with a situation whereby the typical citizen (a) holds few assets, if any, besides monetary holdings ^{2/}; (b) faces prices largely set by the government and prices that bear little relationship to the cost of production; (c) has a low discretionary income compared with his overall income. Much of his income is received through various subsidies so that in a way the government determines his level and pattern of consumption; and (d) has a guarantee that the state will take care of him. ^{3/} It should end with a situation whereby (a) the typical citizen's holding of assets has increased as many of the assets publicly owned will be sold or returned to the citizens; (b) he faces market prices (including his own wage) which are not controlled by the government, can change without warning, and are much more closely correlated to their costs of production; (c) his discretionary income has become a much larger share of his total income--in other words, he has much more discretion over his pattern and level of consumption; and (d) he has much less guarantee that the state will take care of him. In each of these changes the state will have to play an important role.

We have already touched upon the issue of privatization. This is perhaps the thorniest immediate political issue facing these countries. So far little progress has been made and the first attempts in some countries (e.g., Hungary and Poland) have created much skepticism about the process. One problem is that given that prices are

^{1/} One must not ignore the fact that future policymakers will also come from the same background as the average citizen. Thus it would be a mistake to assume that they will not, as a group, reflect some of these attitudes.

^{2/} Compared to the West, the individuals, qua individuals, have claims on only a very small portion of the countries' total wealth.

^{3/} In this situation the average individual is not expected to save. It is the state that determines the level and the use of the country's savings. What effect will this attitude have on the future propensity to save of individuals is uncertain.

controlled and distorted, it is difficult to value assets. The present rentability of these assets is no indication of the value that these assets would have after prices are set free. Second, current managers of enterprises have considerable insider information, which can be used to take unfair advantage in privatization deals. Third, there are few citizens with the resources to buy large enterprises and there is reluctance to let foreigners acquire too many enterprises. Fourth, as already mentioned the workers and the managers of existing enterprises are likely to oppose their privatization for fear of losing their jobs.

Until assets are privately owned, and until individuals receive cash incomes which reflect the value of their contribution to production, there is not much sense in discussing the "mobilization of savings." In a centrally-planned economy practically all the saving is done by the government. Individuals are not expected to save, especially since they are not allowed to buy many assets. The individual's contribution is largely the result of sums accumulated toward the intended purchases of costly consumer durables (cars, televisions) or the result of chronic shortages in markets for consumer goods which reduce the opportunity of fully spending one's monetary income. These accumulated savings are often held in monetary balances and are associated with the so-called monetary overhang. They do not directly contribute to the financing of the investment of enterprises. This investment is decided by the plan and the resources needed are provided by the government. In a way the state is the only shareholder. ^{1/}

There are many steps that the government can follow which would create private owners of assets. Lack of space allows here only a mention of these steps.

First, the state should ensure that it is very easy and almost automatic to be able to establish new private activities. These are likely to be associated with trade and services (restaurants, small shops, etc.) and with small construction and manufacturing activities. These small activities can be expected to be very dynamic and can quickly generate employment, wealth, and substantial incomes. In view of the need to obtain permits and locales from government employers, this form of privatization can easily give rise to corruptive practices. Those in charge of giving permits, or those making decisions about space allotment, may demand some sort of (under-the-table) compensation. This can degenerate into widespread abuses that can become a drag on the creation of a dynamic private sector if the government is not particularly vigilant. Anecdotal information indicates that this has become a serious problem in some of the countries in transition.

^{1/} The so-called "dividend tax" that exists in some of these countries validates this point. It is a tax estimated as a given rate of return on the capital provided by the state.

Second, it should be technically simple, even though politically complex, to privatize housing and land. Here there are no workers' councils or serious evaluation problems. 1/ Privatization of these assets will remove the government from activities in which it should not be involved: it will create more mobility in the labor market if resales are allowed; it will permit the eventual taxation of property; and it will help to wipe out part of the money overhang without the need for monetary reform or inflation. Of course buying something that was available for free may not be attractive for some individuals especially when they also got the utilities (water, electricity, etc.) at highly subsidized prices. Thus it should be no surprise that the sale of houses and apartments will encounter opposition. Arrangements would need to be made to adjust wages and especially pensions to reflect the fact that the cash value of wages and pensions will progressively come to reflect the full compensation received. In other words, as individuals lose benefits-in-kind, part of these have to be made up in cash. Land and housing normally account for a large share of a country's total wealth. Therefore their privatization would go a long way to transfer wealth from the public to the private sector. In both cases those who are occupying the houses or the land should be given incentives to buy them by allowing them to pay mortgages over a period of time.

Small enterprises or small activities could also be privatized without running into the problems of the large enterprises. For these it should be easier to find buyers and it should be less difficult to estimate their value. For the large enterprises three alternatives are possible: continued nationalization for natural monopolies, following the West European rather than the American example; closure, because of obvious lack of competitiveness in a market and an open economy for some enterprises; and privatization after some restructuring for the others. It is not possible here to discuss the various schemes suggested for privatizing these enterprises. 2/

The process of price liberalization is a complex and painful one as the recent experience of Poland indicates. Ideally it would involve, first, some major administrative revision of prices to anticipate and reduce some of the major problems that would arise. Second, it would require a decision on whether some prices might remain controlled for some time. Finally there would be the actual freeing of prices. Price liberalization will have major implications for the viability of many enterprises, for the wages and the jobs of many workers, for the benefits these workers receive since these benefits are often related to wage levels and may be provided by the enterprises themselves, for the budget since the current revenue system is highly dependent on the price structure, and for public expenditure since it will be necessary to

1/ For rural cooperatives there may also be complex problems.

2/ For recent discussions of these issues, see Sachs and Lipton (1990).

adjust pensions and to create some "safety nets" which will include the establishment of funds for unemployment and for dealing with the poorest sectors. 1/ The need to deal with all these issues at one time raises the question of whether "a big bang" is a viable or desirable option. However, selective adjustments in prices may give undesirable results. For example, in Romania, producer prices for miners and farmers have been adjusted without a corresponding increase in consumer prices. The result has been a large increase in subsidies and thus a deterioration of the budgetary situation.

In Poland, the extensive process of price liberalization in 1990 has been accompanied by the creation of a safety net which includes three elements: (a) a labor fund for the unemployed and for training displaced workers; (b) adjustments in pensions to protect to some extent the standard of living of pensioners; and (c) special assistance to the neediest. In Romania the government is considering price liberalization accompanied by the control of the prices of a large number of products.

Price liberalization may not initially bring into existence an efficient relative price structure since these economies are characterized by monopolies, are not subject to foreign competition, and, at least at the beginning, the structure of demand will reflect the existing distribution of income. Relying on world prices to make initial changes is an attractive but limited alternative.

IV. The Role of the State in the Mobilization of Savings

The role of government in mobilizing savings in market economies is normally played through at least four channels. First, and most directly, through its own saving and dissaving behavior (through its budgetary outcome). Second, through the financial institutions that it creates which encourage individuals to save and to lend. Third, through the impact on the decisions of individuals to save or spend coming from the level and the structure of taxation and government expenditure. Fourth, through the macroeconomic situation that induces individuals to pursue particular behaviors. In centrally-planned institutions, the role of the government has been a much more direct one. However, for economies in transition the above aspects will become important. Thus these aspects must receive a lot of attention in the months and years ahead.

1/ In Poland this process seems to have been a particularly painful one. However, Lipton and Sachs have forcefully argued that the outcome so far is not as bleak as official statistics indicate because the growth in output in the parallel economy is not measured and the value of time spent in line waiting for goods is not imputed. (See Lipton and Sachs, 1990.)

1. Monetary institutions

In market economies, basic guiding principles are: (a) the assumed significant relationship between saving and growth; and (b) the assumption that the various sources of savings--household savings, retained profits by firms, private and government pension funds, budget surpluses, etc.--all end up in the financial system from which they are recycled in the form of loans for consumption, production, new investment projects or government deficits. The rate of return on the uses of these funds and the costs of these funds guide their allocation. The borrowers compete against each other and so do the lenders. Thus, in a well functioning financial system, the interest rate and the profitability of investment (or the utility of consumption) determine their allocation. In equilibrium, the interest rate and the rate of return on investment become equal.

Market economies have developed, over many years, the required institutions that make this process possible and relatively efficient. 1/ The banking system can be visualized as a sponge that absorbs the savings and lends them to where they would generate the most good. The rate of interest is the basic allocating instrument. It is also assumed to play a role in determining the propensity to save of individuals although there is much controversy about just how significant a factor it is. 2/

The fiscal system is the other sponge that absorbs resources from the private sector through taxation and that, through a less efficient and more political process, allocates them to required public uses. Limitations in the market mechanism make this public intervention necessary. However, the public sector is not supposed to second-guess or replace the market but only to complement it where necessary. This at least is the theoretical view of public sector intervention. A well-functioning fiscal policy must keep public sector expenditure at the necessary minimum and must finance it through the most efficient taxes.

One must meditate about these guiding principles. The relationship between saving and growth is predicated on the assumption that saving will be used in the most productive uses. If saving goes to finance "white elephants" (as for example the construction of the pharaonic presidential palace in Ceausescu's Romania), that relationship breaks down. In the earlier part of this paper some indirect evidence was provided to show the extent to which resources have been misallocated in centrally-planned economies. Fundamental reforms will be required before one can be satisfied that the mobilized saving would end up in the most productive uses. Until those reforms are in place, the

1/ Some economists have at time questioned the efficiency of this process. See, for example, Stiglitz (1989).

2/ See Sheshinski and Tanzi (1989).

objective of savings mobilization by the government would not necessarily be a worthwhile objective.

The image of the financial system as a sponge that absorbs deposits from surplus units--be these individuals, enterprises, or even governmental agencies--and lends them to deficit units willing and able to pay the price of the funds, summarizes the main function of major and complex institutions. These institutions do not exist in centrally-planned economies and are now being created in economies in transition. The first step is a shift from a "mono bank" system, whereby the roles of commercial banks and of the central bank are combined into one institution, to a "two-tier" banking system in which these functions are separated. 1/

In a typical centrally-planned economy a state bank has significant monopoly power over banking and credit. This bank has unlimited capacity to create credit. There is no significant secondary credit expansion. Specialized financial institutions, which are essentially branches of the state bank, channel credit to enterprises in particular sectors in line with directives from the central authorities.

The household sector receives personal incomes in cash and makes payments for consumption also in cash. Enterprises receive credit from banks and make payments, to other enterprises or to fiscal entities, through bank accounts. Households cannot lend directly to the state enterprises or buy their shares; and they cannot buy directly the output of those enterprises. If they do not fully spend their incomes, they can deposit their surplus funds in saving accounts with banks serving the household sector. On these funds they receive very low, and often negative, interest rates. There is little or no competition for funds between the household sector and the enterprises.

The main function of the monetary system in the centrally-planned economies is the financing of the production plan. The physical plan necessitates a financial plan to allocate the real resources, and the financial plan has three components: a budget, a credit plan, and a cash plan. The State Bank guarantees to the enterprises the loans needed to carry out the plan, controls that they are used for the planned purposes, and provides the cash to pay wages. Interest rates play no role in this allocation. Credit is allocated at very low fixed interest rates regardless of risk. Should the enterprises acquire some surplus financial assets, say, by being more efficient, they would receive very low interest rates if they deposited these surpluses. Or, worse, these surpluses might be taxed away. As a consequence, enterprises have an incentive to overinvest in real assets and especially in inventories, or to increase the amenities they provide to their workers. There are no chances of bankruptcy since both the banks

1/ This discussion is based on V. Sundararajan (1989).

and the enterprises are owned by the government. A losing enterprise is simply one that needs more transfers.

This picture, which, it must be emphasized, is changing rapidly, provides an idea of the potential misallocation of resources, or putting it differently, of the irrelevance of the mobilization of savings, in those circumstances. It also provides an idea of the lack of direct incentives to save on the part of individuals and enterprises alike. Recent reforms in this area have aimed at promoting greater interest rate flexibility and at assigning a more important role to financial policies in macro stabilization efforts. Some competition in the banking system has been promoted and some gains in efficiency have been achieved, but much remains to be done in order to bring the financial systems of these countries closer to the role indicated at the beginning of this section and to make it a more efficient instrument for the mobilization of savings. Until attractive financial assets are available to households and until an incentive is created for enterprises to generate internal funds for their investment, national saving will continue to be the result of decisions related to the way prices are set by the plan. Thus the development of a sophisticated financial market is an important way in which the government can help mobilize savings in the new economic order being created in Eastern Europe. Unfortunately, such a market cannot be created overnight. Its development is likely to require years rather than months.

2. Fiscal institutions

Just as in market economies, the governments of centrally-planned economies need to raise revenue to cover their expenditures for public goods (defense, etc.), specific government services (health, education, etc.), subsidies to families and enterprises, and for other purposes. In unreformed, planned economies, fiscal policy had, however, no distinctive role. The level and composition of economic activity--essentially visualized, and sometimes actually expressed, in physical terms--were determined by the planning authorities. Corresponding to the physical processes of production and distribution, there were financial flows. The essential task of financial policies--both fiscal and monetary--was to ensure that the availability or lack of financial resources did not impede the attainment of plan targets. Fiscal policy was thus, to a large extent, a matter of, often ad-hoc, intermediation of resources between sectors in financial surplus and those in financial deficit. The element of "ad-hoc-ery" was often imparted through discretionary variations in tax and subsidy rates.

Just as in the market economies, the governments of centrally-planned economies need to raise revenue to cover social expenditures. However, this seems to be the main role of fiscal policy since both the allocation of resources and the distribution of income are carried out through more direct means, mainly through the plan. Thus taxes are not designed with the objective of neutrality or equity in mind. The function of stabilization pursued through fiscal policy has been

considered redundant since centrally-planned economies were not supposed to experience business cycles.

Table 2 provides data on general government expenditure for several East European countries. Given the level of per capita incomes of these countries, the ratios shown in the table are very high, as high or higher than those in the richest and most socially-minded of the Western countries (say, Sweden). Given their income levels, it is unlikely that these countries would be able to finance public expenditure levels much higher than, say, 30 percent of GDP if they became market economies and had to rely on the revenue sources used in market economies. Even in their current systems these countries have found progressively more difficult to sustain levels of taxation that would fully finance these expenditures. Thus, increasing budget deficits have become a common occurrence. As in Latin American countries, these fiscal deficits, which have reached high levels in some of these countries (especially the Soviet Union), have been financed by foreign borrowing and by inflationary finance. ^{1/} To make a contribution to the mobilization of savings, the state must eliminate these deficits. But for these deficits to disappear, the level of public expenditure must be sharply reduced since during the transition the level of taxation is likely to fall. ^{2/}

Why is the level of government expenditure so high in centrally-planned economies? There are several reasons but the most important ones are (a) the level of price subsidies which is much higher (by at least 10 to 15 percent of GDP) than in the market economies, and (b) the financing of investments of national interest. Table 3 provides some information on government subsidies for a few countries. Poland has recently taken a big step toward the reduction of these subsidies. Hungary has been trying to reduce them since the early 1980s and especially since 1987. Czechoslovakia and Romania are considering similar steps. The removal of these generalized subsidies (given through the price system) must be accompanied by adjustments in wages and pensions as well as by the reintroduction of well-targeted subsidies. Reducing subsidies and making additional economies in expenditures (say by lowering defense spending) would reduce the fiscal deficit and would reintroduce more incentives for saving by individuals. However, these reforms will require time since they cannot be pursued without adjustments in other areas (pensions, wages, etc.). As already indicated, during the period of transition, tax revenues are

^{1/} Since prices are controlled, the effect of inflationary finance has been goods scarcity in the shops and long lines.

^{2/} In China, for example, government revenue fell from 34.4 percent of GNP in 1978 to 20.4 percent of GNP in 1988 (see Blejer and Szapary, 1990).

Table 2. General Government Expenditure of East European Economies

(In percent of GDP)

	1982	1983	1984	1985	1986	1987	1988	1989
Bulgaria	54.7	53.7	51.9	55.2	61.4	64.7	63.7	61.9
Czechoslovakia <u>1/</u>	67.0	67.4	67.4	69.8	69.8	71.2	74.1	76.6
Hungary	61.2	61.9	59.4	61.1	64.9	61.6	63.0	59.0
Poland	52.2	47.6	48.4	48.2	49.7	47.7	48.0	48.1
Romania	...	...	...	...	...	...	...	...
USSR	49.3	48.6	48.9	49.8	52.2	52.3	53.3	51.4

Source: Various national sources.

1/ In percent of net material product (NMP).

Table 3. Government Subsidies

(In percent of GDP)

	1982	1983	1984	1985	1986	1987	1988	1989
Bulgaria	13.3	13.2	12.5	12.8	15.4	17.2	17.6	15.6
Czechoslovakia <u>1/</u>	12.3	12.8	14.5	14.4	15.0	15.2	15.8	...
Hungary	18.7	19.7	16.5	17.1	16.6	16.2	13.8	13.3
Poland	20.7	16.5	17.3	16.5	16.3	15.9	16.0	14.1
Romania	...	...	...	...	...	...	...	...
USSR	...	...	...	...	...	...	15.0	13.5
USSR (food subsidies)	...	...	...	7.2	7.3	7.9	7.5	9.4

Source: Various national sources. For the Soviet Union, Gur Ofer, "Budget Deficit, Market Disequilibrium, and Soviet Economic Reforms," Soviet Economy, 5, 2, 1989, pp. 107-161.

1/ In percent of NMP.

likely to fall faster than government expenditure. ^{1/} What this implies is that it might be overly optimistic to expect that the mobilization of savings would come from a budgetary surplus although this would be necessary in the absence of large transfers from abroad.

It is not possible in this paper to discuss in detail the tax systems of these countries. ^{2/} It will suffice to point out that an overwhelming proportion of all tax revenue comes from (a) turnover taxes, (b) profit taxes, and (c) payroll taxes. Depending on the country, either the turnover tax or the profit tax is the major contributor to total tax revenue.

Turnover taxes are charged on sales made by the state enterprises to the retail shops. They are not charged on sales between enterprises. The revenue from these taxes depends on the selling prices to consumers. These selling prices are established by the department of prices and can be higher or lower than the cost of production. Therefore the turnover taxes can be positive (i.e., real taxes) or negative (i.e., subsidies). Turnover taxes have been applied at hundreds of rates which can be changed arbitrarily at any time. Since all the financial transactions of the enterprises with the retail outlets are made through the banking system (through credits) and since the prices are administratively fixed, the taxes are simply calculated and withheld by the banks. There is thus no need for a Western style tax administration to administer these taxes.

The profit taxes have relatively little in common with what we call profit taxes in the West. The concept of profit is often an arbitrary one. A recent World Bank mission that visited nine enterprises in Poland received eight different definitions of profit. The definition of profit is distorted by the existence of administered prices, by the discretionary nature of what enterprises can claim as costs, by the extremely distorted rules for amortization, by the valuation of inventories, and by many other factors. Profit is largely a negotiated concept and the taxes on profits are largely negotiated rather than ex ante or objectively determined taxes. Payroll taxes are based on the

^{1/} For a discussion of the reasons why tax revenue is likely to fall during the period of transition, see Blejer and Szapary, op. cit. In Poland, the share of tax revenue to GDP has fallen from 39.0 percent in 1982 to 27.4 percent in 1989. During the transition, public expenditure will remain high because of (a) unemployment compensation for the growing number of unemployed; (b) the establishment of safety nets; (c) the assumption by the government of the social security function of state enterprises; (d) the need to adjust public sector wages; (e) the need to increase spending for health and education; (f) the need to support the financial system (i.e., to increase the capitalization of banks); (g) the need to provide subsidies to restructuring enterprises, etc.

^{2/} For a good description, see Gray (1990).

overall payroll of the enterprises and are collected directly from the enterprises by the banks. These three taxes are transfers between enterprises and the public sector and, since prices and wages are controlled, it is not quite clear whether they are three really different taxes in an economic sense.

The remaining and much less important taxes on the "population" (tax on land and tax on private activities), are largely presumptive taxes. There is almost no checking and these taxes are also negotiated with the taxpayers rather than calculated on the basis of objective accounting practices.

In conclusion, centrally-planned economies have developed an effective framework for raising a lot of revenue. Two significant aspects arise from the simplified description: First, in spite of their effectiveness in raising revenue, the tax system of these countries is very primitive from a Western point of view; there are no returns by taxpayers, no audits, little if any control, and, incidentally, little tax evasion in the Western sense. Second, this revenue system is very fragile with respect to price liberalization, the "privatization" of the banking system, and the liberalization of the means of payment. Tax revenue would be much affected by the transition to a market economy which, almost certainly, would be associated with substantial revenue losses. Thus, a new tax system has to be rebuilt almost from scratch, a process that would take years. Unless drastic, short-term, measures are taken in the transition period, there could be a potentially negative impact on fiscal balances and on public sector savings.

Over the long run these countries would want to have tax systems broadly similar to those in their neighboring countries in Western Europe, while avoiding some of the mistakes made by the latter. Such systems would be highly dependent on general sales taxes, especially value-added taxes, on particular excises, and on income taxes on individuals and enterprises. These countries should refrain from excessive experimentation, that is, from the temptation to go for untried taxes, which may look good in theory but may be of difficult administration (for example, an expenditure tax).

These countries must resist also the temptation to use the tax system to achieve, with different instruments, the same objectives they were trying to achieve with the plan. The tax system should be seen as an instrument for raising needed revenue in the most neutral way possible while paying the required attention to equity considerations. It should not be seen as an instrument used for bringing back preferences and discrimination among sectors. This problem became evident in Hungary where the introduction of a modern tax system was hindered by the strong desire on the part of policymakers to give preferences to different groups. This desire brings serious administrative complications, encourages pressure groups, and introduces substantive inefficiencies in the tax system. In these countries, as

Kornai has noted, the population is not used to paying taxes and it may feel that cheating the state is the right thing to do.

Much attention should be dedicated to creating the administrative mechanism for a modern tax system. This task will, again, take a long time. During the transition period, when prices are freed, a simplified version of turnover taxes with few rates might be introduced until a modern value-added tax can be put into place. Czechoslovakia has recently proposed to replace the hundreds of turnover taxes with just four rates. In the short run this is not a bad decision but would clearly become one if it became a permanent feature.

A modern income tax could be put into place more quickly than a value-added tax, but this has not been an easy tax for many countries. So simplicity is clearly the rule of the game. An income tax with almost no deductions, with a few rates, and with widespread withholding might be the best alternative. Presumptive taxes should continue to be used, where necessary, for the next few years especially for agricultural incomes. Also, although a controversial issue, an across-the-board import duty could be used while the exchange rate is being adjusted. This should be a uniform tariff with no exceptions, an instrument which would have the objective of raising revenue while providing for a while a minimum degree of protection.

V. Concluding Remarks

Before closing this paper, a few concluding remarks may be appropriate. The first is that periods of transition are always difficult, especially when a total change of a system is taking place. The new system will require the creation of many institutions that require time to bring into existence, and some of these will require more time than others. During this period, when the old institutions disappear but new ones are not yet in place, the policymakers of these countries will face extremely difficult problems, especially if there is doubt about future changes. The importance of a consistent strategy, enunciated clearly, and faithfully followed cannot be overemphasized. Details can be changed but the sense of direction should not. If the policymakers begin to vacillate on the direction, the transition period will be much longer and the cost of transition much greater.

The second basic lesson is that the policymakers must come to trust the market. They must not try to second-guess it and they must resist the temptation to pursue only through different instruments the same goals than the plan. The role of the government in a market economy must be a corrective one rather than a directive one.

Addressing more specifically the question of the mobilization of savings, the paper emphasized that there are two aspects to this mobilization. First, is the creation of the saving pool; second is the allocation of that pool to productive uses. There has been much

emphasis on creating the saving pool and little on allocating it properly. Given the evidence of wide distortions in centrally-planned economies, one must conclude that much of the sacrifice in generating saving was for nothing.

In order to improve the allocation of saving, the financial system must be modernized, the return to savers must be raised, and the cost of borrowing must reflect the scarcity value of funds. A better tax system will contribute to this mobilization of savings but for a real modern tax system to exist, time will be required. In the meantime, it will be wise to rely on alternatives which, even though not the economists' first choice, will raise revenue and will contain the size of the potential fiscal deficits. The negative contribution to aggregate saving associated with the existence of large budget deficits is likely to overwhelm the distortions associated with a less-than-perfect tax system. Of course, the freeing of prices and the opening of the economy will be important steps in moving the economy to a more efficient path.

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