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# OVERVIEW

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## Introduction

After a decade of experiments with post-soviet transition, there seems to be a lot of evidence lending support to a view that transition process has been shaped by the existing political/social and institutional conditions rather than economic and technological conditions, as originally anticipated. The most successful countries, in which the transition proceeded relatively fast, were those countries which were more open, more homogeneous ethnically (free of serious internal nationalistic conflicts), and more heterogeneous politically (having relatively strong groups and organizations that resisted country's communist authorities; or the organizations that managed to maintain a certain level of autonomy within the communist state). The current disappointment with transition - especially with the performance of such countries as the Czech Republic, Russia, or Ukraine - is not a result of "bad will" of political leaders in these countries or "bad foreign aid", but rather a consequence of unrealistic expectations and the lack of solid understanding of the process of transition and its underlying factors and forces.

In fact, the conditions at the initial moment of transition in Ukraine were extremely difficult, more difficult, in a way, than in any other former soviet bloc country. Ukraine did very well in establishing its statehood and developing friendly relationships with all its neighbors and all major political powers. Today Ukrainians are better off than the residents of most other CIS countries and of many Balkan countries are. The economy has stabilized and is getting ready to start growing. Yet, Ukraine lacked and still lacks the kind of openness and democratic mechanisms that would provide effective protection against rent seeking, enforce contracts, and establish a competitive market economy. At the initial stage, the old communist *nomenklatura* was powerful (and highly demoralized) and could not be prevented from establishing its controls over the many segments of the formerly highly centralized soviet economy. Once the "commanding heights" of this peculiar vertical-control pyramid were cut off, the controls over the scattered, loosely interrelated, pieces of the Ukrainian economy gained autonomies hard to break by a young, inexperienced, and weak central government. Autarkic behavior – within each segment and within Ukraine as a whole – became pervasive. Powerful alliances of local bureaucrats and managers of large socialist enterprises acquired significant monopolistic controls. Loss of economic transparency, rent seeking, corruption, and increasing segmentation were unavoidable consequences of this peculiar political/economic structure. Unlike for example Poland, Ukraine inherited after the Soviet Union the lack of civil society, grass roots organizations and social structures that could challenge the powerful old and new *nomenklaturas*. Ukraine needed much more time to grow the institutions and organizations that would establish a political "competitive market". This market would, in turn, be able to abolish the corrupted monopolies, remove the "walls" partitioning the economy into the numerous segments, and expose them to the pressures of fair domestic and foreign competitions in order to promote economic efficiency, fiscal solvency, and sustained growth. There are many indications that the last several years have not been wasted and that democratic mechanisms have been gradually emerging. Contacts with other democratic countries, despite various impediments, are much greater today than 5-10 years ago. The exposure of Ukrainians to market and democracy is much broader. The grass-root organizations are much stronger. The "demand for reforms" is much more solid. Initial reforms, although inconsistent and shaky, begin bringing their first fruits.

**"Underground" transition and growth**

Until recently, a rapid development of Ukraine has remained mostly "underground". It has been more qualitative than quantitative and therefore not well reflected by standard economic indicators. This development has been predominantly in the sphere of institutional infrastructure and capacity building. Those of us involved with academic education know very well how rapid the progress of graduates from Ukrainian colleges has been, in particular in economics, finance, business management, and languages -- in English and also in Ukrainian. The understanding of market and democracy among government officials and in mass media has improved greatly.

As of today, the main problem is not the lack of capacity to do solid reforms, but rather the lack of confidence. The feeling of failure persists. A debilitating belief that “nothing can work” and “nobody can change it” prevails. A conviction that “others can make it but not us” endures. The problem is that as long as the people retain these unfounded and misleading perceptions, these perceptions keep living their own life and operating as self-fulfilling prophecies.

What Ukraine needs today, is more patience, more self-confidence and pride of its unquestionable accomplishments in building the statehood and its market institutions. Ukraine needs a strong conviction that things can be done and will be done, a vision – an ambitious, comprehensive and internally consistent reform program -- and courage to implement this program.

**Investment into knowledge**

The next few years for Ukraine should be the time of dynamic growth enabled by an investment into knowledge. This is the safest investment, which gives the best returns. Without knowledge, without solid information and understanding of the general post-soviet transition process and its particular features in Ukraine, no real reforms and no sustainable growth are possible. One word seems to provide the best description for the current status of Ukrainian reforms and the policies of the Government and the donors: confusion. We have finally reached a stage at which we figure out that we know that we don’t know. Data, education, extensive research are the best way to advance reforms and improve policies in Ukraine. One crucially important task is to investigate and monitor the Ukrainian economy. Another task, also of great importance, is to study the transition process in other former soviet bloc countries to learn from the experience of others.

Despite the obvious similarity of problems and policies amongst the former soviet bloc countries, there are little contacts between Ukrainian policymakers and those of other countries of the region, perhaps except Russia. While, for obvious reasons, the events and policies of Russia are closely monitored and analyzed in Ukraine, little is known about other countries. This is regrettable, because – especially in the case of Central European countries that are more advanced in transition than Ukraine and Russia – plenty of both positive and negative experience have been accumulated. Studying and using this experience would be very useful for both the Ukrainian Government and the donors. There are many reasons for this unfortunate situation, including language barriers, unfriendly borders, and complexities of relations among the nations in this region of Europe.

This book is a product of an international effort to help bridge this gap, by investigating recent transition experiences of Ukraine and Poland, while putting them into a broad global context.

## Transition experiences in Ukraine and Poland

As argued above, the initial conditions for Ukraine were quite different from those of Poland. For Ukraine, the collapse of the Soviet Union was, first of all, a great effort in state building. Economic reforms were an important, but not the only, item on the agenda of Ukrainian authorities.

Transition is a complex process, which involves institution building, which is promoted by a strong civil society. In Poland, a relatively pluralistic civil society and some market institutions existed even before this country initiated its shock therapy in January 1990. The early start of Polish reforms and their comprehensive and radical character make the Polish experience especially useful for Ukraine. Learning from this experience and developing close links with Polish policymakers is important for Ukraine, both for building capacity for its own reform efforts and also to improve understanding of the complex reform process.

## The Pultusk workshop

To provide an opportunity for Ukrainian policymakers to interact and discuss reform issues with their Polish counterparts and international experts, USA's Harvard University, Harvard Institute for International Development (HIID), along with Ukraine's Center for Economic Development, Kyiv, and Poland's Center for Social and Economic Research (CASE) and Pultusk School of Humanities, organized a macroeconomic policy workshop.

Macroeconomic issues, in particular those related to fiscal policies, were discussed in the context of recent Ukrainian and Polish experience in post-communist transitions. Special focus was given to the recent world financial crisis and measures to deal with crisis-related problems. The workshop was organized in Warsaw (two days) and Pultusk (five days), on December 6-13, 1998. The seminars were held in Pultusk, a small town 50 kilometers north of Warsaw. They were hosted at the Pultusk School of Humanities, one of the largest private schools in Poland. The participants visited Warsaw for meetings with members of the Polish parliament and government.

Pultusk was a befitting place for the seminar because it is a living example of what changes reforms can bring about. Before the Pultusk School was established in 1994, the town had a depressed economy and a high rate of unemployment. With the opening of the Pultusk School, a purely private initiative, today the town has more than ten thousand students from different parts of Poland and abroad. The school has been the backbone of Pultusk's recovery into a vibrant community. It has recently been ranked the best Polish school in its category.

About forty individuals from Ukraine and Poland participated. They included, senior political leaders, members of parliament, key officials of ministries and other governmental agencies in charge of budget, taxes, social policy, and public debt management. Feedback from the participants indicated that the seminar helped improve their understanding of important fiscal policy issues, policy options and policy instruments. The workshop contributed to capacity building in research, analysis and policy work, establishing close contacts between key policymakers and developing close inter-parliamentary and intergovernmental Ukrainian-Polish relations. It promoted sharing experience and learning standards of different countries concerning fiscal policy issues. As a result of seminar discussion, a package of recommendations in regard to specific Ukrainian policy problems were elaborated and circulated among the policymakers, institutions, and experts.

The topic of the workshop was "Fiscal Policy in a Transition Economy". Many of the current problems of transition economies are related to budget deficit and its financing, public debt management, public sector spending, tax burden, fiscal decentralization. Fiscal stabilization is a necessary, although not sufficient, condition for successful market reforms and growth. Improvements in fiscal policy should help with external and internal debt, the problem of arrears, foreign trade and investment, stability and growth.

Many international experts from Harvard University, University of Pennsylvania, Houston University, Oxford University, University of Paris-I, University of Frankfurt, Sofia Economics University, CASE (Warsaw), Pultusk School of Humanities, Gdansk University, Ukraine's National Academy of Sciences, the Advanced School of Economics in Moscow, KPMG (Barents Group), and several distinguished government officials and experts from Ukraine and Poland made presentations and led seminar discussions. This book is a compilation of the papers presented during the workshop.

**The contents of the book**

The book is divided into three sections. Part I consists of four chapters, which examine the institutional framework of macroeconomic policy, and deal with institutional development, virtual economy, and the importance of the policy variable and of democracy in the success of the reform efforts. Part II contains seven chapters, which are concerned with fiscal reform issues including tax reform, agricultural taxation, budget deficit and debt, local governance and fiscal decentralization. The seven chapters in Part III focus on managing fiscal instability and financial crises and make high public expenditure, demonetization, monetary emission, increasing public debt and budget deficit as their flash points.

**Part I: General concepts**

Chapter 2, by **Herbert Levine and Janusz Szyrmer**, presents general concepts of institutional development, legality and law enforcement, and fiscal policy in transition economies, mainly in Russia and Ukraine, using the basic principles of new institutional economics (NIE). The authors consider the linkage between institutional development and the low level of collection of taxes in Russia and Ukraine. In the soviet economy, market operations, though institutionally constrained, were widely practiced through a pervasive system of black/gray transactions, bribes and corruption. Bribes flowed up the party and state hierarchies. Since virtually everyone was behaving illegally, the system of corruption became quite stable. The bribes formed the protection money that was necessary for conducting business. With the collapse of the Soviet Union, the communist party lost its monopoly and the state emerged in a weak condition. Into the vacuum created by the breakdown of the soviet system of informal payments, came private suppliers of protection and the service related to contract enforcement. This reliance on organized crime groups, the Mafia groups, for protection and contract enforcement has led many firms to operate underground. This deprives the state of tax receipts, which raises the tax burden on legitimate businesses, leading, in turn, to some of them going underground.

Looking at the fiscal motivation for barter transactions, Levine and Szyrmer argue that barter has low transparency and, thus, allows much greater opportunity for tax evasion. Value decreasing firms can enter into mutually beneficial barter transactions with value adders. The value decreasing firm obtains an in-kind subsidy by getting a higher price for its output than is really acceptable by the open market. The value adder reduces its tax liability by showing higher costs.

In Chapter 3, **Paul Gregory** discusses Ukraine's transition to a chronic disequilibrium and a virtual economy. He maintains that, on the one hand, Ukraine's capacity to produce soviet-type goods diminished because it was cut off from traditional suppliers; its lack of ability to produce market-type goods, on the other hand, is due to weak marketing skills, low (and badly allocated) investment, and low resource flexibility. The virtual economy is designed to mask the decline in output of the soviet-type sector, and to discourage the re-allocation of resources toward the market sector. The virtual economy is also characterized by corruption via payoffs to political leaders for rights to allocate privileged status. An attribute of the virtual economy is its ability to deceit – its external appearance as a much larger economy than it really is. This deceitfulness is enabled by subsidies, planned budget revenues and expenditures at a high unrealistic level, and state directed credits, state manipulated deliveries and purchases. Its unusual features are the use of price controls, non-payments of wages and materials, barter, and the use of other kinds of "payments" in a non-monetary economy. The institutions that make market allocation work in mature market economies are not available in the virtual economy. Laws and contract enforcement mechanisms are lacking, credit markets are weak and operate at high real interest rates, the tax regime imposes prohibitive marginal tax rates, and barter and non-payments conceal true production costs incurred by the enterprises. The continuation of soft budget constraint means that demands for industrial materials are exaggerated relative to demand in a profit-maximizing economy. Gregory concludes that Ukraine can escape from this state of disequilibrium only by significant reform of its institutions.

Chapter 4 provides an insight into the development of democratic institutions in different transition countries that helps us to understand the underlying willingness for economic reforms in some of them, or their absence in others. **Krzysztof Ostrowski** observes a divergence in the mode of governance in different countries, primarily in the differences between the parliamentary and the presidential systems. The parliamentary systems in Bulgaria, Czech Republic, Hungary, Lithuania, Poland, Slovakia required building coalitions. This system proved to be effective in guiding major reforms in these countries. The transparency in this system is high and the opposition is able to monitor the political process and point out mistakes in governmental policies. The presidential system in Russia, Ukraine, Romania, and Central Asian countries, on the contrary, makes the role of parliament either ineffective or decorative. The parliamentary control over presidential executive powers is fairly limited. The party groupings are based on their loyalty to the president. The pattern of decisions is not transparent and political careers depend on evaluation by inner presidential circles. Reforms have been hampered by the influence that oligarchs have on the inner circles of power. Ostrowski concludes that these trends have led to a new division in the post-communist world. On one side of the division line, there are growing economies of the Baltic countries, Poland, Slovakia, Hungary, the Czech Republic, Slovenia, and Croatia. On the other side, there are the declining economies of Russia, Ukraine, and a few other former soviet republics.

In Chapter 5**, Janusz Szyrmer** looks at the relationship between policy making and growth in transition economies. In standard economic models, growth is generally shown as a function of labor, capital, and technology. The technology is the focus of the endogenous models, where growth is both the cause and the effect of technological progress. Recent studies have shown that successes and failures in economic growth and post-soviet transition depend primarily on the policies practiced by particular countries. The author views policymakers as macro-engineers who “produce” growth, stability, and prosperity in their countries. Good policies support growth, and bad policies result in economic decline. Growth supports good policies. Decline supports bad policies.

Szyrmer organized the transition economies into several groups and analyzed their growth pattern from 1990 to 1998 in the context of economic policy. He observed that most transition countries experienced their largest annual declines of output in 1991-92. Ukraine had its largest decline in 1994. In all these countries but Ukraine the recession lasted for a few years and ended with growth. The shortest recession, lasting two years, occurred in Poland. The author argues that countries where market reforms were deeper and more radical (such as Poland and the Baltic states) have come out the strongest in terms of economic growth.

In Ukraine (and also in Russia), instead of fundamental market reforms and transparent economic policies, various idiosyncratic tricks have been used to “help” the economy. This way, the gradual transition to a new unspecified “no-system” system has been occurring. Governmental policies, consisting of redistributing income away from profit generating enterprises to loss generating enterprises, have undermined both kinds of enterprises. These measures, combined with a pervasive softness of budget constraints and weak contract enforcement, significantly contributed to the so-called virtuality of these economies. If the lack of transparency reaches a “critical mass”, i.e., if the economy becomes “predominantly” non-transparent (“virtual”), it loses its capacity to grow. The low official budget deficit in the face of rapidly growing barter, arrears, and non-payments, create a peculiar situation in which, for instance, taxes are officially being collected, yet the taxpayers do not have to pay. This is a result of the phenomenon of “mutual cancellations”. The list of this kind of paradoxes is long and impressive.

Chapter 5 has important policy implications for Ukraine. The longer the policymakers delay the introduction of fundamental reforms, the weaker its economy becomes and the higher the cost of reforms will be. Partial reforms or unbalanced reforms (many of which have been sponsored by the donors) tend to hinder rather than stimulate the growth. In particular, macroeconomic stabilization without micro-level restructuring brings economic decline rather than sustained growth.

## Part II: Fiscal and budget reforms

In Chapter 6, **Viktor Pynzenyk** traces the failure of the Ukrainian government to achieve fiscal discipline or to carry out meaningful reforms. He emphasizes that without structural reforms and changes at the micro-level, financial stabilization proved weak and shaky. The policy of granting support to unprofitable, non-competitive producers consumed the profits of the normal market-based sector. The government granted subsidies by writing off or restructuring tax arrears, tax exemptions, and providing privileged credits. These credits are rarely repaid, thus imposing a heavy burden on the budget. Under such conditions, the hope to arrive at the level of budget deficit set by the IMF, without reducing spending commitments, inevitably led to increased budget arrears, especially wages, pensions, and other social benefits. Administrative control on the exchange rate in 1998, and the government's attempts to regulate prices, led to a substantial decline in economic activity. Pynzenyk concludes that fiscal stabilization needs to be introduced simultaneously with structural reforms. Without structural reforms, financial stabilization would be a misleading illusion, providing politicians with room for political maneuvering.

In Chapter 7, **Khwaja Sultan** appraises the indecisive tax reform efforts in Ukraine. Because of fiscal pressures during transition, tax reforms should be a logical priority for ex-communist countries. This has not been the case in Ukraine. Unlike in Poland, the Baltic states, Hungary, and recently Bulgaria, reforms in Ukraine have been tried without strong commitment and for extraneous reasons (e.g., to fulfill IMF conditionalities in order to get the loan). Such reforms can hardly succeed. Sultan discusses the haphazard legislative efforts and backtracking in reforms concerning the value-added tax, corporate tax, personal income tax, and local taxes. He points out that the fiscal burden in Ukraine is not only high but also unevenly distributed, with the legitimate market-oriented sector paying the bulk of the taxes, while the shadow segment and the "soft" segment paying very little tax. Sultan argues that, for a more efficient distribution of the fiscal burden, Ukraine should widen the tax base, remove most exemptions and increase the relative contribution to the budget of indirect taxes. These taxes should be imposed especially on those goods that are purchased predominantly with the shadow income, i.e., the untaxed income from transactions in shadow economy. Passenger cars, automobile services, and gasoline are good examples of such goods. The increase in revenue from indirect taxes can help reduce the pressure from income and payroll taxes in the official economy and stimulate the shift away from the shadow. Also high-handed measures of the tax administration, such as the *kartoteka 2*, that drive firms into the shadow economy, should be abolished.

Chapter 8, by **Evgeny Gavrilenkov**, examines the mismanagement of public finances in Russia and draws some lessons for Ukraine. The Russian experience shows that tight monetary policy alone cannot guarantee economic success. Issuance of short-term government securities could be as inflationary as printing money though its effect on prices may be delayed. The author argues that fiscal correction and stabilization, are key steps in attaining sustainable growth. Financial stabilization in Russia was short-lived due to a massive inflow of foreign capital that penetrated financial markets, but never reached the real sector. Weak enterprises and a weak banking sector along with weak government are the main causes of the fiscal problems in Ukraine and Russia. Firms could not borrow money due to exorbitantly high interest rates. Interest rates remained high due to high level of government borrowing. Firms (with little access to bank loans) avoided paying taxes, forcing the government to borrow yet more money to cover the fiscal deficit. This has created a vicious circle that has not been broken in Russia. Arrears and capital flight have become other pressing problems for the Russian government. Gavrilenkov demonstrates that cumulative capital flight from Russia has been very close to the stock of tax arrears and non-payments to social security funds. Administrative controls to prevent capital flight can have little success if not supported by a proper legal environment, institutional support for macroeconomic policies and reform of the tax system.

Agriculture gets one of the most favored treatment by the government in the form of tax exemptions, tax forgiveness, and subsidies. In her essay in Chapter 9, **Carol Leonard** evaluates the newly instituted Unified Agriculture Tax (UAT), which gives special tax treatment to this sector, and illustrates how distorted markets affect tax dynamics. The evaluation is based on the following criteria: tax neutrality across sectors, the impact on production and consumption decisions and on factor markets, the effect on the public sector, and the effect on transition conditions. In transition economies, tax incentives have different effects than they would in market economies. Taxes interact with features of the former communist economic structures that are not yet dismantled (i.e., soviet-era soft-budget constraints; state ownership and controls; and barriers to entry, to exit, and to labor mobility).

In Ukraine, although the government officially claims it supports agriculture, its (badly designed) subsidies and tax exemptions are counterbalanced by the implicit taxation that is enabled by the government's micro-management of the grain market, and that of storage and distribution of grain. The hidden taxation is built into the still operational state procurement system and administrative price controls. By replacing different taxes and fees on agricultural production with a single tax, the UAT, the authorities claimed they wanted to "encourage agricultural production". Leonard assesses the potential costs and effects of the new tax within the context of the entire economy, particularly the effects on foreign trade, on the tax system, on production and consumption decisions, on factor markets, on the budget, and on contract enforcement. She maintains that, in general, the decision to introduce any special tax measure for one sector, such as UAT, must be considered in a broader context of the effects of this measure on the entire economy, given the institutional features of this economy. In Ukraine, such a measure should primarily aim to reduce abnormalities created by arrears, barter, shadow and corruption, and should help bring the fiscal system in line with world practice.

The next three chapters, 10, 11 and 12, emphasize the economic and political benefits of decentralization. Decentralization, if well designed and enforced, would improve the efficiency of resource allocation between the private and public sector, as well as the allocation within the public sector. It enables citizen-voters to be more effectively involved into the fiscal decision making process and to directly participate in deciding as to the volume and type of taxpayer supported services. In Chapter 10, **Henry Teune** explains the essential features of local self-governance and its relationship to macroeconomic policies. In a democracy, the local self-government should possess legal competencies, legitimacy, and resources. It must have unchallenged transparent rights to enact laws, be accepted as the leading institution to achieve publicly endorsed values, and have the capacity to generate funds from the local sources. Teune also examines the optimal size of the local polity unit. The local self-government must be small enough for the sake of social cohesion, yet large enough to have the capacity to be able to effectively address important local issues. The author emphasizes that instead of being an agent of a higher-level government, the local self-government should be an autonomous entity empowered to enter into horizontal relations with its immediate neighbors.

**Wayne Thirsk**, in Chapter 11, explains the essential features of a decentralized fiscal system. In this context he examines the current status of fiscal decentralization in Ukraine and provides specific recommendations as to systemic changes necessary for improving this system. Developing a sizeable source of own revenues for local governments and a stable and transparent system of intergovernmental transfers are essential. The author compares decentralization of the public sector to privatization of state-owned enterprises. Just as privatization forces enterprises to be more responsive to the market, fiscal decentralization makes the government more sensitive to the demands of citizen-voters. Both replace a supply-driven command economy with a demand-driven system that is sensitive to people's needs and preferences.

In Chapter 12, **Wayne Thirsk** discusses the basic objectives of intergovernmental fiscal reform and addresses a number of important questions, such as: what should be done to develop a significant marginal revenue source for local bodies; how should the investment needs of local governments be met; which level of government should be the grant unit – oblast or rayon; what kinds of minimum standards are needed in Ukraine; and what needs to be done to improve efficiency of the existing social safety net? The author also examines the importance of regional differences in expenditure requirements. Finally, he explains the mechanism of two alternative formulas for central subventions to local authorities.

## Part III: Managing fiscal and financial crises

In Part III of the book, specific problem areas in the economy that could potentially lead to financial crisis are discussed. Except for one essay that discusses the global financial crisis of 1998 and its impact on the Bulgarian economy, the others focus on Ukraine.

In his short essay in Chapter 13, **Vladimir Lanovoy** analyzes the actual amount of budget deficit, which includes items not considered in the official budget deficit figures. For instance, prior to 1996, the Pension Fund was in surplus; since then, it too has a deficit, which the government fails to finance. Then, there are deficits of other extra-budgetary funds, and arrears, which are government's liabilities. According to Lanovoy, the actual budget deficit (speaking about draft Budget 1999) is likely to end up being several times higher than the officially approved deficit. The author emphasizes that government's obligation to execute the budget is stipulated by the Constitution of Ukraine. Balancing the budget would require active microeconomic reforms, including liquidation of loss-making enterprises, active encouragement for competition, extensive privatization, and reforms of the tax and budget system. This would require formulation of a surplus budget, policies leading to the positive foreign trade balance, implementation of a program of conversion of short-term state debts into long-term securities, and stimulating a large inflow of foreign capital.

In Chapter 14, **Viktor Lysytsky** argues that excessive consumption by public authorities is one of the key factors for the economic decline in independent Ukraine. Public consumption, which was high in the erstwhile Soviet Union, continues to be high even after Ukraine's independence. Between 1990 and 1997, public consumption grew three times faster than household consumption. Significant increases in the share of taxes in the gross value added left little room for economic adjustment within the official economy. Lysytsky recommends that a significant reduction of public consumption commitments should become the main priority for the macroeconomic management of Ukraine in the coming years.

Chapter 15 examines the degree of monetization in transition economies, which is often low, and answers the question whether arguments made in some quarters for printing money is reasonable. **Gerard Duchene, Apostolos Papaphilippou and Alexei Sekarev** argue that, in Ukraine, the opportunity cost of holding hryvna is related to its erosion due to inflation and currency depreciation. The monetization level is not abnormally low, when a narrow money aggregate M1 is taken. This level stems from structural characteristics such as a weak banking system, a high level of barter transactions, inter-enterprise arrears, high level of dollarization. Without a change in these characteristics, a significant monetary emission will result in a severe inflation. Inflation, in turn, will have adverse social and economic consequences. It would hit the hardest the poorer segments of society. The solution, according to the authors, lies in tackling the fiscal imbalances and structural distortions of the Ukrainian economy that cause low monetization.

**Ihor Zhylayev** investigates the different “zones” of the demonetized economy (DME) in Chapter 16. These include barter, mutual settlements, arrears, money surrogates, promissory notes, corporate and regional money substitutes, and tax write-offs. Zhylayev emphasizes that DME is a systemic phenomenon and can be liquidated only as a system. When fiscal authorities prohibit selling below cost, and reducing cost to equilibrium level becomes impossible, the only way out for economic agents is to use DME. Zhylayev stresses that instead of authoritarian measures to collect taxes and end tax evasion, which further aggravate demonetization, policy measures should aim at creating right incentives for producers to move out of the DME.

Like Lysytsky, **Miroslaw Gronicki**, in Chapter 17, reiterates that the financial crisis in autumn 1998 was the result of irresponsible fiscal policies and slow process of structural reforms. There is little political will to introduce painful decisions that would reduce public spending, widen the tax base, or remove bureaucratic controls over the economy. Gronicki examines the microeconomic foundations and the macroeconomic causes of the financial crisis, and compares the Ukrainian situation with that of Poland. In Poland, one of the initial successes of reform was the creation, in a very short period, of over 2 million small firms, which cushioned the effects of lay-offs in the state sector. In Ukraine, small and medium size enterprises have practically been negligible in the official sector. The major macroeconomic cause of the financial crisis was inconsistency between monetary policy and fiscal policy. Without painful but necessary changes in its fiscal policy, things are unlikely to improve. This should be a first step in consistent reforms. Simultaneously, deregulation to allow freedom of entry and exit for small and medium businesses is especially important. Gronicki cautions that restructuring may initially decrease GDP even further and increase inflation. But this simply means that unwanted goods, often traded in barter, would be replaced by goods of better quality and market value. Price adjustment may cause some pain but is necessary for establishing proper relative prices and removing implicit subsidies.

In Chapter 18, **Marek Dabrowski** argues that the main reasons for the financial crisis in Russia and Ukraine in autumn 1998 were the persistent budgetary crisis and slow structural reforms in both countries. Failure to correct them prevented economic growth, which contributed to the crisis. He emphasizes that neither the Central Bank in Russia (CBR) nor the National Bank of Ukraine (NBU) undertook monetary base sterilization, through reduction of the net internal assets, when capital inflow and currency reserves were growing due to T-bill purchases by foreigners. When currency reserves started draining out, the central banks began to fill in the money base with additional domestic credit. The NBU resumed large-scale financing of budget deficit through purchase of domestic T-Bills on the primary market. Dabrowski suggests normalization of the currency market and removing the administrative controls that were then in place, restructuring of T-bill liabilities, achieving zero-deficit budget, and launching of large-scale cash privatization as measures that would help normalize the situation. He advocates return to the free-floating hryvna, which until late 1999 was held within a currency corridor.

In Chapter 19, **Rumen Gechev** explains how the financial crisis of 1998 affected Bulgaria. In both Bulgaria and Ukraine, most investments were short-term portfolio assets, which were sold by the governments at high yields because of the risky environments in both countries. When the crisis started, many of the foreign portfolio investors left. Healthy exports could have assuaged the situation, but exports were not picking up because of difficulties in adjusting to new market conditions, the slow progress with structural reform, and the collapse of COMECON. A drop in the world prices of ferrous and non-ferrous metals and chemicals further added to the problems for the transition countries that relied heavily on these items of exports. Delay in privatisation has worsen the situation, because, after a few years, most of these state-owned companies would become practically impossible to sell due to the large amount of accumulated debts to suppliers, banks, and the budget. Gechev argues that privatisation is the key component of economic restructuring. Privatization is the sole means that can attract substantial foreign investments and generate cash inflows for the state budget. The experience of Bulgaria has shown that simultaneous implementation of both the financial stabilisation mechanisms and structural reforms is of crucial importance. Both are necessary at the same time. Bulgaria and Ukraine need to undertake large scale and dynamic structural reforms in all sectors in their transitions to modern market economies.

**Conclusions**

There is plenty to do and still a long way to go. Ukraine will have to abandon a pervasive wishful thinking in its policies, stop mixing dreams with reality, forsake its unrealistic budgets, the commitments that cannot be fulfilled, and unaffordable comforts of a welfare state. It has to face all the pains of a hard budget constraint imposed on the state and its institutions, on enterprises and households. It must introduce harsh financial discipline, enforce contracts, secure an effective protection to property, forbid (even criminalize) arrears and nonpayments of wages and other liabilities, cut subsidies, abolish most of current tax exemptions and other privileges. It has to close down loss making enterprises. It must learn to live with a much higher level of unemployment (at least for some time, until a dynamic growth enables the absorption of labor force into an efficient modern economy).

Ukraine should open up its economy, both internally and externally. It should do away with its powerful oligarchic groups and cartel-type organizations that share controls over the society and economy by segmenting it into a network of semi-autonomous fiefdoms. It must demolish old soviet-type “vertical links” within the societal and economic structures and replace them with strong “horizontal links”. It should enable and support grass-root activities that permit democratic institutions and market to operate. It has to tear down numerous barriers that protect inefficient producers and corrupted officials and expose the entire economy to a fair market competition. Healthy growth is not possible without a certain minimum level of lawfulness and fairness, of economic and institutional transparency, consistency, safety, and predictability. The state must provide a secure protection and support for all investors and producers, not only those who are dearest to the authorities. The principle of equal opportunity lies at the core of a market democracy. At the same time the state must get over its harmful inclination to micro-manage the economy.

Several important and useful ideas emerge from the various chapters of this book. One is that fiscal stabilization cannot be achieved without deep structural reforms that would cure the weak micro-foundation of the economy. Postponing the reforms, and creating appearances of stability (for instance, by maintaining administrative prices and exchange rate controls), weakens the economy further. The government has to live within its means. This would imply carefully selecting expenditures that need to be reduced. The fiscal burden has to be reduced to a level that is close to the revenue capacity of a country with per capita GDP of about USD 600. Without fiscal corrections and structural reforms, the problems of arrears, barter and mutual cancellation will be difficult to eradicate. Example of Poland and other transition countries shows that the governments that formulated good macroeconomic policies and took the lead in ambitious programs of restructuring and privatization are now reaping the reward for their efforts. By fostering market institutions, these countries continue improving their international ratings, which helps attract foreign investors. The magnitude of challenges that Ukraine faces is great. The workshop in Pultusk provided a forum for discussion about the tasks that lie ahead.

Until now we have witnessed too much pretense, too much Patyomkin village effects, and not enough real economic reforms. A peculiar game has been played, the “lose-lose” game. Ukraine has pretended that it was doing reforms and the international donors have pretended that they were helping. At the end of this game both sides have been frustrated with each other and unhappy with its outcomes.

Today, eight years after the transition adventure has begun, the obvious task for the Government and the donors is to take advantage of the existing ample experience. Especially we should learn from the previous mistakes of Ukraine, and -- even better – from the mistakes of others. Our goal should be to get out of this important but hurtful game with a “win-win” outcome. This book was put together in view toward helping in this task. When Ukraine wins, Eastern European transition wins, and the whole Europe wins.

# 2

## INSTITUTIONAL DEVELOPMENT AND FISCAL POLICY IN COUNTRIES IN TRANSITION

*Herbert S. Levine and Janusz M. Szyrmer*

### Introduction

Arguments, in the early days of transition, in particular in the debates on how Russia, Ukraine, and other FSU countries should be proceeding focused on the issues how they are different. How do we really take into account national differences? All countries are different, some more different than others; and that is a problem. The way to look at these differences and to use them in some serious analytical work has escaped economists for a long time. The issue of how useful neoclassical economics is, with all its assumptions about perfect market, perfect information and rational human behavior, in analyzing real economies, has come to the fore in the development of new institutional economics. Old institutional economics tried to be a subject of study all by itself, just institutions. New institutional economics tries to embed some institutional elements within the rich analytical tools and, within some abstractions, patterns and models, of current day economics.

This paper attempts to present some thoughts on institutional development and fiscal policy in transition economies by looking at the basic principles of institutional analysis as developed by Douglass North (North 1993). The idea is to show how this approach could be applied to two particular experiences, primarily, in Russia and Ukraine. We will look at some aspects of legal institutions and legality, and then at some aspects of corporate governance institutions, as they appear currently in the backdrop of the virtual economy.

### Institutional constraints

Let us look first at some of the basic principles of institutional economics. As Douglass North sets up his approach, he defines institutions as the rules of the game, as humanly designed constraints that structure human interrelations. Why do people need these constraints? Because, the number of decisions that have to be made approach infinity, and the information that is required to deal with it is, even today, not easy. To formulate and model this information to the extent that it is useable is a difficult game. So, constraints are set up.

Some constraints are formal, e.g., laws. If you are driving an automobile, and you are approaching an intersection with a red light, you are supposed to stop. You may look both ways and see that there are no cars coming, but still you are supposed to stop. And most of us do this. There are also informal institutions with constraints. The informal ones are perhaps equal, if not dominating, the formal ones, in terms of how they affect transition economies. The informal institutions are the norms and belief systems that all societies live by. Accepted behavior and unaccepted behavior are not codified in law, but in most legal systems have the strength of law. According to North, these constraints on human behavior define the incentive structure of the economy. Incentives that drive human beings to behave in certain ways come from interrelations of institutional structures, both formal and informal, and their enforcement characteristics.

Furthermore, if the institutions are the rule of the game, then organizations are the players. Organizations can be in the economy or in the society. In the economy, organizations are firms, enterprises, labor unions, etc. In the society or the polity, they can be political parties, other groups, universities or hospitals. These are all organizations that try to maximize their objectives within these institutions.

The development of this approach was done, initially, by economic historians like North himself. They were looking at a long expanse of time, and they could leisurely examine how institutions have changed. What we are interested in, however, is how transition economies adopt the institutions of the market economies and how do people, in dealing with informal norms, learn and accept different types of behavior.

**Changes in institutions**

Benjamin Franklin talked about the norms of behavior of Americans in the phrase: “A penny saved is a penny earned.” In the development of the US economy, people had to forget about this dictum. They learned that spending is good for the economy, and certainly good for firms, who produce goods and want to sell them. So, over a period, people learned how not to save.

How do institutions change? Primarily, they change when organizations find that the current institutional structure restricts their ability to achieve their goals. In the economic sphere, it could mean to increase their wealth. Institutions change when the organizations act upon this knowledge or belief, that new institutional arrangements would be better for them in achieving their goals. For example, formal institutions were changing when the creation of limited liability companies was permitted by law. Partnership firms observed that, with new technology that was coming along, profit opportunities lay in greater capital intensity of the production process. So, they pressed parliaments and governments for a change in the laws that would allow them to draw capital from thousands of people and not have these shareholders liable for all the debts of the company. This was, truly, one of the major institutional changes in the development of the market system.

**Institutions in the soviet system**

In this context, it is interesting to look at the issues of legality in the soviet system. Among the major institutional weaknesses the transitional economies of the former Soviet Union face is the poor development of a legal system that is appropriate to a market economy. Enforcement of this legal system is a major hindrance. This is especially so in the fiscal sector, in particular, with respect to the low level of tax compliance.

What are some of the issues that link institutional development to the low level of collection of taxes in Russia and Ukraine. Let us start with looking at the soviet system. While the state, under the soviet system, was the nominal owner of the means of production and planned the economy, it was, of course, people who put the state plans into operation. In the soviet economy, market pressures, though institutionally constrained, made themselves felt through a pervasive system of bribes and corruption. This ranged from the retail clerk selling goods in high demand through the back door, to consumers paying bribes to get to the front of the queue for scarce goods such as housing, and automobiles, to the "*tolkachi*" (literally, pushers) using bribes and connections to acquire vital supplies for their company. There was this whole system of illegal payments outside the formal institutional arrangements. But these bribes and corruption were not haphazard; rather the system was well organized, mainly by the communist party.

The party controlled all the key posts in the soviet economy, and only the party approved candidates who could fill these posts. Holders of important jobs, in turn, aspired for personal enrichment. Bribes and payments flowed up the party and state hierarchies. Moreover, the fact that virtually everyone was behaving illegally, given the formal institutions of this system, helped cement the system of corruption. With the communist party in control of the police and the judiciary, those who played by these informal rules of pervasive payments were protected and those who violated these informal norms could, on occasion, be openly punished by selective enforcement of the law. This corrupt system was widely understood, and for many years was quite stable. In short, the soviet economy was controlled by, what in essence was, an organized criminal syndicate. The bribes that flowed up the party hierarchy formed the protection money or the tribute that was a necessary part of conducting business.

**Institutional changes in the post-soviet period**

With the collapse of the Soviet Union, and the movement toward market reform, the communist party lost its monopoly on executive, legislative and judicial power. Also gone were the coordinating functions in the economy that the party had performed. Furthermore, the state emerged from this collapse of communism in a weak condition. The effects of this were often underestimated. An important factor was the weakening of the police power.

North says that, if the rules within the formal and informal institutions and their enforcement characteristics make it profitable to engage in piracy, then pirate organizations will develop. Looking at it through the prism of institutional development, one can say that, into the vacuum created by the breakdown of the soviet system of informal payments, came private suppliers of protection and of other services that they supplied to their clients. In particular, was the service related to help in contract enforcement. In the post-soviet transition period, reliance on organized crime groups for protection and contract enforcement has led many firms to operate underground. This deprives the state of tax receipts, which raises the tax burden on legitimate businesses, leading, in turn, to some of them going underground.

What had developed, given the existing informal norms, as the practice of side payments, as some economists put it somewhat euphemistically, just transferred itself to the new post-soviet system. Organized crime groups, the Mafia groups, were formed. Obviously they existed before too. The types of corruption that existed in the soviet system have shifted to a market system, in a way that made organized crime more disorganized than it was under the soviet system.

**Post-soviet fiscal system in a virtual economy**

This overt privatization of organized crime has caused damage to the fiscal system. It has resulted from the expansion of the informal institution of organized crime, and the inability of the state in the transition period to provide protection and contract enforcement to private firms. What developed was what economists refer to as a bad equilibrium. People do not pay taxes because the state is weak and cannot enforce laws effectively. In making rational decisions to pay or not to pay taxes, the advantages of not paying taxes just seem to outweigh the disadvantages.

Another example of the development of inappropriate institutions from the point of fiscal policy in the transition economies is to be found in the institution of corporate governance. Clifford Gaddy and Barry Ickes have developed the virtual economy concept (Gaddy and Ickes 1998). They argue that, contrary to expectations, value-destroying privatized firms have been able to survive the movement toward a market system.

When one says value-destroying firms, it has meaning within a certain context. In another context, loss-making firms are firms whose inputs cost more than the value of their output in a market. These firms have been able to survive because of the development of certain practices of institutional arrangements, primarily in corporate governance.

**Fiscal motivations for barter transactions in a virtual economy**

Barter, in the context of the virtual economy, serves several purposes. If money is tight and the arrears are building up, then barter becomes an effective way of doing business, even though, it has high transaction costs. To set any deal in a barter arrangement requires a lot of negotiations, whereas, if you sell it for money at a certain price, it is a lot easier to get the deal consummated. Now, barter arrangement has allowed firms, and not just the loss-making firms, to survive. One of the interesting aspects of the work of Gaddy and Ickes is that barter arrangements have been attractive to firms for reasons other than just the absence of cash. Essentially, a loss making firm, whose product has a value on the market of, say, a hundred rubles, and which costs two hundred rubles to produce, can, in a barter arrangements, say that its product is worth three hundred rubles. The other firm, partner to the barter, will accept that deal for several reasons, including the fact that it helps overstate the costs.

Barter has led to a situation that puts further pressure on the cash in the system. There is not, at these exaggerated values of the loss-making firms, enough real output to be able to pay both taxes and wages.

Let us look at the institutional aspects of this. In the beginning of transition in Russia, and to some extent in Ukraine, the feeling among people who pressed for fast privatization was that it does not matter who gets the initial ownership; that once firms are privatized, the market will force the owners to behave according to market institutions. And if they do not, they will have to sell the firm at high price, if this is a potentially profitable firm. The new owners will restructure it and then will be able to make profits. The argument, initially, was that, what is important is to get the privatization done. When we look at this from a virtual economy perspective, we find that in these surviving loss-making firms, there normally is a strong boss. In many cases these are still the red directors from the soviet days. Their objectives are not necessarily to make profits for the firm but to pursue their own interests. There is developing here the famous agency problem in running corporations, where there is a separation of owners and managers.

In Russia, to a great extent, the owners were insiders in the deals that Mr. Chubais made to get political support for privatization. Given this situation, and given this power that these former red directors had, they were able to pursue their own interests in developing the new institutions with regard to corporate governance. First of all, corporate governance is weak, and owners do not control managers in firms with workers shareholders and government ownership stakes. Often, the management is also a shareholder but its power comes not from ownership but from control of the firm. Minority owners, both domestic and foreign, are often victimized by dilution schemes, transfer pricing, barter and other activities. The weak court surveillance and weak bankruptcy law ensure that creditors have practically no leverage over managers. What happens, obviously, if loss making firms survive, is that there are subsidies being paid, either hidden or open. And often there are open subsidies paid by suppliers and by local governments. Local governments, either through corrupt relationships or employment maximizing considerations (red directors often have a patronizing, protective attitude toward their workers and their jobs), have interests in supporting these firms. Finally the institution of taxes in kind, that government has come to accept, feeds the system.

Furthermore, in barter transactions between firms, there is low transparency and, thus, a much greater opportunity for tax evasion, with its consequent effects on the fiscal system. Value decreasing firms can enter into mutually beneficial barter transactions with value adders, that is, profit makers such as Gazprom. The virtual sector firm obtains an in-kind subsidy by paying in a barter arrangement and gets energy from Gazprom in exchange for a much higher price for its own product than is really acceptable. The value adder Gazprom, in effect, reduces its tax liability by showing higher costs.

**Conclusion**

What is happening is not very shocking. The development of all these institutions falls within the definitions that people engaged in institutional analysis use. The problem is to do this analysis *ex ante* rather than *ex post*. The *ex post* analysis of behavior pattern can give interesting explanations of what has happened. What all of us want to know, however, is what will happen in the future. Institutional economists are beginning to look at these issues: how fast can institutions change, how fast can people learn the advantages of new institutions, etc. Historically, the new institutions are coming because, over time, they demonstrate their superiority in creating wealth and in creating better life for all of us. But how fast can these expectations be realized. One of the few periods in Russian Empire history is the rapid development in the 1890s under von Vitte (Gerschenkron 1965, Mosse 1996). A tremendous amount of learning, at least at the high levels, went on in this period. Ukraine was very much involved in this fast investment in the 1890s. Rapid developments took place in output growth, and in institutional arrangements, including capitalist institutions. How far it went is another matter. These are the issues that institutional economics has to develop to become a truly useful tool in analyzing policies and in analyzing what will happen as different policies are chosen.

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# 3

# THE UKRAINIAN VIRTUAL ECONOMY: TRANSITION TO A PERMANENT DISEQUILIBRIUM

*Paul R. Gregory*

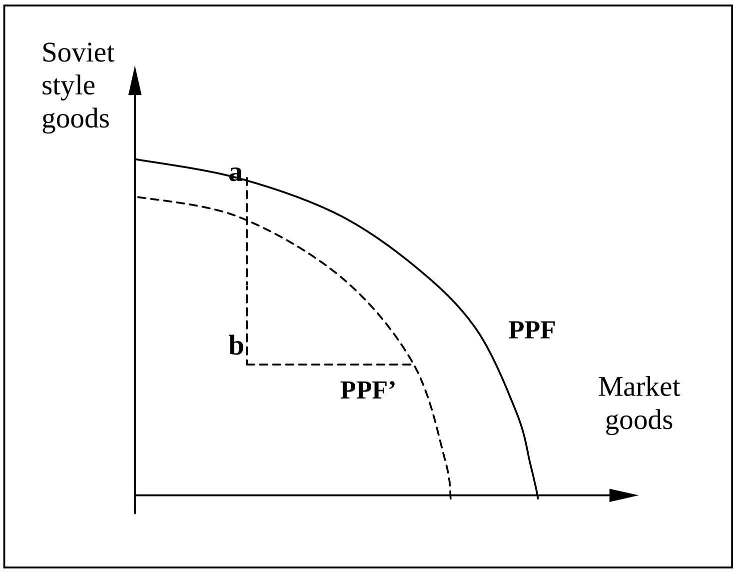
**The transition task**

Ukraine, like other former Soviet republics, faces an enormous transition problem. Ukraine's transition problems are more severe than those of Central Europe due to the following factors:

- Ukraine was part of the "single" market of the USSR.
- Ukraine lacks a political consensus on the goals and processes of transition.
- Ukraine lacks strategic resources, such as oil and gas that would enable it to attract foreign investors.

Ukraine's transition problem can be described in terms of its Production Possibilities Frontier (PPF). The initial Production Possibilities Frontier (PPF) shows (Fig.3.1) Ukraine's production capacities to produce soviet type and market-type goods at the start of transition. Ukraine's initial mix (choice) of output favored soviet-type goods over market-type goods. As Ukraine entered the transition, the desired mix of output shifted in favor of market-type goods and away from soviet-type goods. Also, Ukraine's capacity to produce soviet-type goods diminished, given its industry's energy intensity and the cut off from traditional suppliers in what had become foreign markets. Ukraine's diminished productive capacity is reflected in PPF', which depicts a downward shift in the PPF. Ukraine's capacity to produce soviet-type goods diminished, but it still lacked the marketing skills, new investment, and resource flexibility to increase its production of market-type goods.

Figure 3.1




Joseph Schumpeter wrote about the “creative destruction” of capitalism – the fact that market economies undergo constant change. At any point in time, there are rising industries and declining industries. For an economy to grow, resources must flow from the declining to the expanding industries. Schumpeter recognized that oftentimes resources are slow to withdraw from declining industries due to resistance to change.

Schumpeter did not have to deal with transition problems of the magnitude that emerge in Ukraine; namely, the disruptions caused by large shifts in production technology and tastes. Even under milder conditions, Schumpeter recognized that the uneven pace of expanding and contracting industries and the difficulty of withdrawing resources from contracting industries would lead to business cycles. The movement of output, in such circumstances, would not be along an existing Production Possibilities Frontier, such as PPF’, but a sharp movement to the interior of the PPF, such as from point *a* to *b*.

Thus, during the transition, the contraction of output in declining industries would be greater than the expansion in expanding industries. This is clearly the Ukrainian situation. Although there has been a modest redistribution of resources, basically the Ukrainian economy continues to produce similar mix of output (at least in the official economy), only less than before.

## Creation of the virtual economy

Faced with such enormous transition problems, the Ukrainian and Russian economies have created a new type of system, which threatens to endure. The virtual economy is designed to prevent or mask the decline in output of the soviet-type sector, and to limit the movement of resources to the market sector. It also includes a massive redistribution of income and wealth from the state sector to individuals, who receive ownership and distribution rights to resources in the course of the collapse of the old system. The virtual economy is also characterized by massive corruption via payoffs to political leaders for rights to allocate resources and property as massive rent seeking takes place throughout the economy.

The formal features of the virtual economy are an economy that gives the appearance of greater size via subsidies, planned budget revenues and expenditures, and state directed deliveries and purchases. Its unusual features are non-payments of wages and materials, barter, and the movement to a non-monetary economy. The virtual economy is also characterized by profits being earned via speculative activities and control of monopoly rights with few profits earned through investment in productive activities.

Figure 3.2 shows one source of the virtual economy. It depicts an unregulated natural gas distribution monopoly, which has been awarded to a private owner through monopoly rent seeking. The owner is free to charge the monopoly price (p) and earn a monopoly profit, depicted as the area of the rectangle determined by the difference between price (p) and average costs (ac). Moreover, because this monopolist is receiving many of its revenues through barter and may not be paying for materials and wages on time, it is impossible for tax authorities to determine its profits. Profits may be high if the bartered goods can be sold at high prices in world markets, thereby generating cash revenues that are kept offshore. Through barter transactions, for example, it might be able to state that its price is a lower p’ and its average costs are ac’. In this example, the state loses in two ways: First, it has passed up the opportunity to earn budget revenues through the sale of the monopoly license. Second, it is losing tax revenues due to the concealment of profits.

Figure 3.2

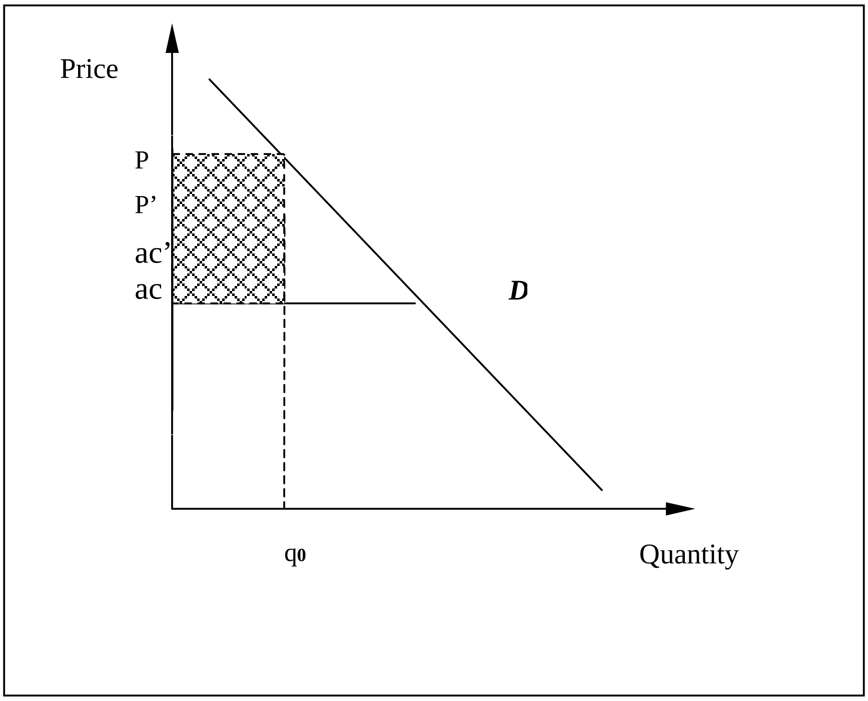



Figure 3.3 shows yet another source of the virtual economy – namely, the use of price controls for speculative profits. It depicts a monopoly supplier (facing a downward sloping demand curve), whose prices are controlled by the state, but set at a low level, perhaps for the ostensible purpose of ensuring enterprises and household consumers access to the product at a low price. If the producer produces at point *a*, its production clears the market at the regulated price, and it loses the opportunity to receive bribes from buyers willing to pay more than the regulated price. If it restricts its production to *b*, however, a consumer willing to pay in excess of the regulated price will be prepared to offer bribes (the vertical distance between the demand curve and the regulated price). The use of price controls to limit production and maximize bribe income creates a substantial vested interest in favor of continued price regulation.

Figure 3.3

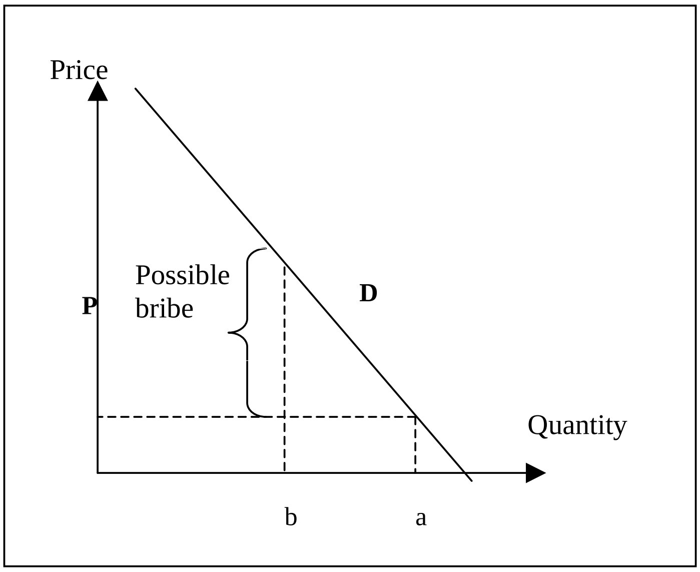
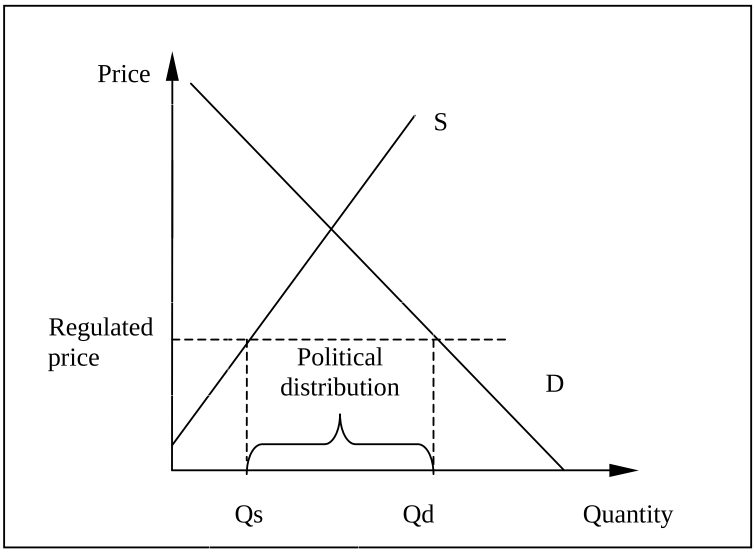



Figure 3.4 depicts a potentially competitive market of numerous producers and consumers (hence, a positively sloped supply curve) with regulated prices below the equilibrium level. In this case, there are more buyers than suppliers, and speculators (who gain access to the product at the official price through political access or bribes) are able to make easy speculative profits by selling to those willing and able to pay in excess of the regulated price.

Figure 3.4



**The balance mentality**

In the virtual economy, there is considerable reluctance to allow the market to allocate resources - to balance supply and demand. The above examples largely involve government price regulation to create the features of the virtual economy. Consider, however, a virtual economy in which there are numerous buyers and sellers operating in unregulated conditions. At first glance, it would appear that resources could be allocated effectively by this economy by allowing the price to settle at equilibrium.

In the case of the virtual economy, appearances are deceiving: laws and enforcement mechanisms are lacking to insure that buyers or sellers fulfill their contract obligations. Credit markets are lacking or operate at prohibitive real interest rates. The tax system may impose prohibitive marginal tax rates. In other words, the institutions that make market allocation work in mature market economies are lacking in the virtual economy. Moreover, the barter and non-payments systems make it difficult to know what enterprise costs are and the continuation of soft budget constraint means that demands for industrial materials are exaggerated relative to demand in a profit-maximizing economy. The maximization objectives of managers of state enterprises are largely unknown. They may operate the enterprise in their own interests (skimming revenues), rather than in the interests of the actual owners.

For these reasons, the political leaders of virtual economies tend to be reluctant to rely on market resource allocation. The administrative “balance mentality” of the soviet period persists. Agricultural producers must deliver to state reserves dictated amounts at dictated prices; energy producers must do the same – thereby undermining the market basis of the economy.

**Solutions**

The Ukrainian economy has become a virtual economy. It can escape from this status only by significant reform of its institutions. It must create an impartial capital market, institutions for real contract enforcement, and a management system that creates shareholder value. It must discontinue price controls and state intervention. It must solve its budgetary deficits so as not to crowd out private investment from capital markets. It must cease acceptance of tax payments in barter and in kind.

Unfortunately, the steps required to end the virtual economy are very difficult; they require the creation of institutions that were developed over long periods of time in mature market economies.

# 4

## ECONOMY AND DEMOCRACY IN TRANSITION: THE CASE OF POST-COMMUNIST SOCIETIES

*Krzysztof M.Ostrowski*

### Democratizing governance

The failure of the communist system raised hopes that the democratic state will introduce efficient and non-bureaucratic forms of governance or even incorporate new institutions. Those analysts, who predicted the end of traditional institutional democracy based on party systems and parliamentary representation, found in early transformations of 1989-1990 a lot of supportive arguments. The basic rules of governance were the same as in established democracies, but the institutional framework was surprisingly different. Broad political movements like Solidarity in Poland, Sajudis in Lithuania and Civic Forum in Czechoslovakia enjoyed popular support incomparable with narrow actions of re-born political parties. Former ruling parties were in disarray. Constitutional arrangements discussed at round-table meetings of the political elite were more effective and tangible than immediate re-establishments of representative systems. The first free elections to the Polish Senate in June 1989, where new Solidarity majority took 99 percent of the seats, raised doubts as to whether, in these new circumstances, an electoral system could protect the rights of political minorities.

However, in a matter of months, it became evident that stability and continuity of democratic reforms must be secured by strengthening traditional institutions with proven record: parliaments and local self-governments. On the one hand, interaction between mass demonstrations and existing centers of power signaled (first in Romania and later in Russia) the danger of new authoritarian repression. On the other hand, popular movements, so effective in dismantling communist system, were too heterogeneous to build stable majorities. Soon they began splitting into several political groups.

The decisive factor in choosing old methods rather than new experiments was the acceptance of free elections as the basic principle for organizing power at the national and local level. Despite rather low turnouts and ineffective electoral laws, the elected bodies became power-holders in Central Europe. After a short duration of "velvet revolutions", the political systems in Central Europe returned to traditional democratic institutions: representative democracy and political parties. Russia and many other countries of CIS have chosen another path: presidential power, based on democratic elections with limited influence of representative bodies and rickety party systems. Nevertheless, in the whole region, elections are competitive, alternative choices do exist and the functioning of the state is under the control and responsibility of the elected officials. Compared to the previous one-party system and *nomenklatura* appointments, the change in the rule of governance was radical and expeditious.

The first phase of transformations in the system of governance was quite similar across the region in terms of basic premises and objectives. However, the implementation of the transformation processes led to a divergence in two fundamental ways: the mode of governance and the level of governance.

The divergence in the mode of governance is observed primarily in the differences between the parliamentary and the presidential systems. The parliamentary systems in a number of countries (Bulgaria, Czech Republic, Hungary, Lithuania, Poland, Slovakia) experienced one or two transitions as a result of competitive elections. These transitions were smooth. In all these countries, there have been no stable majorities. Building coalitions became a regular practice. Coalitions reflect the pluralistic character of governance, in some cases strengthened by cohabitation of a parliamentary majority with a president of a different political orientation (Lithuania through 1998, Poland since 1997). The rights of the opposition got protected.

The parliamentary system proved to be effective in guiding major transformations, although the speed and direction of changes varied along with political programs. The transparency of the parliamentary system is high. The opposition is able to monitor the political process and point out deviations and mistakes in governmental policies. The media are fully operative and accountable, provide reliable information and control over political performance. Two weak points can still be detected.

First, the use of public position for political or private gains has become frequent. This is a phenomenon not unknown in mature democracies, but for the young democracies, still in the process of transition, this political paternalism may become a threat to reforms. It hinders progress in the buildup of an autonomous public service. The old evil of *nomenklatura* returned under new disguise.

The second weakness is the slow progress in the formation of stable party systems. Changing composition of parties and their programs, ad-hoc coalitions, shifts, breakdowns, and purges are quite frequent. For a parliamentary democracy, the absence of a stable party structure is not healthy in the long run. Perhaps, this is unavoidable in the early stages of development.

The presidential systems in the post-communist countries (Russia, Ukraine, Romania, and Central Asia) opt for control, stability, and continuity. A simple set of rules assigns a lot of power to the president, making parliamentary contribution either ineffective or decorative. The parliamentary control over presidential executive prerogatives is fairly limited. The multiparty system is in operation, but is often dominated by groupings that build influence based on their loyalty to the president. The pattern of decisions is not transparent and political careers depend on evaluation by inner presidential circles. The bureaucratic apparatus of the presidency is numerous but neither visible nor identifiable by clearly defined responsibilities. The new *nomenklatura* is in place and getting stronger.

This description may sound grim for advocates of parliamentary democracy. However, presidential systems in post-communist countries are based on competitive presidential elections and enjoy sufficient public support to be treated as legitimate. It seems that this mode of governance is suitable and adequate to the political culture of some of the post-communist countries. An important role of the state is to establish an effective mechanism that, despite all internal and external pressures, is able to maintain conditions conducive to change and development. In this respect, the record of the presidential systems in the FSU countries has been mixed. However, there are signs of evolution of the presidential systems towards more pluralistic regimes: the changes in Albania and Armenia and the continuous balancing of presidential and parliamentary prerogatives in Ukraine.

The mode of governance will remain a crucial issue in judging the performance of the state in post-communist societies. Another test is the level of governance. A centralized state will always try to keep the top level of governance as predominant. A federal state is bound by its own rules to recognize prerogatives of its federal membership. A pluralistic state recognizes the primary importance of lower levels of power. The decentralization of state power is usually correlated with introduction of self-government at the local level. Delegating state prerogatives to local self-governments is crucial for linking state to civil society. The decentralization of power was the declared objective in post-communist transformations, especially in dismantling the soviet system. Although communist state structures originated from the local soviets (councils), which mushroomed before and after the October revolution, the centralized state became soon a sole executor of imperial power. The first step of decentralization was to assess sovereignty and establish or regain new statehood. The logical next step in democratic transformations should be further decentralization down to grassroots levels in order to build power structures bottom-up rather than top-down. The legal basis for such decentralization exists in all FSU countries. The constitution or local government laws stipulate this. However, their implementation has often been slack.

A successful decentralization of power must rely on a combination of three elements: economic resources, political prerogatives, and activeness of the citizens. There is no post-communist country in which an effective combination of these three elements exists. The most successful efforts to coordinate political and economic aspects of decentralization can be traced in Central Europe. The most challenging attempts to link local power with traditional forms of peoples' activeness have been made in Central Asia. In vast territories of Russia, the federal character of the state hampered uniform solution of grassroots power but allowed for diversification along region-specific lines. The decentralization of power became one of the most intriguing attributes of post-communist transformations. This will continue redesigning and modifying the role of the state and of its executive authorities.

## Economic resources and political prerogatives

The Central European transformations link decentralization of power with decentralization of public services. The system of central allocation of resources is gradually replaced by a new system that is based on strong local budgets. In a recent administrative reform in Poland, the primary criterion for establishing second and third level of self-governments was the economic potential and existing infrastructure in new administrative units. The impact of tradition or public preferences was treated as secondary. As a result, the diversity prevailed at the first *(gmina)* level, ranging from rural communities of few thousand people to cities with population of more than one hundred thousand. The relative equalization (in size) of the second level (*poviat*) helps to secure comparable services within the unit of average size of one hundred thousand people. The third level (*voievodship* or region) with population of 2-3 million should be capable of undertaking major development projects. Self-governing prerogatives of the first and second level and the mixed character of the third level should allow to process complex sets of decisions within the representative system rather than confine them to state administration.

In Central Asia, yet another approach is used. The newly born states have recognized traditional entities of communal life as the power base, giving them prerogatives primarily in organizing social life and maintaining order. *Mahallas* committees in Uzbekistan, *maslihats* in Kazakstan, *gengeshy* in Turkmenistan, *jamomad* in Tajikistan differ in their organization and scope of activities but serve similar objectives of establishing links between the people and state power structures. However, most important decisions are still the privilege of state administration. Traditional forms of social organization are not necessarily based on egalitarian and democratic principles and in some instances could be disruptive to state integrity. Further analysis is necessary to assess the performance of these new forms of state organization.

In Russia the basic distribution of power is between two levels: central (federal) and federation units. It is too early to expect decentralization of power down to grassroots level when basic rules of the federation are still not formulated. However, it should be noted that some of the units of federation are already in the process of decentralizing their own still limited power. Some autonomous republics, like Tatarstan and Bashkortostan, try to strengthen local governance in order to buttress their sovereignty within the federation. The same could happen soon in *krays* and *oblasts* supporting decentralized model of federation. Municipal structures in Moscow and St. Petersburg have already developed efficient district administration based on elected officials.

The fact that all, except one, units of federation are governed now by officials selected through competitive and direct elections has a historic significance for the democratic process in Russia. In the first stage of post-communist transformations, the central authorities challenged the local ones by introducing the new office of president's representatives. These offices could coexist for years with heads of local administration preserving a long established mode of top-down governance. The fact that local governors are now elected in a direct ballot has changed the situation on two accounts. Firstly, the federation demonstrates its will to broaden democratic procedures. Secondly, the heads of the units of federation can rely on democratically expressed support of its own electorate. This may soon influence relationships between the federal level and members of the federation.

**People's activeness**

One of the often forgotten attributes of state in post-communist transformations is the support for active role of individuals in all spheres of life: political, social and economical. This role, generally defined as activeness, is key to the success of the democratic process. It would be hard to built democracy without people's support and be useless to introduce democratic institutions against the wishes of the people.

All post-communist societies have different experiences with the state over the last two to four generations. For some, like in the Baltic republics or Moldova, the Soviet state was an aggressor suppressing their identity. For some, like in Central Asia or Caucasus, the joint statehood with Russia was an expression of imperial influence going back to the previous century or more. In both cases, the preservation of national cultures and religious identity became particularly important and stimulated people to take an active position toward their heritage, but not necessarily confronting other functions of the state.

In Central Europe, the twenty-year period between the two world wars was too short to consolidate the state structures emerging from the Second World War. Again, national and religious identity was the core of people's activeness. Most countries of this region witnessed attempts to confront authoritarian state. The dramatic uprising in Hungary in 1956, the peaceful changes in Poland in the same year, the Prague spring of 1968, the strikes in Poland in 1970 and 1976, and finally the birth of Solidarity in 1980 marked the acute confrontation between the people and the state in these three countries. These played a decisive role in the dismantling of the communist system.

The common denominator of these forms of activeness was the ability and readiness of the people to assemble in large numbers, articulate common causes and confront the state. The reaction of the state machinery was always oppressive, in most cases leading to direct use of military force. However, more modest forms of confrontation also existed. Signature campaigns, meetings in informal circles, boycotts of state actions, clandestine publishing became well-known patterns of behavior among intellectuals and students.

The intensity of action differed among the three countries, but the regularity of such actions established elements of civil society that confronted the state using democratic means and objectives. The reinforcement of such civil society resulted in the emergence, in Poland, of organized labor disputes. After wave of powerful strikes, this led to the creation of an independent trade union, Solidarity, having the support of almost ten million members. This base of mass activeness, although cracked by the martial law, re-emerged in 1989, giving a mandate to a non-communist coalition to take over state power. The events in Hungary, Czechoslovakia, and the Baltic republics took a different path but led to the same solution: the activeness of the people was a decisive factor in shaping new democracy through the electoral process. Attempts to confront people by force failed (Prague 1989, Vilnius 1991).

In the FSU countries, the outburst of mass activeness was noted at the time of the coup d'état in 1991. Although world attention was focused on events in Moscow, the mobilization of public support for legal authorities was significant in the major cities of Russia. This indicates that the framework of civil society established primarily within intellectual circles under *perestroika* was sufficient to reach out to the public. Independent media and new parties followed the failure of the coup attempt. However, major political changes including the dismantling of the Soviet state and of the communist party occurred as a result of elite's rather than public action.

As early as in 1992, the right to vote in competitive elections, the right to choose among various political parties and the right to choose the channel of information were the most important features for public activeness. The public reaction was encouraging. High turnout of voters and the rapid growth in the number of non-governmental organizations indicated that people's activeness would become a major factor supporting transformations.

Another form of activeness emerged in the economic sphere. Entrepreneurship was to substitute the weaknesses and failures of the state controlled economy. In introducing the market principles, signs of active participation in building private economy were mostly welcomed. In Central Europe, economic and political conditions were conducive for such results. In Poland, 85 percent of land was in private use and private craftsman sector was always strong. In Hungary, in 1980, 3.4 percent of the economically active population were active in the private sector. Between 1982 and 1990, this rate grew to 11 percent, reaching 20 percent in 1992. In the Soviet Union, private sector was not officially recognized, but it was obvious that substantial part of food and other consumer goods were distributed through unofficial channels. To the question: "would you like to be an entrepreneur" in the public opinion survey, 28 percent of Hungarians, 30 percent of Russians and 32 percent of Poles responded positively[1]. The base for economic activeness was quite strong.

In the process of transformation, the state should not be an obstacle to people's activeness or a target of people's frustration. On the contrary, the state has interest and obligation to promote citizen's activity as legitimate base for state functions. The developments in post-communist societies indicate that this did not happen.

The turnout of voters is sufficiently high to claim legitimacy of the elected bodies. However, in some countries in Central Europe, the turnout figure goes below 50 percent, especially in local elections, while in others, in Central Asia, goes up to 95 percent resembling figures from the past, when voting was an expected act of loyalty rather than expression of personal attitude. The political parties face difficulties in mobilizing support and resources outside electoral campaigns. The non-governmental organizations, even with substantial external aid, do not attract broad interest and support. The trade unions are either strongly competitive or surprisingly quiet and passive. The media in most of these countries remain free and independent but face a hard time to attract public attention. The infrastructure of the civil society seems to be weak and underdeveloped.

[1] Gyorgy Lengyel. *The Spread of Entrepreneurship in Eastern Europe*. Unpublished manuscript, contact szoc_lengyel@pegasus.bke.hu.

**Statehood: protecting the sovereignty and accessing global relations**

For most of the countries of Central Europe, sovereignty was attained by elimination of foreign dominance. For some countries in this region, statehood was redefined, and the federal structure broken (Czechoslovakia). For Baltic republics, achieving sovereignty was equal to return to pre-annexation status. For peoples in the rest of the FSU, and former Yugoslavia, defining sovereignty and establishing statehood was and still is a more complex and more painful process. The base for sovereignty was the federal structure of the states, but the structure of nationalities and the structure of economic and political interests immediately interfered. Tendencies for further disintegration and for immediate unification on redefined federal principles appeared primarily in political programs, but in some dramatic circumstances, such tendencies tore people into armed conflicts.

The concept of sovereignty is already written down into laws in all countries of the region and in some autonomous republics of the Russian Federation. International recognition, including membership in international organizations, established a pattern of balancing aspirations of national groups with aggregated interest of its immediate and distant neighbors. Occasional expressions of unification do not express any significant tendency towards accepting existing arrangements.

Taking into account the complexity of issues, the process of achieving sovereignty was remarkably smooth. As a result, a task of protecting sovereignty became now an important objective of regained or newly established statehood. The traditional way of defending sovereignty by use of force fits neither the present rules of global relations nor the capacity of most states in the region. All FSU countries have cut their military forces drastically, and in case of emergency (like in Tajikistan or Georgia), they have relied on outside aid. It is important to note that this kind of assistance has been provided on the basis of multinational agreements, often with UN presence, therefore without damaging the sovereignty image. Countries of Central Europe choose another approach to security: by joining NATO. However, it is clear that effective protection of sovereignty will be based on non-military means.

Two possible threats to sovereignty can be identified in the region: one embedded in national and religious diversity, the other arising from economic rivalry. The national and religious differences have produced two types of concerns related to sovereignty. In the case of countries with substantial minorities, the threat is primarily internal, but with possible external pressures (the Baltic republics, Central Asia). National and religious identity of the predominant groups has helped to build the image of the state in new entities. This image can be badly distorted in the international community by accusations of intolerance. The state is, therefore, pressed by internal and external queries. The re-focused role of the state in post-communist societies is to regulate national and religious tensions by means of negotiations, conflict abatement, and coalition building. Such a role of the state must be interpreted not as non-partisan mediation, but as defense of the sovereignty. For highly homogenous countries, like Poland, international integration is perceived, in some quarters, as a menace to national sovereignty.

Another threat to sovereignty is related to economic rivalry in global and regional markets. Today, vast parts of the earth are integrated by political, financial, and technological means, reducing the significance of sovereignty. The disputes over the use of natural resources in Central Asia or over the oil and gas pipelines passing through Eastern and Central Europe could serve as recent examples of threats to newly established or regained sovereignty. The FSU states, losing controls over centrally planned domestic economies, must now pay attention to another sphere of influence: international markets.

**Conclusion**

During the last few years, a new division has been emerging in the post-communist world. On one side of the division line, there are the generally growing economies of the Baltic countries, Poland, Slovakia, Hungary, the Czech Republic, Slovenia, and Croatia. On the other side, there are the declining economies of Russia, Ukraine, and a few other former soviet republics. Romania, Moldova, and countries damaged by civil wars in the Balkans and Caucasus remain on the borderline between the two groups. Only deep, consistent, comprehensive, and balanced reforms of Russian and Ukrainian economies will arrest this unfortunate trend among the FSU countries.

Two tendencies can be seen in Russia and Ukraine: first, a growing awareness of the need for reforms, increasing intellectual capacity and the build up of a conceptual “infrastructure” for reforms; and second, growing corruption and crime, declining output, pauperization, social disintegration, and depletion of material resources. It is difficult to predict which of these two tendencies will prevail. The main task of the democratic world should be to provide support for the first trend and to make efforts to restrain the second. This will require rethinking of the role of international assistance, its mechanisms and actors.

# 5

# RELATIONSHIP BETWEEN POLICY AND GROWTH IN POST-SOVIET ECONOMIES: A COMPARATIVE ANALYSIS

*Janusz M. Szyrmer*

## Introduction

In standard economic models, growth is often expressed as a function of labor, capital, and technology (Temple, 1999). Growth is made possible by households' savings that are used for investments into people (human capital), into roads, buildings, and machinery (physical capital), and into research and development efforts (technology). Technology is the focus of the so-called endogenous growth models, in which growth is both the cause and the effect of technological progress (Talalay, Farrands, and Tooze, 1997; Barro, 1998a; Barro, 1998b). Alternatively, the lack of growth is the cause and effect of technological decline.

Recent dramatic events in developing countries and countries, such as the East Asian financial crisis, the Russian crisis, and the economic chaos in Latin America, brought about a new wave of debates on economic policies (Assessing Aid, 1998; Stiglitz, 1998, Sachs, 1999a, Sachs, 1999b, Svensson, 1999). The role of national governments and international financial organizations has been subject to close scrutiny. Recent studies of emerging markets have demonstrated that successes and failures in economic development (and post-soviet transition) can be explained, to a great extent, by countries' policies (Olson, 1996; Gaddy and Ickes, 1998; Woodruff, 1999). Policy focused models are used as a macroeconomic extension of the endogenous growth models. They treat policy as a "macro-technology". The macro production function expresses changes in GDP (aggregate consumption and investment) as an outcome of policy measures. Policymakers appear as macro-engineers who "produce" growth, stability, and prosperity in their countries. Good policy, i.e. good macroeconomic technology, supports growth. Strong growth supports good policy. By the same token, bad policy results in economic decline. This decline stimulates various populist pseudo-measures and endless short-term anti-crisis corrections that cause more crises and more corrections, and more decline.

In this paper, different patterns of post-soviet transition will be identified and briefly analyzed from an economic policy perspective. In the case of former soviet bloc [FSB] countries the relationship between policy and growth seems to be very transparent and robust. I will try to explain the pattern of growth of these countries by looking at their economic policies.

For the sake of this analysis, the FSB countries will be organized into three groups (Table 5.1). Group 1 is further divided into three sub-groups. The analysis does not cover the countries directly involved in civil wars in the Balkans, the Caucasus, and Central Asia. East Germany (which has reunited with West Germany) and Belarus (which has opted for a non-transition variant of reforms) are also excluded from this analysis.

Column 3 (LOW-1) of Table 5.1 shows the year in which a given country had the largest annual decline of output during the transition period (1990-1998) and provides, in parentheses, the magnitude of this decline. For example, Poland experienced its largest decline of GDP in 1990, by 12 percent. Column 4 (HIGH-1) shows the year(s) of fastest growth after the recovery from the transition-related recession. Several countries, after a short period of growth (or low decline), experienced recession again. This second wave of GDP declines is shown in column 5 (LOW-2). Some of the countries managed to recover again and their economies are currently growing (HIGH-2). For example, Bulgaria experienced its greatest GDP decline in 1991, by 12 percent. In the mid-1990s its economy began improving – its growth rate reached 3 percent in 1995. The GDP declined again in 1996 and 1997 (by 10 percent and 7 percent, respectively). Currently Bulgaria enjoys a strong recovery. In 1998 its economy is predicted to grow by 4 percent.

Table 5.1

| 1 | 2 | 3 | 4 | 5 | 6 |
|---|---|---|---|---|---|
| Group | Country | LOW-1 | HIGH-1 | LOW-2 | HIGH-2 |
| 1A | Poland | 1990 (-12%) | 1994-98 (~6%) | | |
| 1A | Slovakia | 1991 (-15%) | 1994-98 (~6%) | | |
| 1A | Slovenia | 1991 (-9%) | 1994-98 (~4%) | | |
| 1A | Croatia | 1991 (-21%) | 1995-98 (~5%) | | |
| 1B | Estonia | 1992 (-14%) | 1995-98 (4-11%) | | |

| | | | | | |
|---|---|---|---|---|---|
| 1B | Lithuania | 1992 (-38%) | 1996-98 (~5%) | | |
| 1B | Latvia | 1992 (-35%) | 1997-98 (~7%) | | |
| 1C | Hungary | 1991 (-12%) | 1994 (3%) | 1996 (1%) | 1998 (5%) |
| 1C | Bulgaria | 1991 (-12%) | 1995 (3%) | 1996 (-10%) | 1998 (4%) |
| 2 | Czech R. | 1991 (-12%) | 1995 (6%) | 1998 (-1%) | |
| 2 | Romania | 1991 (-13%) | 1995 (7%) | 1998 (-7%) | |
| 2 | Moldova | 1994 (-31%) | 1997 (1%) | 1998 (-5%) | |
| 3 | Russia | 1992 (-15%) | 1997 (1%) | 1998 (-5%) | |
| 3 | Ukraine | 1994 (-23%) | 1997-98 (-3%) | | |

*Source: Macroeconomic data base, HIID-Kyiv*

The following observations can be made about the FSB countries included in the table:

- All of these countries had positive rates of growth in the late 1980s (except Romania).
- All of them began transition in the early 1990s. Poland was the first to introduce radical reforms that resulted in a significant contraction of GDP. Poland was followed by other FSBs that experienced their largest annual declines in 1991-92, except Ukraine and Moldova, which had their largest declines in 1994.
- The smallest annual decline of GDP (Table 5.1, column LOW-1) occurred in Slovenia (by 9 percent in 1991); the greatest annual decline of GDP occurred in Latvia and Lithuania (by 35-38 percent in 1992).
- For all the countries but Ukraine, the recession lasted several years and ended with growth. The shortest recession occurred in Poland (2 years).[1] The longest recession was experienced by Russia. It lasted seven years, from 1990 to 1996. In Ukraine, during the 1990s, there has been no single year with economic growth. The decline is predicted to continue. Ukraine's high point was the year 1997 when GDP shrunk by only 2.6 percent. The fading of the economies of Russia and Ukraine is unprecedented in modern history. Apparently, the economy of no other country in peacetime has ever declined that much.[2]

[1] The commitment of its Solidarity-led government to economic reforms explains this shortness (Balcerowicz, Blaszczyk, and Dabrowski 1997).

[2] It must be emphasized, however, that there are great methodological difficulties in measuring GDP of FSB economies. One can argue that the GDP in the late 1990s is a different GDP from that of the 1980s. Since we lack a "common denominator", the estimates of GDP changes are likely to be loaded with a significant measurement error, or simply ruled unmeasurable.

### *Group-1*

Group-1 is composed of countries whose economies are currently growing. In this group Estonia is believed to possess the strongest economy, in which market reforms are more advanced than in other countries of the region. This year, the GDP/capita and average wages in Estonia are expected to be twice as high as in Russia and four times as high as in Ukraine. Despite high social and political costs, the Estonian government has implemented, with remarkable determination, an ambitious program of enterprise privatization and restructuring. Estonia, along with the Czech Republic and Slovenia, enjoys relatively high grades for its credit and investment opportunities granted by international rating agencies (Standard & Poor's, Moody's, and others). This rating helps in attracting investors. Its foreign direct investment per capita is among the highest in the region. Its currency is stable. Its foreign debt remains low.

During the next several years, all countries in Group-1 are expected to maintain their current growth rates (5 percent or higher) except Slovakia that seems to have the weakest economy in this group (*Table 5*.2). It is the only country in Group-1 whose growth rate is likely to decline. Slovakia did remarkably well after its "velvet divorce" with the Czech Republic. Despite gloomy predictions, its economy performed better than the Czech economy. Both suffered from "abuses" by the populist policies of their strong leaders – Vladimir Meciar and Vaclav Klaus. After several years of fast growth, the Slovak economy has begun displaying signs of over-heating. Recently, S&P, the rating agency, has downgraded Slovakia from a low investment grade to a speculative (non-investment) BB+ grade and classified its economy as one with "negative outlook". S&P blamed the Meciar government for irresponsible policies and lack of fiscal prudence. Its fiscal deficit and current account deficits are high. Its indebtedness is rapidly growing. So far, the new Slovak government has failed to offer a trustworthy program of reforms.

Table 5.2

| Indicators | Slovakia | | Estonia | |
|---|---|---|---|---|
| | 1997 | 1998F | 1997 | 1998F |
| GDP, % change | 6.5 | 4.0 | 10.6 | 4.0 |
| Private investment, % change | 10.0 | 6.0 | 15.5 | 16.9 |
| Budget balance, % of GDP | -6.0 | -10.0 | 2.2 | - 0.3 |
| FDI/capita, stock, $ | 170 | 260 | 800 | 1000 |

| | | | | |
|---|---|---|---|---|
| Foreign debt/capita, stock, $ | 2,000 | 2,200 | 260 | 260 |

*Source: Macroeconomic data base, HIID-Kyiv*

Subgroup-1A includes countries that started reforms early (in 1990-91), and whose economies have been growing for several years: Poland since 1992, Slovenia since 1993, Croatia and Slovakia since 1994.

Subgroup-1B includes the Baltic countries that began reforms later than the countries in the previous subgroup. Their economies began growing in 1995-96. The painful process of de-linking from the former Soviet economy and implementation of radical reform programs caused a recession that lasted longer and was much deeper than that in the countries of Subgroup-1A. The initial conditions of the Baltics were similar to, but much more difficult than those of Poland and former Czechoslovakia. Their economies suffered from the gloomy soviet heritage: complex political and national problems, devastated natural environment, lack of private sector, destabilized economy, large loss making industrial enterprises, inefficient and highly energy intensive production (fully dependent on energy imports from Russia), lack of banking and very weak service sector. Yet, consistent reform efforts of the Baltic countries have begun bringing fruits. Most economic indicators for these countries are good. Macroeconomic and exchange rate stability is supported by strong foreign direct investment. Consumption and domestic investment are growing. Average wages, in dollar terms, have increased from a two-digit level to the $200-300 range and are growing. Many economists believe that the Baltic countries will become the fastest growing group during the next few years.

Subgroup-1C includes two countries – Hungary and Bulgaria. These two countries, after a short period of growth, suffered from a “mid-transition” crisis. Bulgaria experienced a sharp GDP decline (1996-97), and Hungary experienced a significant slow-down (1995-96). In both countries, there occurred an increase in inflation and unemployment, sizable currency depreciation, and loss of foreign exchange reserves. In both countries, the crisis was caused by the weakness of their banking sectors and low fiscal discipline. Both countries inherited, from their pre-transition communist governments, high foreign debt - $1300/capita (Bulgaria) and $2100/capita (Hungary). This debt had to be serviced during a difficult period of early post-communist transition.

The debt service and high costs of social safety nets resulted in high fiscal deficits. Between 1991-95, the average annual budget deficit for Bulgaria was 6.4 percent of GDP while for Hungary it was 6.1 percent of GDP. Hungary was better positioned to finance this deficit because it managed to attract foreign investors from whom it cashed in almost $20 billion. In order to fix their fiscal and financial problems both countries decided to seek help from IMF and the World Bank that were instrumental in elaborating tough reform programs. Policymakers in both countries were clearly committed to implementing these programs which included many unpopular measures: budget cuts, bankruptcies of unprofitable enterprises, further privatization and restructuring, even more unemployment, and significant declines of households' incomes and consumption.

Table 5.3 shows selected economic indicators for Bulgaria and Hungary in 1994-96. For Bulgaria, these indicators improved between 1994 and 1995, and deteriorated in 1996. The Hungarian economy was stronger and the reforms were more advanced. Therefore, the crisis in Hungary was milder than in Bulgaria. The performance of Hungarian indicators was mixed. Some indicators, such as dollar GDP, unemployment, and foreign reserves, improved in 1995 but got worse in 1996. Several other indicators - private investment, unemployment, and foreign debt - deteriorated in 1995 but improved in 1996. A sharp growth of private investment in Hungary (in 1997 by 11 percent and in 1998 by 9 percent) and in Bulgaria (in 1998 by 10 percent) supports an optimistic forecast for the next few years, during which the GDP is predicted to grow by 4-5 percent.

Table 5.3

| Indicators | Bulgaria | | | Hungary | | |
|---|---|---|---|---|---|---|
| | 1994 | 1995 | 1996 | 1994 | 1995 | 1996 |
| GDP, % change | 1.8 | 2.4 | -10.9 | 2.9 | 1.5 | 1.0 |
| Total GDP, $ billion | 10.0 | 13.1 | 10.2 | 41.5 | 43.7 | 43.1 |
| Private investment, % change | 1.1 | 8.8 | -13.5 | 12.5 | -4.3 | 6.3 |
| CPI, % | 122 | 33 | 311 | 21 | 28 | 20 |
| Budget balance, % of GDP | -5.8 | -5.6 | -11.0 | -8.4 | -6.8 | -3.2 |
| Unemployment rate, % | 12.8 | 11.1 | 12.5 | 10.9 | 10.4 | 10.5 |
| Exchange reserves, $/cap. | 167 | 190 | 107 | 676 | 1,186 | 961 |
| Foreign debt/capita, stock, $ | 1,360 | 1,210 | 1,140 | 2,790 | 3,110 | 2,710 |

*Source: Macroeconomic data base, HIID-Kyiv*

### ***Group-2***

Group-2 includes the Czech Republic, Romania, and Moldova. These countries still lack the capacity for sustainable growth partly because of inconsistent policies of their previous governments (in early and mid-1990s) and partly because the corrective measures undertaken by their current governments still do not seem to be strong enough and deep enough to fix the problems. The recently introduced budget cuts, contraction of household consumption, and diminishing investment have pushed GDP down. For the next 1-2 years, a negative growth (or zero growth at best) is predicted, followed by a low positive growth during the first few years of the next century.

A major stumbling block in these countries is the sluggishness of structural reforms at the enterprise level. The old enterprise sector remains strong. It includes many large enterprises that remain state owned or have been "mass-privatized". In the latter case, in the Czech Republic, many enterprises have been acquired by the so-called investment funds, which are owned by banks, which are owned or controlled by the state. The outcome of the Czech mass privatization has been in many cases either an effective re-nationalization – via the privatization funds, or "re-socialization" – via the mechanism of highly dispersed ownership. In both cases, no transparent ownership was established. The effective control over the enterprises has been taken over by insiders rather than outside owners. Many of these enterprises failed to restructure and kept generating their pre-transition "socialist" output. The anti-unemployment policies and other restrictions helped them preserve the status quo.

At the same time, a new sector has emerged that includes new private firms, or old firms that have been privatized and restructured, with strong outsider control. Many of them are owned or co-owned by foreigners. While the new sector expands rapidly, it cannot balance out the old sector, since the latter remains large and strong. Also, in these three countries, the banking industry and capital markets have remained weak.

Officially, by 1995, both the Czech Republic and Romania managed to achieve an apparent macroeconomic stability. Their inflation rates reached the lowest levels since 1990 - 8 percent in the Czech Republic and 28 percent in Romania. Unemployment rates were kept at a low level - 3 percent in the Czech Republic (one of the lowest levels in Europe) and 9 percent in Romania. The fiscal and current account deficits remained low - about 1-2 percent each in both countries. Yet, this was a fake stability, not supported by solid restructuring of enterprises. An asymmetry between the macro-level and the micro-level occurred. The macro rigidities of tight monetary policies and budget cuts, because of the weakness at the micro-level, instead of helping growth contributed to GDP declines.[3] While the Czech Republic was able to afford the vagaries of its policy,[4] Romania lacked amenities and resources to pay the price for its sluggish and inconsistent reforms. In both countries, recession was unavoidable (see Table 5.4). The final result of current policy fixes depends on how serious the new governments of the Czech Republic and Romania are about the reforms they promised to deliver.

Table 5.4

| Indicators | Czech Republic | | | Romania | | |
|---|---|---|---|---|---|---|
| | 1996 | 1997 | 1998F | 1996 | 1997 | 1998F |
| GDP, % change | 3.9 | 1.0 | -1.0 | 3.9 | -6.6 | -3.0 |
| Total GDP, $ bln | 56.2 | 51.5 | 53.0 | 34.9 | 37.7 | 45.7 |
| Private investment, % change | 8.7 | -4.9 | -1.4 | 4.5 | -15.9 | -7.5 |
| Budget balance, % of GDP | -0.1 | 0.5 | -0.8 | -5.0 | -3.3 | -4.0 |
| Unemployment rate, % | 3.5 | 5.2 | 6.6 | 6.4 | 8.8 | 11.2 |
| Foreign reserves, $/capita | 1,214 | 951 | 971 | 43 | 148 | 139 |
| Foreign debt/capita, stock, $ | 2,019 | 2,078 | 2,233 | 343 | 405 | 432 |

*Source: Macroeconomic data base, HIID-Kyiv*

The Czech Republic and Romania, along with Moldova, which is struggling to regain control over its entire territory, several Balkan countries and the Caucasus, are "border-line" countries. They do not belong to Group-1 of successful transition economies. They do not belong to Group-3 of shrinking post-soviet economies. While the Czech Republic, thanks to its westward geographic location and good initial conditions, is likely, sooner or later, to join Group-1, the fate of the other countries of Group-3 is not clear. The next few

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[3] At that time, Vaclav Klaus, the prime minister of the Czech Republic, claimed that his country had already finished the transition and possessed a true market economy. It is difficult to find factual support for this statement. In fact, both previous Czech and Romanian governments continued socialist-type populist policies hidden behind the free-market rhetoric.

years may decide on which side of a new "wall" (an emerging new West-East dividing line) they will end up.

### *Group-3*

Group-3 includes Russia and Ukraine that for the last several years, similarly to the Czech Republic and Romania, were focused on macroeconomic stabilization (which became an objective by itself), while neglecting structural reforms at the microeconomic level. A main accomplishment of this kind of stabilization was the achievement of many good official indicators (budget deficit, inflation, currency stability, speed of privatization, etc.), which made these countries eligible for additional funds from the IMF and the World Bank.

A good example of these confused economic policies is the recent anti-crisis measures in Ukraine, introduced for the sake of preservation of macroeconomic stability. These measures granted the authorities the power to decide which firm would be allowed to exchange currency and to do business. Those firms that were not permitted to purchase foreign currency had to discontinue their business or shift their activities underground. By persecuting firms that operate in the shadow the government promoted the shrinkage of the economy and the shrinkage of its tax base. This in turn resulted in more wage and pension arrears, etc.

Governmental policies, consisting of redistributing income away from profit generating enterprises to loss generating enterprises, have undermined both kinds of enterprises. By granting subsidies, the government effectively promoted "bad" enterprises and did not stimulate them to restructure and to become competitive. By heavily taxing "good" enterprises, the government punished the profitable firms for generating profits. These measures, combined with a pervasive softness of budget constraints and weak contract enforcement capabilities, significantly contributed to the so-called virtuality of these economies. As a result, both Russia and Ukraine have been systematically undermining the sources of their budget revenues. The imposing of an officially low budget deficit was accomplished by implementing "brute force" budget cuts. No efforts to restructure and streamline the budget sector were undertaken.

[4] Especially, the revenue generated by a flood of foreign tourists visiting Prague (more than 100 million

Similarly, the privatization of commercial enterprises was accomplished by formal transfer of the ownership title. This privatization does not help the economy, unless contracts are enforced and loss-making enterprises are forced to discontinue their operations.

In both Russia and Ukraine, fundamental market reforms and transparent economic policies have been replaced by various idiosyncratic tricks to "help" the economy. Instead of admitting that the economic failures are caused by the slow progress of reforms, some policymakers began blaming the reforms (despite the fact that these reforms have never been fully implemented nor given a chance to be tested). The most frequently used argument is the claim that a particular country's economy is "different" and therefore "very special" measures should be used. Various interest groups often vigorously support these special measures. This way, the gradual transition to a new unspecified "no-system" system has been occurring.

The crisis in August-September 1998 demonstrated that reforms could be successful only, if large price distortions[5] are abolished, if enterprises are effectively restructured, and if a minimum level of transparency for the national economy is secured. What we have learned from this crisis is the importance of undistorted information to the economy. If the level of distortions of information -- which is accessible to country's authorities, policymakers and policy analysts, investors and producers -- reaches a certain "critical mass", the economy becomes "virtual" to such a degree that it loses its capacity to grow (and eventually it may even lose its capacity to operate). While people in Russia and Ukraine enjoyed low official unemployment, low inflation and stable exchange rate, the economies of these countries were gradually becoming unpenetratable. The imposition of low budget deficit - at the expense of rapidly expanding barter, arrears, non-payments, and shadow - creates an impossible situation in which, for instance, taxes are collected though taxpayers do not pay (the phenomenon of "mutual settlements"). The countries continue large budget expenses despite the obvious lack of ability to finance them (the phenomenon of pervasive non-payments); small official budget deficits "cohabit" with huge effective fiscal deficits (the phenomenon of miscellaneous extra-

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each year) was a significant contribution to the state budget and households' incomes.

[5] The price distortions include obviously those of the exchange rate and the interest rate. These rates were controlled (and heavily distorted) by the authorities for the sake of the "macroeconomic stability".

budgetary funds and budget arrears); etc. The list of this kind of paradoxes is long and truly impressive.

Interest free debts (wage arrears), pervasive deliveries of free goods (non-payments by consumers of electric power), the use of large production inputs that produce almost no outputs (due to rampant shadow economy), etc., are becoming standard features of these post-soviet economies. Although the wages of government officials are very low, the living standards of these officials often exceed those of government officials in the richest countries. Pensioners, if they are lucky, receive their pensions in tires and sugar; if they are less lucky, receive no pensions. Many bankrupt loss-making enterprises invest and expand. Many profitable enterprises disinvest and fade away.

Policymakers in these countries are subject to different kinds of pressures from powerful interests. The job of a large group of bureaucrats is to allocate scarce resources or at least influence these allocations. They have at their disposal a variety of measures. The foreign exchange controls keep some companies in business and send others out of business. Taxes and tax penalties (including the infamous “*kartotekas*”) provide tax administration agency with similar powers. Open credit lines with governmental guarantees provide liquidity to some enterprises while different kinds of arbitrary payments and fines squeeze liquidity from other enterprises. Critical import lists, special economic zones, price regulations (open and hidden), numerous licenses, etc., provide the government and local administrations with powerful controls over economic activities.

The legal system is internally inconsistent. Therefore, running a business without breaking the law becomes impossible. Many decide to give up and quit. Others keep their businesses at a low level to avoid problems with the authorities. Some decide to stay in business and expand but then they must be breaking the law one way or another. Thus, they can be easily convinced to cooperate with corrupted authorities. As known, the main task of the market is to allocate scarce resources. Good regulatory measures and a true marketization of the economy would leave thousands of bureaucrats at all levels of state administrations jobless. A market reform would strip them of many gains and privileges they currently enjoy.

The budget process can serve as an example of confused policies that are detrimental in both short run and long run. When the budget law is elaborated, “the defenders of the poor” demand high wages, high pensions, and high social transfers despite the lack of funds to cover these expenditures. This policy leads to wage and pension arrears and growing indebtedness, which result in inflation and currency depreciation. This, in turn, hurt poor people whose only income are official wages and pensions. Inflation and currency depreciation produce significant redistribution effects. They increase income inequality by making the wealthy people wealthier and the poor people poorer. High-income households operate mostly in the shadow economy and hold their savings in dollars. Inflation and depreciation are equivalents to levying an additional tax that is highly regressive. Mostly low-income people whose income is predominantly in domestic currency pay this tax. In the long run, this policy promotes economic decline, reduces budget revenue, real wages and pensions.

There emerges a peculiar kind of post-soviet economy. Every year, this economy absorbs several billion dollars of foreign aid and credits. Despite these transfers (or, perhaps, because of these transfers), this economy keeps shrinking. The main problem of this economy seems to be its low capability for adjustment and self-reforms. Reformability – the capacity to learn and change (to initiate and endure endless adjustments and transformations) -- is a fundamental attribute of market democracies and a main source for their sustainability and success. The soviet economy disintegrated because it was not reformable. By the same token, the economies of Russia and Ukraine will collapse unless they become reformable.

## Conclusions

The interaction between transition-related policies and economic growth seems to be very strong. Countries that experience the fastest growth are not those with large natural resources (Russia) or those endowed with relatively good human and physical capital and modern technologies (the Czech Republic), but rather those with good policies (Estonia, Poland, and Hungary). Economic growth helps policies and policies help growth.

The longer the country waits with the introduction of fundamental reforms the weaker its economy becomes and the higher the cost of reforms is. Partial reforms or unbalanced reforms tend to hinder rather than stimulate growth. In particular, the macroeconomic stabilization without microeconomic restructuring (as in the case of the Czech Republic, Romania, Russia, and Ukraine) has caused damage to the economy.

Poland was first to introduce market reforms and has been the best performer among the FSB countries. Among currently growing economies, Estonia and Hungary seem to have the greatest growing potential while Slovakia seems to be heading toward a recession. The Baltic countries and Bulgaria experienced deep declines but, after successful reforms, are expected to grow at a high rate during the next several years.

Ukraine and Russia still lack the capacity to successfully reform their economies. Their economies have been shrinking for many years and will continue fading until a radical reform program turns them around. The elaboration and implementation of such a program requires vision, courage, firm leadership, commitment, and perseverance. The list of things to do is long, yet well known: comprehensive reforms of the central government and state administration, transparent fiscal policies, low number of taxes, low tax rates and broad tax base, abolishment of subsidies, of tax exemptions and other privileges, tight monetary policies, regulatory reforms that enable the markets to operate (especially the capital market, land market, labor market, credit market, foreign trade, etc.), further orderly and transparent privatization, an effective protection of private property, contract enforcement, hard budget constraint for state budget, budget sphere organizations, and commercial enterprises, enforced bankruptcy, etc. All the institutions that perform damaging bureaucratic controls must be abolished, including the infamous "*kartotekas*", "*propyskas*", miscellaneous licenses and other oppressive practices that hinder economic activities.

During the last few years two trends may have been noticed: (1) a growing awareness of the necessity of reforms accompanied by an increasing intellectual capacity (the buildup of a conceptual "infrastructure") for the reform in Russia and Ukraine; (2) increasing corruption, gradual demonetization, devastation of the economy, pauperization, social disintegration, and exhaustion of material resources. It is difficult to predict which of these two trends will eventually prevail. The main task of international assistance should be to help support trend (1) and to help obstruct trend (2). The most recent policies in both Ukraine and Russia (fall 1998) do not seem to be leading these countries in the right direction. Yet, there is hope that a growing pressure for change will prevail. Soon.

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# 6

## FISCAL REFORM IN UKRAINE: THE PROBLEMS TO BE SOLVED

*Viktor M. Pynzenyk*

**Introduction**

Ukraine is going through its second financial crisis. In 1992, following the price liberalization in Russia, Ukraine's "benevolent" politicians decided to protect Ukrainian people from constantly rising prices and the economy from declining working capital through an "indexation" – increase in nominal revenues. The source of indexation was easy to find, and the National Bank of Ukraine (NBU) printing press began to work at full capacity. To be precise, the emission was carried out by the Finance Ministry, not by the NBU. Having two separate accounts - revenues and expenditures - the Finance Ministry was financing budget expenditures without consideration for the revenue balance, making the NBU face eventual emission.

The rapid decline in monetization of the economy followed by the popular belief that unreasonably tight NBU monetary policy failed to provide the economy with the required money supply led to new monetary emissions. The Government stubbornly proceeded to cover its fiscal deficit by the easiest, though the least sensible, manner – through direct credits from the NBU.

Fortunately, the trial and error method of reform, which is extremely hard on both the economy and the people, enabled policymakers to realize that the emission route to cover the deficit helped only as much as a new doze of drug helps a drug addict. The situation continued to get worse.

The policy of passive monitoring of economic developments from 1992 through 1994 led to a 40 percent decline in GDP and industrial production and 11,000 percent increase in consumer prices. The Government continued to face a growing deficit of funds. In 1994, the consolidated budget deficit exceeded 10 percent of GDP.

Table 6.1. Selected indicators of Ukraine’s economy, 1992-1997

| | 1992 % | 1993 % | 1994 % | 1994 1991=100 | 1995 % | 1996 % | 1997 % | 1997 1991=100 |
|---|---|---|---|---|---|---|---|---|
| GDP change | -9.9 | -14.2 | -22.9 | 59.6 | -12.2 | -10.0 | -3.2 | 45.6 |
| Industrial output (change) | -9.0 | -7.4 | -28.2 | 60.5 | -12.7 | -5.1 | -1.8 | 49.2 |
| Agricultural output (change) | -4.8 | 3.6 | -17.2 | 81.7 | -2.1 | -26.3 | -8.7 | 59.0 |
| Inflation | 2,106 | 10,255 | 501 | 10,800 | 282 | 140 | 110 | 46,900 |
| Real wages | -38.0 | -51.9 | -16.8 | 24.8 | 4.6 | -12.9 | -1.1 | 22.4 |
| Consolidated budget deficit[6] as % of GDP | -12.2 | -6.5 | -10.5 | - | -7.9 | -4.6 | 7.1 | - |
| Monetization coefficient[7], end of the year | 50.0 | 32.5 | 26.5 | - | 12.5 | 11.1 | 13.5 | - |

*Source: State Committee for Statistics*

At the end of 1994, as a result of economic and social pressures, the government was forced to take radical steps to reduce budget expenditures. The reduction affected state capital investments, purchases of agricultural products, direct subsidies to the economy and to housing and communal services. Probably, this was the only period to witness a true reduction in the budget deficit. In addition, since the beginning of 1995, direct emission was no longer used to finance the deficit. Instead, the government began to issue treasury bills. Budget constraints, combined with tight monetary policy of the NBU, enabled Ukraine to experience a drastic drop in inflation and a stabilization of the national currency. The average monthly increase in consumer prices dropped from 14.4 percent in 1994 to 9.0 percent in 1995, 1.8 percent in 1996, and 0.8 percent in 1997. The real exchange rate increased more than three times since October 1994 and the nominal exchange rate remained virtually unchanged during 1996 through 1998.

The autumn of 1998 witnessed the second financial crisis in Ukraine. The government proved unable to service its debt liabilities to both residents and non-residents. This shook the country’s financial system.

[6] The budget deficit was calculated according to Ukrainian methodology which included proceeds from privatization into the budget revenues, and debt interest charges and amortization of principal into expenditures.

[7] Monetization coefficient is the ratio between M2 and GDP

**Underlying causes of the financial turmoil**

Today’s analysis of the economic policy over the last three years confirms that the financial turmoil was inevitable. Intentions to implement a package of essential structural reforms aimed at radical reduction of tax burden, elimination of red tape and other impediments to investment and entrepreneurship, and reduction of government spending, unfortunately, remained only good intentions. There was no political demand for measures that could contribute to economic growth. The package of draft laws on reform measures lacked an “owner”. The government abandoned these laws and silently watched the Verkhovna Rada reject one draft after another.

With no structural reforms and no changes at the micro-level, the foundation of financial stabilization proved weak and shaky. On the one hand, no preconditions were set to increase the budget revenues through economic growth. On the other hand, the policy of granting support to unprofitable, non-competitive producers reduced the profits of the normal market-based sector, which were consumed by the unprofitable manufacturing sector. The lack of opportunity for restructuring of obsolete manufacturing (which requires more than just tight budget constraints) continues to provide serious arguments for political pressure on the government to grant subsidies. And the government does grant subsidies by writing off or restructuring tax arrears, deferring tax payments or granting tax exemptions, providing privileged credits either from extra-budgetary funds or through international credit lines. These credits are rarely repaid, thus imposing a heavy burden on the budget. Ukraine’s “kartoteka” invention (an order by which funds are taken off from the debtors’ bank accounts) produced a cogent justification for tax evasion. Absence of a mechanism to ensure responsibility for failure to meet mutual financial liabilities created a class of “hybrid” owners. These new owners have a perverse mentality and their best interest is in selling the assets of enterprises rather than in investing. All the above produces a negative impact on those who still pay their taxes and encourages them to shift into the shadow. Lack of appropriate attention to structural reforms is also a serious mistake of the IMF in its work with Ukraine.

**Weaknesses in fiscal management**

The period of real reduction in the budget deficit in Ukraine was rather short. Later, the budget deficit was reduced only on a cash basis, without reduced commitments of the budget sectors. The budget was financed at the expense of the market-based sectors, which saw their financial position getting worse and worse, as products they delivered and/or services they provided were not paid for. Hence, it is no surprise that transactions with the budget sector are considered the least reliable by any "normal" business in Ukraine. The payment may never be received or take years.

There were no decisions to reduce the budget network – number of recipients of budget funds. On the contrary, steps were taken to create new bodies of executive power and increase the wages and number of employees in existing ones.

After an initial increase of charges for housing and communal services by 20 times in real terms, and reaching 80 percent cost recovery ratio, these prices remained unchanged for more than two years. This caused a significant amount of ineffective budget expenditures.

Essentially, the real budget deficit of Ukraine has so far been unrevealed. On the one hand, the real needs of the budget sector are unknown since they do not diminish automatically with the reduction in budget financing. They only increase the accounts payable by the government. On the other hand, the financial situation of the last few years have forced many budget organizations to begin rendering paid services. The income received for those services remains undisclosed to the government. Effective control over the utilization of funds received from the paid services rendered by the budget organizations is absent. Therefore, these funds do not always find efficient uses.

Aspiration to arrive at the level of deficit demanded by the IMF, at least on paper, without reducing needs for funds, inevitably led to increased budget arrears, especially socially harmful arrears such as wages, pensions, scholarships, and other social benefits. The last two years have witnessed a 70 percent growth in pension arrears. Therefore, even if the government had achieved a balanced budget (on a cash basis) and issued no treasury bills, the financial crisis would have been inevitable. Social arrears do have their limits.

Once again, we should mention the shortsighted position of the IMF, which continues to follow the principle of “accepted budget deficit on a cash basis”. Even a requirement for a monthly reduction of the budget wage arrears (first introduced in Ukraine as a performance criterion of the IMF program) has failed to work. With no real steps to reduce government spending, this requirement is nothing more than a good intention.

While many recipients of budget funds cannot make ends meet, some enjoy significant surplus. This happens because Ukraine has no “united” budget. There are dozens of “Finance Ministers” in Ukraine, and each of them has his personal understanding of financing priorities. Not all budgetary revenues are being consolidated in a single account of the State Treasury. A considerable portion of revenues is used through extra-budgetary funds. There are about a hundred of these funds affiliated with the central government and dozens more are formed by local governments.

A considerable portion of funds is “targeted”, even though they are formally processed through the State Treasury account. These funds accounted for 16 percent of the consolidated budget revenues for the first eleven months of 1998.

Some government agencies receive large amounts in their extra-budgetary funds and begin to appear like commercial rather than government institutions. This mainly refers to the Tax Administration, which directs 30 percent of additional taxes it uncovers to its own extra-budgetary fund, not to the State Treasury.

Current circumstances make any coherent policy of government spending impossible. Hence, there are precedents of expensive renovation of administrative buildings while pensioners, doctors, teachers and military servicemen do not get paid for months. The country’s political elite finances its expensive vacations from the budget, whereas delays in payment of social benefits are ignored.

The absence of transparency in government spending contributes to inefficient uses of budget funds. Only an insignificant portion of spending is done on a competitive basis. Despite recently adopted regulation, ministries do not implement allocations regarding amounts and directions of their spending.

Approval of the budget with a considerable hidden deficit brings about the so-called “manual” financial management that allocates budget revenues on a daily basis.

This management provides funds primarily to those who happen to have access to the room in which the daily allocation takes place. Planning of budget revenues is restricted to an informal nature. This planning is not used to authorize the allocation of operating funds for imperative execution by the State Treasury.

The current allocation regime causes a significant overfinancing of some Budget Law articles and underfinancing of others. For instance, for the first eleven months of 1998, scientific research received only 50.2 percent of financing envisaged in the Budget Law, National Defense – 65.4 percent health protection - 77.8 percent whereas the construction industry took in 255.0 percent of the plan, transport, communication and telecommunication - 103.8 percent, housing and communal services - 102.5 percent

The existing system of budgetary relations between the central and local governments fails to encourage a search for additional revenues to local budgets and any interest in saving of budget money. In addition, this system promotes lobbying and inter-regional conflicts, and provides a basis for putting the sole responsibility for the current situation in Ukraine on the central government.

To a great extent, the ideology of the Finance Ministry is to act as a supplementary structure of the *Derzhplan* (state planning agency). The Finance Ministry continues to view servicing of "material" flows as its principal assignment. This ideology remains so powerful that the ministry is unable to reject the practice of first calculating the output in physical units, and only then determining GDP and budget revenues. Hence, accomplishment of the planned budget deficit should be credited to the NBU rather than to the Finance Ministry.

The excessive dependence of businesses on government officials has provoked a new source of corruption into the budget sphere. Absence of any real competition in the distribution of funds causes considerable overspending. And the volume of budget mutual clearance threatens to reach such a stage where members of parliament and government officials are paid in sugar beet, bread, or vodka promissory notes. The motivation for budgetary mutual clearance is easy to understand when we see pensioners receiving their pensions in sugar or other goods at prices significantly above the market ones.

A relatively long period of financial stabilization with no real economic growth and improvement of living standards induces decisions that will continue to complicate the government's fiscal problems. The Verkhovna Rada has recently approved laws on a new system of income indexation and indexation of households' deposits devalued during the hyperinflation period. The amount of such indexation would exceed Ukraine's annual GDP.

Many countries with successful reforms have experienced substantial fiscal problems. However, these problems were caused by radical structural reforms that led to a temporary decrease in budget revenues. Ukraine's second financial crisis occurred not because of structural reforms, but because of their absence, and because of a political fear to take decisions to reduce budget expenditures. Unfortunately, this fear was not eliminated by the financial crisis in the fall of 1998 that caused 80 percent devaluation of the national currency.

The response of the government to the crisis reminds one of a bad doctor. If a clinical thermometer shows that the economy is sick, it is the thermometer that must be treated, and not the patient.

Administrative regulation of the national currency exchange rate and the government attempts to regulate prices led to a substantial decline of economic activity, particularly in the small business sector. A modest growth in output, witnessed in May-August 1998 (between 0.1 percent to 0.4 percent), quickly reversed itself, and the first 11 months of 1998 registered a decline of 1.2 percent.

The currency market saw its turnover reduced dramatically. While during January-August 1998, the average monthly turnover of US dollars was 2,484 million, of German marks was 250 million and of Russian rubles was 1,051 million, September-November 1998 recorded turnovers of $ 843 million, DM 64 million, and RUR 995 million. The supply of hard currency into the economy has been complicated. To avoid the administratively fixed exchange rate, the long forgotten flight of hard currency out of the country resumed. The financial crisis also resulted in reduced budget revenues. Real revenues of the consolidated budget in October 1998 were 20 percent lower than in October 1997, whereas the central government budget revenues were 26 percent lower.

Instead of introducing an essential policy of balanced budget, the government submitted to the parliament a draft budget with a significant hidden deficit. Instead of a considerable reduction in government spending and wide-scale deregulation, the government resorted to writing off or restructuring the tax arrears, exempting several sectors of the economy from VAT, introducing new tax-free zones, providing several businesses with import duties exemption, and decided to make people happy by printing money. Many believe that the economy can absorb “targeted” monetary injections without getting pregnant with inflation.

## Conclusion

Financial stabilization, along with corresponding fiscal and monetary policies, should be introduced simultaneously with structural reforms. No time lag should be allowed between stabilization and structural changes. Without structural reforms, financial stabilization would be a misleading illusion, providing politicians with room for political maneuvering. Given the lack of political will, and misunderstanding of the essence of structural reforms, this illusion is dangerous.

An untimely introduction of structural transformations would create a new class of opponents to reforms. It would be misleading to consider left-wingers as the only opponents of reforms. Unfortunately, many of the so-called new capitalists, who strive for capitalism (but only for themselves), are also opponents of reform. Financial stabilization has blocked the largest channel (inflation) for redistribution of wealth. Instead, current developments in energy, gas, and some other sectors are nothing other than looting of state property. And privatization has failed to stop it, especially when privatization certificates (vouchers) were used.

Countries with insufficient political will for reforms cannot afford the luxury of budget deficit. Moreover, it is the most financially intricate period that provides a window of opportunity to balance the budget on a real rather than cash basis. Ukraine’s experience of 1994-1995 confirms that such period allows for steps that are impossible to take in any other time.

Administrative reform should become the first step on the road of comprehensive reforms. It is necessary to start with measures acceptable to the people; these measures should clear the way for essential further changes. It is difficult to justify the importance of sacrifice by the population when the state apparatus keeps growing.

Regretfully, Ukraine has not achieved its reforms, despite suffering. This is the only conclusion possible in a situation where policy makers hide their heads in the sand instead of facing the problems, where a lack of action and day-to-day maneuvering are preferred to decisive steps forward.

Reforms cannot be imposed on people. The public must realize the necessity of, and grant support to, reforms. There are two different ways to mobilize support for reforms: through the mind and through the stomach. Unfortunately, Ukraine has so far chosen the latter. This conclusion is confirmed by the politics of the last few years that saw voters selling their votes for empty populist promises and slogans, as well and for the very physical pound of sausage, sugar, and flour.

The stabilization of 1995 through 1997 would have been impossible without the hyperinflation of the early 1990s. Recent events demonstrate that Ukraine begins reversing the situation after its last financial shock. Things have been going badly in Ukraine as the country is guided by the following rule: nobody will take any action until a “thunder” strikes. However, the thunder could play a positive role when there is no political will.

# 7

## TAX REFORMS IN UKRAINE - GAPS AND LESSONS

*Khwaja M. Sultan*

### Introduction

Reformers in the government and in parliament have been struggling, with only partial success, to move ahead with economic reforms. During the summer of 1996 and the first half of 1997, the government tried to push a package of reforms through the parliament (Verkhovna Rada) that would have given some headway in the areas of tax reform, structural reforms deregulation, fiscal policy and financial sector reforms. Unfortunately, only a few tax measures could get through (the passing of the new VAT law and the Enterprise Profits Tax (EPT) Law) and these too have been riddled with frequent backtracking. There was little support for reforms in the Parliament. Even within the government, commitment to economic reforms was weak and half-hearted. Unlike Poland, where the parliament led by the Solidarity Union pushed for comprehensive stabilization and liberalization program known as the 'Balcerowicz plan' (Wellisz, Kierzkowski and Okolski 1993), Ukraine has not had a reform-oriented parliament. The parliament has not had any group or coalition of parties that holds a majority and gives the impression of a direction-less body. The communists have remained the biggest group, though without a majority. There is, thus, no pressure from the parliament to move ahead with reforms. On the contrary, the parliament has very often blocked the few economic reform measures that come its way.

### Reform and public choice

The willingness and the desire for reform have to come from within the country. Reform is a matter of public choice. If people want reform, they elect a reform-oriented parliament, which forces the government to carry out reforms. The policymakers have, in turn, to convince the people that the reforms they are embarking on are good for the country in the long run, even though they may cause pain and difficulties in the early years. Tax reforms, as well as other policy reforms, can take place only when there is enough political leadership and support from those who advocate them, and only when the resistance from those who oppose them can be contained (Hamada 1994).

Countries that have taken up reforms with a resolve to change the existing system, and to break from the past, include Poland, the Baltic states, Hungary, and recently Bulgaria. On the other hand, reforms in Ukraine have been tried without conviction, and for extraneous reasons, such as, the need to fulfill IMF conditionalities in order to get loan from them. Such reforms tend to be haphazard half-measures.

Progress with structural reforms and deregulation has been slow in Ukraine. Without them, there is little hope for economic growth. Without economic growth, there is little hope for improvement in tax collection. In 1998 alone, tax arrears (according to the Ministry of Finance) have jumped from about UAH 2 billion in the beginning of the year to about UAH 9 billion in December. Large state-owned enterprises continue to produce goods that they cannot sell. Barter then becomes the most convenient option for paying wages to their employees, dues to their suppliers, and taxes to the government. Subsidies keep such enterprises alive but hamper their restructuring. Many privatized enterprises continue with the same management, and operate quite like the old soviet enterprises. Their condition is, thus, quite similar to the state-owned enterprises, or even worse. A modern tax system needs a thriving private sector where the enterprises work for profit and face a hard budget constraint. These market fundamentals are fragile in Ukraine.

### Ukraine’s experience with tax reform

Fiscal pressures tend to be the most serious constraints on the road to stabilization; however, the more rapidly the economy is liberalized and reformed, the less binding the constraint becomes (Blejer and Marko Skreb 1997). This makes tax reforms a logical priority for transition. Ukraine made a determined effort for tax reforms between 1995 and mid-1997. After this, the momentum for reforms got lost. A new monopoly- or rent-seeking capitalist elite has risen from the ashes of the old communist “patriarch” elite, and has used its influence to delay real reforms or freeze them in a fledgling state that suits its interests (Havrylyshyn 1997). This is apparent from the procrastination that has been witnessed in the reform process.

Take the case of the value added tax (VAT). A good VAT law based on the EU model was instituted in April 1997. Instead of keeping it stable, there have been periodic changes that have diluted its essential features. In October 1997, an essential aspect of VAT - liability on accrual basis - was replaced by liability on cash basis. This made it easy for taxpayers to evade tax by claiming that payments have not been made for their sales. Without an effective information-matching mechanism, such claims are difficult to refute. Although some exemptions were removed in October 1997, energy sector continued to be exempted. Exemption was also extended to “critical imports” which consists of a list of goods approved by the Cabinet of Ministers. From October 1998, the accrual method was re-established. However, its application for energy supply to households and to government has been postponed till the year 2003. At the same time, a system of advance payment has been introduced for VAT. Since VAT is already collected at every stage of value addition, it is not logical to have advance payment for it, as is done in the case of income taxes.

In the case of enterprise profits tax (EPT), the law was passed in late 1997, but amendments on depreciation allowance have continued to be debated[1]. Several adjustments have been made in the budget laws to restrict the depreciation to only a part of what is allowable under law. The draft law on real estate tax has been in Parliament since mid-1997, but has not made much headway. The weak status of private ownership of land, and of land market, has made the introduction of real estate tax difficult. The draft law on a new personal income tax has been in Parliament for more than a year and has been through one reading in the last Parliament. It has not been taken up by the new Parliament elected in March 1998. A new Unified Agriculture Tax has created a sector specific tax, which instead of harmonising the tax system has segmented it further. It undermines the principle of uniform taxes, which do not cause sector-wise distortions.

[1]A new Depreciation Law was passed by the previous Parliament but vetoed by the President. The law contained several features that were different from the EPT law, especially with respect to inflation indexation and accelerated depreciation.

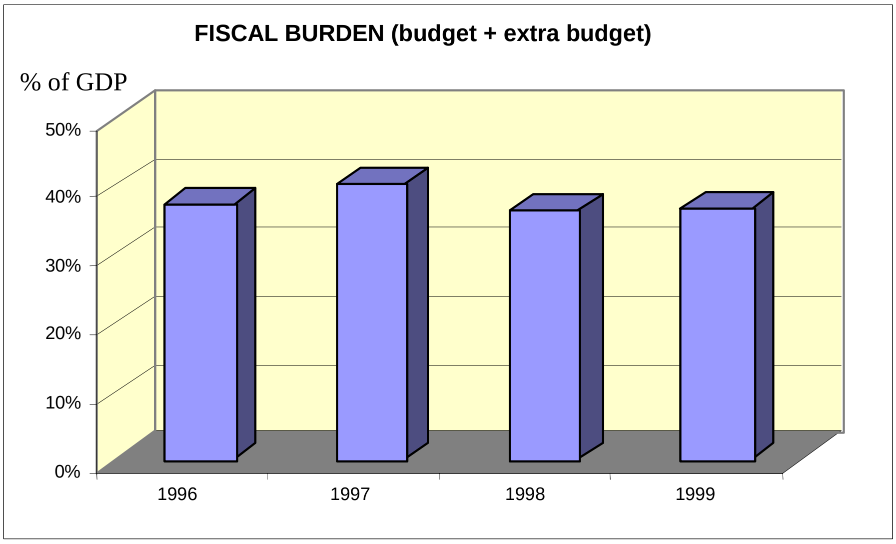
**Problems with the tax structure**

Ukraine's economy is characterized by a high fiscal burden, a narrow tax base, a large shadow economy and serious price distortions created by high payroll taxes.

*Fiscal burden*

Ukraine's fiscal burden (budget revenues plus extrabudgetary levies) has stayed at around 37 percent of GDP (Figure 7.1). This is too high for a country like Ukraine. Fiscal burden is closely related to the income level of the country. High-income countries tend to have a higher fiscal burden relative to GDP - between 35 and 55 percent, while low-income countries tend to have much smaller fiscal burden – 15 to 30 percent (International Monetary Fund). Over the last eight years, Ukraine's official per capita GDP has slumped to about 40 percent of the level in 1990. At less than US $ 1000 per capita, the income is too small to support a fiscal burden of 37 percent.

Figure 7.1




*Source: Ministry of Finance and on the Budget draft (#2) for 1999*
** Extra budget includes the Pension Fund and several other smaller funds*

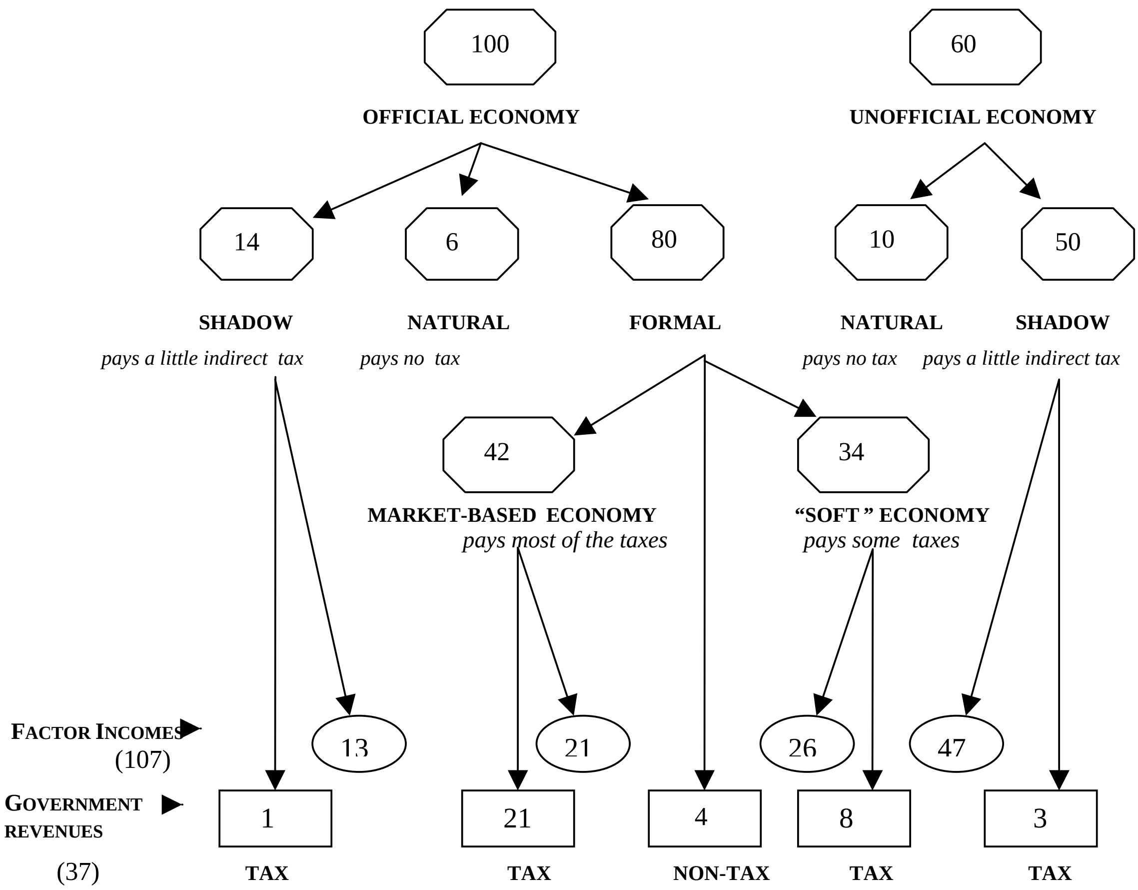
In Ukraine, the segment of the economy that operates on market principles, and that generates profits, is rather small. Accordingly, tax payments in cash constitute only two-thirds of fiscal revenues. The remaining one-third is collected through mutual cancellation or barter, mainly from enterprises that are value subtracting and are not able to sell their goods for cash. Most of the tax paid through mutual cancellations and barter transactions are not at market-determined prices. Thus the value of revenues collected is often much lower than the nominal value of the cancellation (Thirsk and Ricoy 1999).

*The distribution of the fiscal burden*

A greater concern than the fiscal burden itself is its uneven distribution. This is shown in the chart below (Figure 7.2), which provides estimates of tax paid by the official and the unofficial economy. For 1998, the official GDP is about UAH 100 billion. This includes the formal sector, the part of the shadow economy that is included in the official GDP and part of the natural economy. In addition, we have estimated[2] the unofficial economy to be another UAH 60 billion (UAH 50 billion in the shadow and UAH 10 billion in the natural economy). The natural economy pays no tax. The shadow economy pays some indirect taxes (VAT and excise) – about 7 percent of its value added. Within the formal economy, most of agriculture, mining, energy, and many state enterprises form the "soft" segment which is supported by direct subsidies, tax exemptions, preferential credits, and forgiven tax arrears. Their fiscal burden is small: about one fourth of their total value added. The normal, market-based enterprises, that face hard budget constraints and pay all taxes, end up paying a half of their total value added in taxes.

[2] Estimates of the Economic Modeling Group, CASE-HIID, Ukraine Macroeconomic Policy Project, Kyiv.

Figure 7.2. Distribution of the fiscal burden across different segments of the economy




*HIID estimates based on HIID-CASE Macroeconomic Database*

This creates wrong motivations. It punishes enterprises that are operating in the official economy and are profitable. By redistributing scarce financial resources from profitable enterprises to unprofitable enterprises it promotes inefficient allocation and hampers growth. High tax burden and draconian tax procedures like *kartoteka 2*[3] force people to avoid keeping their money in banks. According to the Ukrainian Association of Banks, the *kartoteka 2* charges on banks are higher than the total assets of the banking system.

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[3] *Kartoteka 2* is a system by which the tax authorities confiscate the bank account of an enterprise if the tax is not paid in time. This is done without recourse to the legal process of the court system and without giving the enterprise an opportunity to pay or to explain.

*Large shadow economy*

The high tax burden and excessive regulations are important causes for the huge size of the shadow economy in Ukraine. Excessive regulations make the transaction costs for doing legal business prohibitive, pushing many enterprises into the shadow.

Logically, a person would evade tax when the costs of evading are lower than the benefits of evading. This can be represented by the following formula:

$$B^{te} + B^{cc} > C^{e} + C^{h} + piC^{r} + C^{tm}$$

Where:

| | |
|---|---|
| $B^{te}$ | the amount of tax that is evaded |
| $B^{cc}$ | compliance costs saved |
| $C^{e}$ | Direct costs of evading[4] |
| $C^{h}$ | Costs of hiding evasion[5] |
| p | Probability/risk of being caught[6] |
| $C^{r}$ | Value of the risk[7] |
| i | Certainty of the punishment if caught[8] |
| $C^{tm}$ | Tax morality - (personal discomfort[9] and peer pressure[10]) |

In Ukraine, we have both high taxes and high compliance costs. These make the benefits of evading high. At the same time, a weak administration makes the chances of getting caught small and the corruption element makes it easy to get out if caught. There is also little peer pressure for paying taxes. Therefore, the costs of evading are not high. Overall, there is greater benefit in evading here. If taxes are reduced, procedure made simpler and the administration made more effective and fair, the situation will improve.

[4] Costs involved in cash transaction, hiding inventories and sales, and costs of keeping dual sets of accounts.

[5] Cost of keeping blackmailers quiet, of bribing the tax inspectors and the Mafia.

[6] This depends on how effective and vigilant the tax administration is.

[7] Depends on the penalties and imprisonment and how the individual perceives these punishments (i.e., how risk averse a person is).

[8] Depends on the integrity and honesty of tax officials and on how easy it is to bribe oneself out of a situation.

[9] Depends on how much guilt or worry a person attaches to not paying taxes.

[10] This is partly a cultural aspect and depends on whether the society, friends, relatives and colleagues do the same thing and consider it smart or whether they dislike tax evaders.

*Price distortions created by payroll taxes*

A large part of the fiscal burden – about 10 percent of GDP – consists of the Pension Fund (Chernobyl Fund has been withdrawn from 1999). In addition, there are other payroll taxes (Employment Fund, Social Insurance Fund etc.), which together make labor heavily taxed (Figure 7.3). This discourages hiring, and prevents efficient utilization of manpower resource in which Ukraine has a comparative advantage. On the other hand, energy, which is Ukraine's main import, is taxed lightly. There are several exemptions and subsidies given to this sector, and excise on gasoline is low. By making labour expensive through high taxes, and energy cheap through subsidies, Ukraine is losing the comparative advantage it has in labour, and is over-consuming energy resources that it has to largely import.

**Theoretical base for a good tax policy**

Economists and social philosophers, from Adam Smith on, have expressed their views on what constitutes a good tax system (Musgrave and Musgrave 1989). The following are some of the important ones:

*Economic efficiency:* Taxes should be chosen so as to minimize interference with economic decision making in otherwise efficient markets. Such interference imposes efficiency loss that should be minimized. In Ukraine, given the level of its output, it seems difficult to achieve sustained economic growth unless the tax burden is reduced to about 25-30 percent of official GDP.

*Economic growth*: Taxes should foster savings and investment. Depending on the economic situation in a given country, the tax structure should facilitate use of fiscal policy for stabilization and growth objectives.

*Fairness*: The distribution of the tax burden should be equitable. Everyone should pay his fair share. People with equal capacity should pay the same tax (referred to as 'horizontal equity'), and people with greater ability to pay more tax (referred to as ‘vertical equity’). A system that is not fair, and allows tax breaks arbitrarily, lacks respect and reduces the willingness to comply.

*Low compliance cost:* If the incidental costs of complying with the requirements of the tax laws and procedures are high, people have a greater tendency to evade**.**

*Low administrative cost:* The administrative costs have to be low in order that the net revenue from the tax, which is available to the government, is adequate. The tax system should employ procedures that are cost-effective. For instance, it is expensive to carry out tax audits in all the tax declarations. Such audits tend to be not well focused. Selective but investigative audit of a small percentage of cases (employed in many countries) usually gives better results in terms of detection of fraud and reducing evasion.

*Simplicity and stability:* If tax revenues fluctuate greatly over time, it will adversely affect government programs. Constant changes in rates, rules, and exemptions (as is seen in Ukraine) make it difficult for the private sector to make long-term investment plan. Taxes then become a significant source of risk.

**What needs to be done**

The tax capacity of a country is closely related, *inter alia*, to the level of the per capita GDP. Countries with Ukraine’s level of income normally have fiscal burden of about 25 percent (International Monetary Fund)[11]. This roughly matches with Ukraine’s tax collection in cash as a percentage of GDP. Although the fiscal burden is about 40 percent of GDP, about one third is collected by mutual cancellation or barter (Thirsk and Ricoy 1999). A lower fiscal burden will promote growth and encourage people to come out of the shadow economy. This will improve compliance. Unfortunately, there has been no appreciable change in this burden in the last three years, nor in the budget proposals for 1999.

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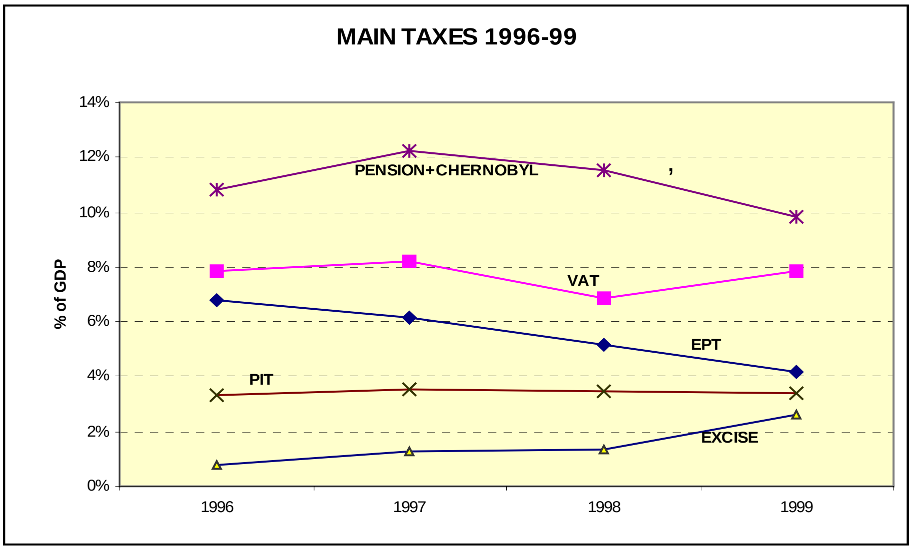
[11] See also Papaphilippou, A. (1999). “A Note on Revenue Capacity and Structural Factors in FSU Economies with some Implications for Ukraine.” Kyiv: TACIS, mimeo, for an estimate of Ukraine’s revenue capacity, based on a cross-country comparative analysis

Figure 7.3




*Source: Ministry of Finance and macroeconomic database of HIID-Kyiv*
*(N.B. Figures for 1999 are based on the draft Budget for 1999)*

For better distribution of the fiscal burden, we need to increase the relative weight of indirect taxes, VAT, import duties and excise taxes (especially on goods that are consumed widely in the shadow economy). This will help increase the tax collection from the consumption, derived from income generated in the shadow economy. This, along with elimination of most tax exemptions will help widen the tax base. The increase in revenues from indirect taxes can help reduce the pressure from direct taxes - income taxes and payroll taxes.

Excise taxes and VAT on energy are difficult to evade. Further, since energy is an important input in most business activities, taxing energy encourages compliance in downstream activities. Ukraine should further raise the rate of excise duty on petroleum products, so that the proportion of excise taxes to GDP can gradually be raised to about 4 percent - the average level in Eastern Europe.

In order to reduce the fiscal burden on labor, we need pension reform that will move from a Pay As You Go pension system to a fully funded system based on individual retirement accounts.

## Conclusion

The general direction of tax reform in Ukraine should be to widen the tax base and remove exemptions. Tax neutrality across sectors encourages the development of private enterprise. The tax system should not create major distortions in consumption and production behaviour. It should not favour one sector against another. The tax should foster savings and investment. In Ukraine, economic growth is difficult to achieve unless the tax burden is reduced significantly, to about 25-30 percent of official GDP.

If tax laws fluctuate greatly as in Ukraine, it makes it difficult for the private sector to make long term investment plans. Taxes then become a significant source of risk. If compliance costs are high, there is greater tendency to evade.

The revenue base of the local authorities needs to be strengthened by establishing a stable real estates tax at the local level. This needs to be done in conjunction with allowing private ownership for land, which will help in the development of a land market.

The tax administration needs to be less high-handed in its approach towards taxpayers. Systems like the *kartoteka 2*, drive people into the shadow economy. Usually, the greater the contact with fiscal authorities, the greater there is resistance to paying taxes. The more the tax inspectors check, visit or audit taxpayers, the more people want to evade them. If, instead, tax authorities collect information from third party sources and try to catch tax evaders by matching information, and good evidence, there will be greater compliance. Also tax procedures have to be made simpler, so that the obligation for filing declarations are not too frequent, are not too expensive and not too complicated.

Finally, tax reforms have to be a part of a comprehensive set of structural reforms. It would be very difficult to transplant a modern tax system in an environment where markets are not well developed, primitive methods like barter continue, banking system is insignificant, and contract enforcement is not effective. Therefore, it is very important to complete structural reforms that would support tax reform.

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# 8

## STRUGGLING WITH BUDGET DEFICIT, DEBT AND ARREARS

*Evgeny E. Gavrilenkov*

**Introduction**

Fiscal adjustment, as a part of macroeconomic stabilization, is a key step in attaining sustainable growth. Low fiscal deficit becomes a crucial target for transition economies, as low monetization pushes interest rates up and, thus, causes domestic borrowing to be extremely expensive. An M2 (currency plus time deposits in domestic currency) to GDP ratio of approximately 15 percent (the typical rate for most of the CIS countries), with a fiscal deficit of about 5 percent of GDP (if covered by domestic credit), increases money supply by one-third and, similarly, affects prices. In fact, high inflation is typically a symptom of a deep-seated crisis in a country's public finance (Heymann and Leijonhufvud 1995).

The Russian experience in 1997 offers a good example of mishandled macroeconomic stabilization. After the government had brought down inflation in 1995 and 1996 by introducing an exchange rate corridor and issuing government securities, the economy showed signs of growth in 1997. Inflation decreased to 11 percent and official statistics recorded a 0.8 percent GDP growth and a 1.8 percent growth in industrial output. At the same time, low inflation affected interest rates, which, in turn, contributed to an increase in investment activity (fixed investment clearly began picking up in the third quarter of 1997 when lending rates fell below 30 percent).

The Russian experience shows that tight monetary policy alone cannot guarantee economic success. Permanent expansion of the government securities market successfully brought inflation down; however, this effect was but temporary. Indeed, Russian performance proved that issuance of short-term government securities could be as inflationary as printing money though a price/growth effect may be delayed. As the ruble appreciated in real terms from 1992 to 1997, imports significantly increased from an average of RUR 4 billion per month in 1994, to an average of more than RUR 6 billion per month in 1997 and in the first half of 1998. The fall in world market prices of energy caused exports to decrease, from an average of RUR 7.5 billion per month in 1996 and 1997, to roughly RUR 6 billion per month in 1998. The above factors and growing interest payments to foreign investors contributed to the country's fiscal balance shifting from a surplus of between RUR 3 to 13 billion during 1993 to 1997, to a deficit of RUR 6 billion in the first half of 1998.

The economic situation deteriorated markedly after the default of the public debt, liquidation of the government securities (GKO) market and the devaluation of the ruble, though warning signs that the economy was in decline had appeared almost a year before these events. Falling oil prices and the financial crisis in South East Asia caused foreign investors to question Russia's ability to service its debt; thus the mass exodus from Russian markets began. A comparative look at emerging markets shows that in the fall of 1997, Russia was just under Thailand, Indonesia and South Korea in terms of short-term foreign debt to international reserves ratio (Table 8.1).

Numerous Russian government economists attribute Russia's problems of 1998 to external factors, namely the decrease in oil prices and the change in investors' attitudes toward emerging market economies. An important additional component to Russia's difficulties, however, lies in internal factors, such as the pervasive financial distortions throughout the Russian economy. In fact, the financial crisis in South East Asia and the fall in energy prices only accelerated the collapse of stabilization in Russia.

Mismanagement of public finances and high fiscal deficit prevented stabilization of interest rates at low levels, despite monetary authorities' attempt to enforce tight monetary policy. Financial stabilization in Russia was short-lived due to a massive inflow of foreign capital that penetrated financial markets, but never reached the real sector. Unfortunately, the outflow of foreign capital destabilized not only financial markets but the entire economy as well. In fact, due to the low level of monetization[1] and the relatively low level of liquid international reserves[2], an outflow as small as $ 10 to 20 billion could potentially destroy the entire financial system.

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[1] Before the crisis, Russia's monetary supply was equal to RUR 370 billion, or, $ 60 billion.

[2] Reserves, excluding gold, reached $ 20.4 billion in mid 1997.

Table 8.1. Short-term foreign debt as % of forex reserves, selected emerging markets

| | |
|---|---|
| South Korea | 224% |
| Indonesia | 184% |
| Thailand | 182% |
| Russia | 180% |
| Argentina | 130% |
| Mexico | 107% |
| Philippines | 82% |
| Brazil | 71% |
| Turkey | 65% |
| Hungary | 48% |
| Chile | 44% |
| Malaysia | 42% |
| Czech Republic | 41% |
| Egypt | 30% |
| India | 27% |
| Taiwan | 20% |
| China | 20% |
| Poland | 20% |

*Source: UNIFUND*
*Note: For Russia, this figure includes internal government securities purchased by foreign creditors.*

In October 1997, international reserves began falling sharply as the authorities struggled to support the ruble while investors were withdrawing their assets from the country. Due to continuous fiscal problems, the government was forced to increase borrowing and interest rates were pushed up as a result. Thus, in December 1997, the stock of GKO in circulation exceeded international reserves (excluding gold) by two times. That was a clear signal to investors to leave the country. After President Yeltsin dismissed Prime Minister Chernomyrdin in late March of 1998, the economic situation worsened.

The unclear economic policies of the new Prime Minister, Kirienko, did not improve the country’s economic situation. Rather than specific palliative measures that would prevent further economic deterioration, investors heard only vague declarations. Due to high risk and political instability, interest rates soared in April of 1998 and by mid year, in real terms, they exceeded 100 percent. From March 1998, expenditures on debt service increased sharply as a result of short-term borrowing with high yields at the end of 1997. At the beginning of 1998, government expenditure on debt service ranged between 16 to 18 percent of federal revenue; in March, debt service expenditure began growing rapidly and, thus, claimed an increasing percentage of the country's revenue. In

January through May 1998, domestic debt service reached 37 percent of total federal revenue, and *total* debt (domestic plus external) service reached nearly 50 percent of revenue (Table 8.2). Therefore, from March 1998, the main portion of federal revenue was spent on debt service. In March, in particular, debt service exceeded fiscal revenue by 3.9 percent; in April and May, the government was forced to spend 44.1 and 63.2 percent, respectively, of federal revenues on debt service. This negatively affected other areas of spending, thus increasing wage arrears in the public sector and social instability in the country.

Table 8.2. Debt service, 1998

| | 2/1/98 | 3/1/98 | 4/1/98 | 5/1/98 | 8/1/98 |
|---|---|---|---|---|---|
| Federal revenues: cumulative, RUR million | 24,257 | 44,919 | 60,768 | 83,031 | 150,281 |
| Debt service: cumulative, RUR million | 3,861 | 11,997 | 28,456 | 38,281 | 75,286 |
| Internal debt service, RUR million | 3,861 | 7,923 | 22,088 | 30,639 | 59,194 |
| Total debt service, % of federal revenues | 15.92 | 26.71 | 46.83 | 46.10 | 50.09 |
| Internal debt service, % of federal revenues | 15.92 | 17.64 | 36.35 | 36.90 | 39.39 |
| Nominal GDP, RUR billion | 187 | 371 | 569 | 773 | 1398 |
| Total debt service, % of GDP | 2.06 | 3.23 | 5.00 | 4.95 | 5.39 |
| Internal debt service, % of GDP | 2.06 | 2.14 | 3.88 | 3.96 | 4.23 |

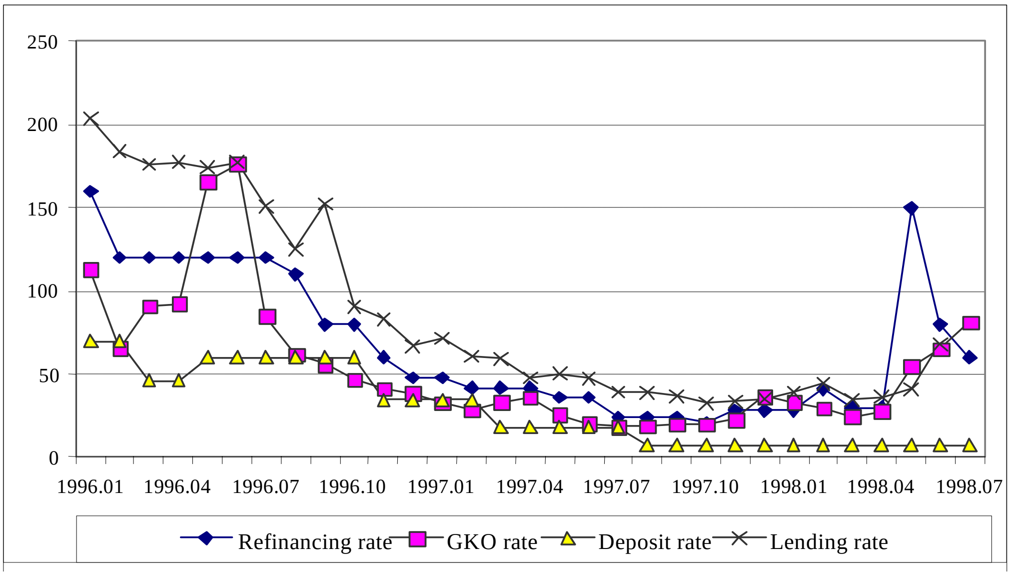
*Source: Russian Ministry of Finance and Central Committee on Statistics (Goskomstat)*

This table also shows that federal revenue as a percentage of GDP has fallen sharply from 13 percent in January to 10.7 percent in February through July. The country was obviously approaching a debt crisis as, during these seven months of 1998, more than half of revenue was spent on debt service. In the second half of the year, the government had to pay RUR 190 billion (more than $ 30 billion) which was nearly 3 times greater than the country's international reserves, excluding gold. In principle, the debt crisis should have unfolded in October of 1998, as the government was obliged to repay about RUR 35 billion to domestic creditors alone.

When the Russian population, expecting devaluation, withdrew their deposits from commercial banks and changed their rubles into dollars, the country faced a banking crisis that spread throughout the economy. Tax revenue fell and interest rates increased. In August 1998, the government defaulted on internal debt and the ruble was devalued. In January through November 1998, industrial output decreased by 5 percent, relative to the same period in 1997. Investment contracted by 6.2 percent over the same period.

The absorption of liquidity by rapidly growing public debt was one of the most immediate problems hampering both macroeconomic and microeconomic restructuring and economic growth. Firms could not borrow money due to exorbitantly high interest rates (Figure 8.1). Interest rates have remained high due to continuous government borrowing. Banks were not interested in lending to the real sector as government securities, before the default, could guarantee higher return with lower risk. Firms (and other taxpayers) avoided paying taxes. The government was forced to borrow more money to cover the fiscal deficit. This was a vicious cycle that had not been broken.

Figure 8.1. Interest rates in Russia, % annual

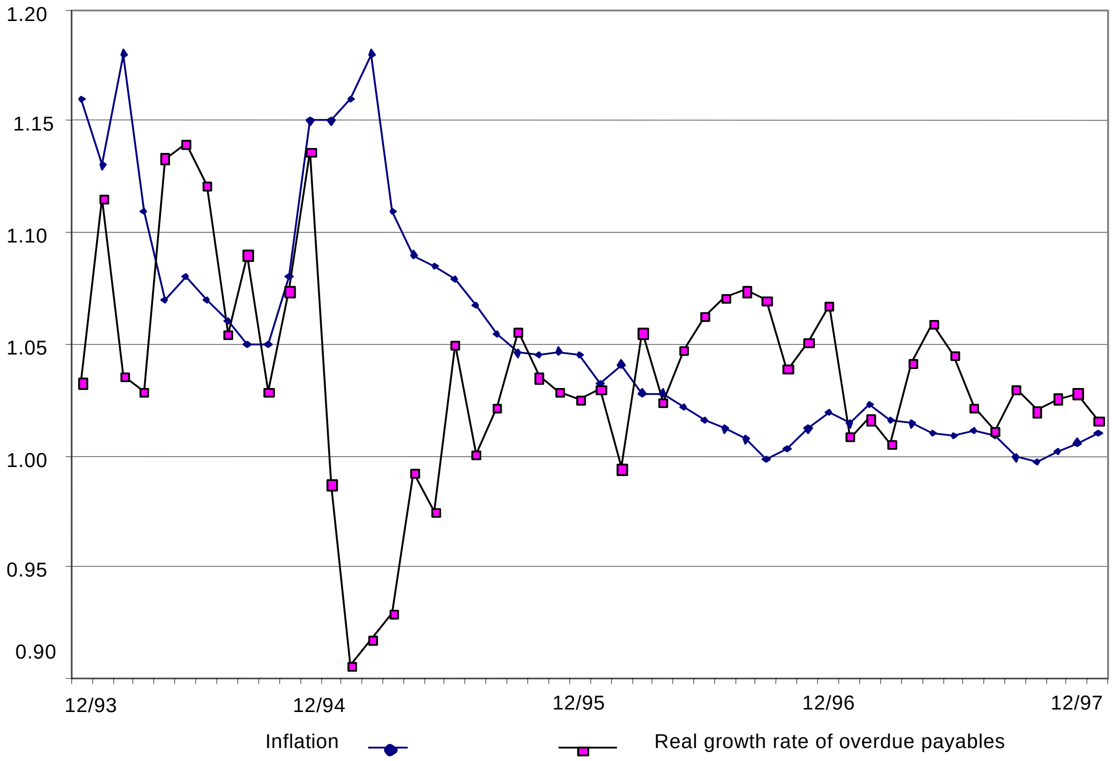



*Source: Russian Central Bank*

The origin of such problems can be traced back to 1995 when, in order to fight inflation, the government started to refrain from using the Central Bank's credits and increased issuance of government securities. While this policy reduced inflation (Figure 8.2) shows an inverse correlation between inflation and arrears measured in real terms), it served to sever monetary flows between the enterprise sector at one end, and the banks and the government at the other end. In this environment, banks were mostly serving the government instead of the public sector. In turn, demonetization of the real economy negatively affected tax collection. All types of arrears (i.e.: tax, inter-enterprise, wage) have grown in the past several years.

The arrears issue has become one of the most pressing problems for the Russian government; the authorities themselves have established a self-perpetuating mechanism of arrears in the form of regulations to solve fiscal problems. To quote former Russian Prime Minister Chernomyrdin: “We wanted to make the situation better, but it turned out as usual”. In brief, if a firm did not pay taxes on time it was charged penalties, which were high in real terms since the penalty rate was introduced during a period of high inflation and remained unchanged when inflation went down. Thus, the stock of penalty arrears by mid 1998 substantially exceeded the stock of tax arrears. These regulations further disadvantaged firms, as money appearing in a firm’s bank account would be automatically transferred to the state budget if the firm was indebted. Thus, the incentives for firms to deposit funds into Russian bank accounts were eliminated. Moreover, in the long queue of a firm’s creditors, the state was the first, while banks and real creditors, were pushed behind.

Figure 8.2. Monthly inflation and real growth rate of payables, times to preceding period

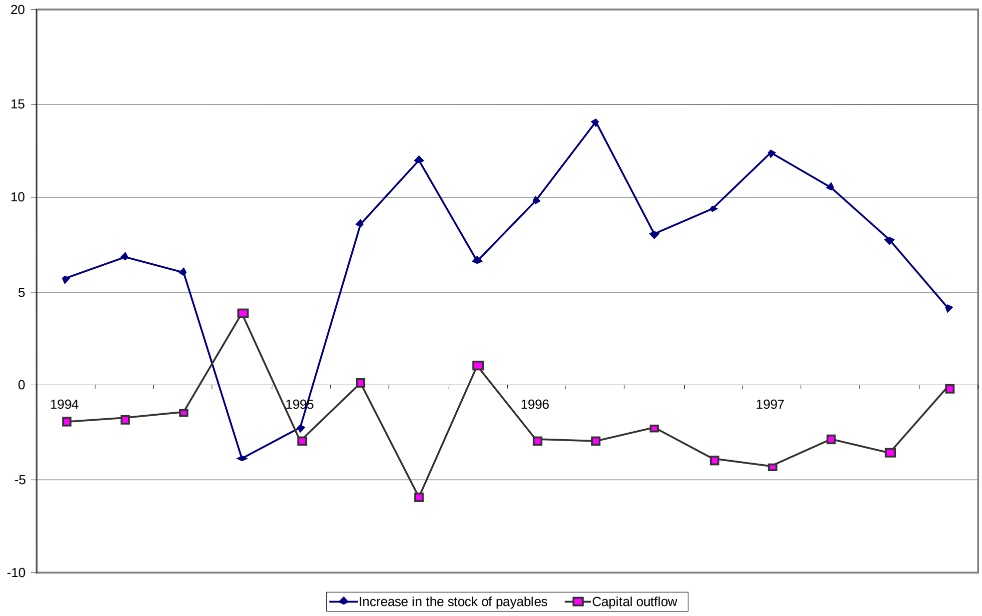



*Data source: Goskomstat*

Empirical evidence indicates that Russian firms may have used hard currency to pay each other, not only in Russia but also abroad through foreign banks. It is possible to estimate capital flight from balance of payments statistics. The low bound of capital flight is “net errors and omissions”[3] that are negatively correlated with changes in the stock of payables (Figure 8.3). This may support the hypothesis that, in order to avoid paying taxes and penalties, Russian firms settle their mutual payments offshore. In fact, Figure 8.3 shows that the stock of arrears fell, or at least did not grow as rapidly, when capital was flowing back to Russia (as in the fourth quarter of 1994).

[3] To estimate capital flight more carefully, one should also add change in the stock of non-repatriated export earnings and a portion of trade credits and import advances.

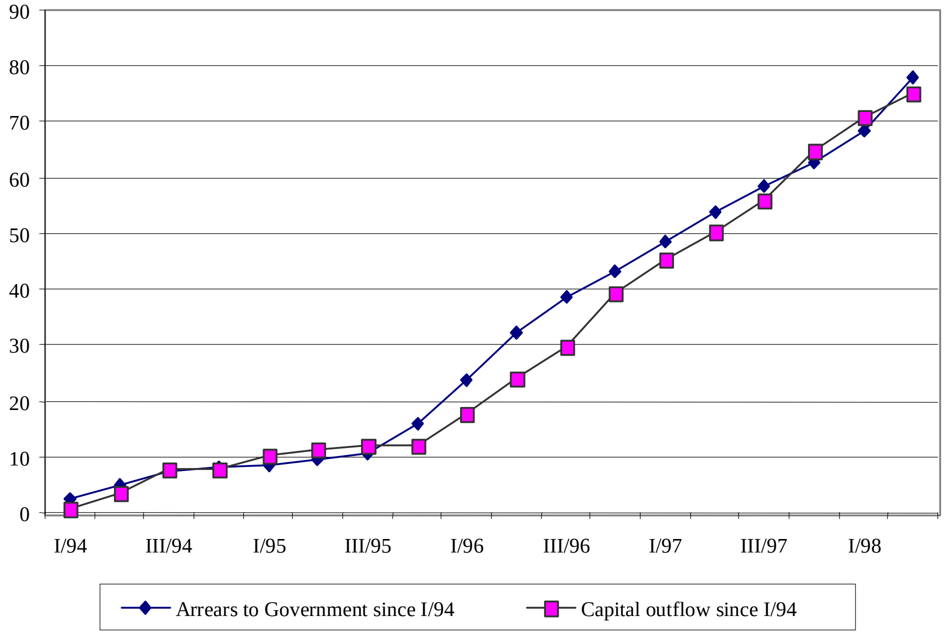
Figure 8.3. Quarterly capital outflows and growth in stock of payables, 1994-97, $ billions




*Source: Bureau of Economic Analysis and Gavrilenkov (1998)*

In this process, another type of liquidity emerged. Russia has returned to a "dual" monetary system, as was the case in Soviet times. Legal money (the ruble) has been substituted by barter, arrears and hard currency offshore. Another obstacle to investment and growth was the peculiar Russian banking sector, which largely eschewed participation in the real economy. Figure 8.4 shows that cumulative capital flight from Russia was very close to the stock of tax arrears and non-payments to social security funds (calculated in U.S. dollars, using the average quarterly exchange rate). Although the government can use administrative controls to prevent capital flight, this policy can achieve only little success if it is not supported by such measures as the establishment of a proper legal environment, institutional support for macroeconomic policies and reform of the tax system.

Figure 8.4. Cumulative capital flight and the stock of tax arrears plus non-payment of social security funds, $ billions




*Data source: Central Bank and Goskomstat*

Remonetization of the economy will be a long-term process that accompanies stabilization. Real money supply growth could be achieved in a low inflation environment. Low fiscal deficit (or even surplus) is, in turn, necessary to achieve price stability.

## Conclusion

Weak enterprises, a weak banking sector and weak government are the main causes of the fiscal crisis in Russia. The government cannot achieve macroeconomic stabilization without significant improvement in the fiscal situation. Such an improvement can be achieved by increasing tax collection from both the corporate sector and households.

To some extent, the above problems mirror those of Ukraine as well. The Ukrainian government and monetary authorities must wield caution and should not rely so greatly on foreign lenders. Although the inflow of foreign capital may help stabilize economy on the short run, due to the low level of monetization of the economy, the outflow of foreign capital can generate financial instability in the long term. The recent experiences of Russia, Brazil and other developing countries provide abundant evidence confirming this observation.

In contrary, economic crisis did not occur in those countries where governments avoided deficits. Thus, before any meaningful economic growth may occur, the fiscal imbalance must be eliminated.

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# 9

## TAX AND SUBSIDY POLICY, AGRICULTURE AND TRANSITION

*Carol S. Leonard*

### Introduction

This article is about the effect of transition conditions in the 1990s on agricultural tax and subsidy reform in Ukraine. It illustrates the way in which missing and distorted markets affect tax dynamics (particularly the redistributive effect) in post-communist economies. It uses the "Unified Agricultural Tax," (UAT) introduced in Ukraine in June 1998 for implementation in 1999, to illustrate this point.[1] The UAT, which simplified and unified taxes for one sector, represented partial reform in conditions where the passage of a more inclusive tax code was politically infeasible. By replacing different taxes and fees on agricultural production with a single tax on land, it was designed to "encourage agricultural production". The potential costs and effects of this law, however, must be assessed within the larger context of the entire economy. As a land tax, in contrast to an export tax, it privileges rural producers at the expense of urban consumers (Skinner 1991).

The literature on the dynamics of taxes in developing countries emphasizes the effects of interaction between tax and other policies, such as protection and price controls, and common problems such as black markets and undeveloped financial markets (Heady and Mitra 1987; Khalilzadeh-Shirazi and Shah 1991; Shah and Whalley 1991). In transition economies, similarly, taxes will interact with features of the former communist economic structures that are not yet dismantled (i.e., soviet-era soft-budget constraints;

[1] This analysis is based on the draft law produced following the Presidential decree Nr 215/98, issued on 23 March 1998, for measures in support of agricultural production. In preparation of this analysis, the author gratefully acknowledges comments on the Unified Agricultural Tax by Don Van Atta, Peter Solar, Khwaja Sultan and Janusz Szyrmer. The "Comments on the draft Law of Ukraine 'On a Special Tax Regime for Agricultural Commodity Producers'" by the German Advisory Group (Dr St. v. Cramon-Taubadel, Dr Ulrich Theissen, and Ludwig Striewe) were also consulted.

extensive state ownership and interference in production and distribution; barriers to entry, to exit, and to labor mobility). There is new research on how tax incentive structures are different for transition countries than they would be for the advanced market economies, due largely to residual soviet-era expectations (Csontos, Kornai et al. 1998). This article draws attention, in a more general way, to the equally important impact of residual economic structures, in this instance, the large, former state and collective farms, which will gain from tax relief without being provided incentives for restructuring.

**Agricultural tax and subsidy transition policy**

During the post-soviet transition in the implementation of stabilization and price liberalization, fiscal restraint was required, and subsidies to the agricultural sector fell sharply. Adverse terms of trade in the form of high input costs and low, and mostly fixed, farm-gate prices and import competition from the EU also disadvantaged agriculture and food processing, such that livestock and fodder crops were particularly affected. The subsequent drop in output fueled resistance to further reform by rural-based lobbies, which had previously emerged in the soviet era in the context of large, direct producer and consumer subsidies (as much as 80 percent of the price of meat, for example) that aggregately reached 17 percent of GDP by 1989 (Leonard and Serova 1999).[2] In Russia, lobbies found means to restore some subsidies by the mid-1990s especially at the regional level, where overspending typically leads to debt and has repercussions for the budget (Aizenman 1998). Quasi-state authorities permitted utility providers to provide credit for tax offsets (Leonard, Oxenstierna et al. 1996; Commander and Mumssen 1999); in addition, there was annual debt write-off.

[2] In the 1970s and 1980s, agricultural reinvestment was rationalized as concern with food security. Support comprised, among its mechanisms, extensive direct producer subsidies and infusion of directed credit on an emergency basis (See Appendix). After the collapse of communism, reformers approached the budget more advisedly to focus on how the "national income pie" should be divided, and agricultural programs were cut back. But these budgetary programs were formulated and executed in the say way as before, with production norms used to calculate sectoral needs, and there was no program analysis or project appraisal involved in government spending. In other words, budget planners in transition used subsidies to control production rather than to set up an incentive structure (Leonard, Oxenstierna et al. 1996). In a market economy, with strict law enforcement, taxes affect economic behavior. It is impossible for an individual to pay a higher tax bill without increasing income, reducing consumption, reducing savings, or increasing borrowing. In the transition environment, raising taxes was more likely to contribute to corruption and evasion.

In Ukraine, the state continued in the 1990s to maintain considerable control over prices and distribution by interfering in commodity exchanges (Czaki and Lerman 1997). It is important to underscore that although the government aimed to support agriculture, the intended effect of such support was counteracted by the implicit taxation that resulted from the government's intervention on agricultural commodity markets. Controls on grain marketing, on state monopolies in storage and on movement of grain, as well as recurring regional export bans and de facto continuation of state procurement contributed to lower farm gate prices for grain and other commodities (Cramon-Taubadel, Striewe et al. 1998).

Because of the extent of non-monetary transactions and tax evasion, it is difficult to estimate exactly the net effect of taxes and subsidies in Ukraine. Long-term structural effects, however, can be roughly identified. The hostile regulatory environment and conditions of continued state support for large-scale production in general will inhibit small rural and urban enterprises and small and medium-size farms in the FSU in the 1990s (Leonard 1999). Without incentives to leave large farms, labor will continue to be retained by managers who run the former state and collective farms much as they did in the 1980s. Former collective farm members will maintain access to common resources for their private vegetable gardens. Elsewhere in Central Europe, for example, in Slovakia and Poland, far-reaching agrarian reform promoted rural markets early in the transition process and severed the ties between large farms, private plots and labor intensive production. Much labor left the agriculture sector in the early transition, and the production process improved. In Ukraine, as in Russia, political circumstances were the main constraint on reform. Rather than meaningful reform that encouraged market-oriented behavior, the government implemented short-term tax mechanisms. This article argues that under political constraints, tax policy must be redesigned with consideration for institutional features of the transition process as well as the standard optimal tax theory.

## Unified agricultural tax in Ukraine

The UAT, introduced by presidential decree on June 18, 1998, was in some ways an improvement on the previous tax system. It replaced ten taxes - enterprise profit tax, land rent, tax on owners of transport vehicle, communal tax, charges for prospecting, Chernobyl Fund charges, Social Insurance Fund charges, Construction Fund charges, Pension Fund charges, Innovation Fund charges - by a single land tax. The rate was fixed by decree: 1.3 percent of land value for arable land, hayfields and pastures, and 0.3 percent for perennials. There were two exclusions: (1) enterprises with under 50 percent of gross income derived from the sale of agricultural commodities and (2) enterprises with gross tax payments (calculated in the old way) that exceeded by more than 50 percent the unified tax rate. The importance of this reform lay in its simplification and unification of the tax structure.

This did not, however, promote reform and restructuring. The reason is that taxes and subsidies interact with each other and with economic structures. There are three stages in designing and analyzing tax and subsidy policy. Current taxes and subsidies and their effects are analyzed to evaluate alternative instruments for encouraging economic growth across sectors. Political decisions are taken regarding the desired relative weight of taxes and subsidies on rural producers and urban consumers (or social welfare) and calculations are made for missing markets and distortions, for example, unclear property rights in land (Hoff, Avishay et al. 1993). The final stage is to design a tax and subsidy regime that achieves the chosen policies (Sah and Stiglitz 1992). In other words, a tax on any sector should be designed with regard to all sectors. For example, in FSU countries, where the mobilization of resources is a key objective in transformation, it is counterproductive to impose a tax that encourages the retention of population in one sector, where the productivity of labor and earnings can be expected to be lower than in other sectors. Such policies further isolate the former state and collective farms from services and industry, implying inconsistency in economic reasoning as well as fiscal design. It is non-agricultural earnings that should be stimulated in rural communities of the FSU, where narrow production profiles are poor insurance against downside risk.[3]

[3] Rather than ‘pure risk,’ which is used in investment appraisal, the more appropriate description for agriculture is ‘downside risk,’ where any significant deviation from the norm is adverse (Hardaker, 1997, p. 7).

### Analysis and tax planning

In addition to concern for mobilization of resources, the formulation of policies for a transition economy also requires concern for technical issues that shape the kind of taxes that can be imposed. In transition countries, as in the developing world, there are limitations on monitoring transactions within the rural sector, which make taxes on trade difficult and costly. If they are imposed, there will be extensive evasion. Taxes on property require records that are not kept and assessments that cause controversy and conflict as well as legal costs. The government will need to tax the trade between the rural and urban sectors. The equivalence of various taxes makes it possible to choose between tax instruments, which can have different administrative costs. A marketing board, which imposes controls on food and producer prices, for example, has effects comparable to those of taxes and subsidies levied on consumers and producers, with different costs of administration. In determining the incidence of taxes and subsidies, the only vital consideration is relative prices. This underscores the importance for transition governments to determine beforehand, what sectors and groups of producers and consumers are being subsidized and which ones bear much of the burden of taxes.

### Key issues in tax reform in transition economies

The general revenue objective of tax reform in transition is to widen the base by shifting the main burden of taxes to households and to make the income tax on enterprises more moderate and more directly related to profits. Another revenue objective is to reduce direct cash payments as a means of subsidizing an activity, while obtaining greater revenues by lower, more collectable rates. In its developmental objective, the government aims to encourage markets by stimulating private production through tax neutrality across sectors and across the public and private spheres. Tax reform in transition thus brings fiscal structures into conformity with world practice. New taxes are designed to allocate resources through effects on consumption and production decisions and modify the distribution of income and wealth. Because of particular problems arising in transition, such as arrears, barter, and corruption, tax systems in transition countries also aim to reduce these dysfunctional outcomes.

**Evaluating the unified agricultural tax in Ukraine**

The evaluative criteria used to analyze the UAT are founded in questions about how well this tax meets the above general objectives and specific transition tasks. The criteria are: (1) the structure of taxes (neutrality across sectors and spheres); (2) the impact on production and consumption decisions and on factor markets, (3) the impact on the public sector, and (4) the impact on transition conditions. In view of the missing markets and distortions in the economy, which limit the quality of predictions, this article aims only to set the analysis in the context of economic conditions in Ukraine in the 1990s, the environment determining how new tax will affect production and consumption decisions.

*Domestic effects*

The main domestic effect of tax relief, envisaged as part of the agricultural land tax, is to eliminate the profit tax from the corporate sector in agriculture, creating both sectoral effects and distortions in rural production costs. This easing of taxes for agribusiness creates a disproportion between large corporate farm enterprises and individual farmers, contributing to the decline in numbers of the latter in the late 1990s. Furthermore, the land tax brings about greater uncertainty in net income for all farmers than would, say, an export tax (Hoff 1993; Skinner 1993), especially in view of transition circumstances where risk has been increased due to considerably reduced use of fertilizer and herbicide (Leonard and Serova 1999). Smaller and subsistence farmers will feel the impact of risk more powerfully than large corporate farmers due to the greater diversity of production on large farms. Due to the potential importance of risk, the export tax is preferred generally to the land tax so that governments, with better access to credit markets than farmers have, can pool the risks (Newbery and Stiglitz 1981; Skinner 1991).

The Ricardian tax on net land profits, which causes no distortions in principle, is, nevertheless, a difficult standard to achieve. Assessment procedures can fail to distinguish between the Ricardian site value of land and its market value (inclusive of improvements - the net income, or market-value tax, usually falls on capital improvements) (Skinner 1991). If soviet-era estimates of the value of land are not updated for this land-based tax (which is unlikely since land is not available for sale in

Ukraine), the tax turns into a form of rent. Short-term rentals, like the land tax, in principle, depress the value of real estate.

Depression of land values can be expected from the UAT due to the special issues that arise when land is taxed. The predominant features of land are that it is fixed in supply and that it is durable. When there is a tax, the present discounted value of the stream of rents falls not only by the present amount of the tax, but by all future tax liabilities, since they must be calculated in the future stream of returns. Capitalization, by which a stream of taxes is included in the price of an asset, means that future landlords get benefits in the lower price paid for the land; thus capitalization is part of the analysis of the incidence of a tax on land.

In their effort to reduce their taxes, landowners will try to conceal information about the true value and extent of their holdings (Skinner 1991). Generally, when such taxes are imposed, then in the valuation process and afterwards, in anticipation of valuation, landed resources will be concealed, sold, or not cultivated, which can be detrimental to land improvement.

Next to the depression of land values, potentially the most significant negative effects of this tax will be its distributional effects under present conditions. In view of the range in the value of land used for agriculture in Ukraine, this tax will affect different regions in different ways. The burden of the tax as a fraction of the land value is greatest where the land is least productive and lowest where it is most productive. In poor communities in some regions of western Ukraine, the tax will be especially burdensome. The ramification of these effects will gain in importance over time. In the short term, collections may rise and revenues improve, although this may not necessarily be the case. In the medium and long term, the general effects associated with such taxes will assume weight and significance. The low-productivity sector will retain and potentially increase its share in employment, although it will not increase its share of GDP, and land value will be depressed in areas with highly fertile soil. As terms of trade shift, agriculture will be protected relative to other sectors, raising some problems in international negotiations on trade. The consequences of protectionism will aggravate the effects of the failure of institutional transformation.

There are inter-sectoral effects of the UAT that emerge largely from the exemption of farms from the profit tax, which is retained for other kinds of enterprises. Job creation in the low-productivity unreformed sector, if it occurs, will attract some urban workers into agricultural production, where their efficiency will be lower than in services or manufacturing. Although in the 1960s and 1970s, the main trend was an outflow from rural areas, the transition has led to a reversal of this trend. The share of rural dwellers has increased, rather than declined, as subsistence farming and vegetable production on small plots became a form of by-employment for urban as well as rural dwellers. In Ukraine, the share of the labor force in agriculture is already substantial (22 percent).

*Foreign trade effects*

Because of the importance of FDI and outward processing trade to technological development in transition economies and because of the key role exports have in encouraging agriculture, a main focus of transition tax analysis should be the effects of a tax on foreign trade. As Ukraine seeks admission to the WTO and other multi-lateral political and economic organizations, the potential effects in foreign trade must not be ignored. Ukraine's international commitments, including anti-dumping provisions of multi-lateral agreements, as well as Ukraine's application for membership in the WTO, may necessitate a reconsideration of the relative value of the domestic political advantage of such a tax. The tax adds to an already highly protective regime, extended through subsidies, including debt write-off, and tariffs, which are generally high. Import tariff rates on dairy and sugar, among other commodities, are in the range of 30 to 100 percent. Ukraine could potentially be one of the major grain and dairy producers of CEE, and it risks affecting bilateral agreements as well as multilateral arrangements in the regional free trade agreements. Ukraine's two major trade partners, Russia and EU, are potentially affected, since protection is already an issue in negotiations. Ukraine exports beet sugar to Russia, for example, and refines imported cane sugar for domestic use. The UAT may shift prices significantly in the sugar industry, such that beet sugar, for which there is little world demand, is favored over the more efficiently produced cane sugar, for which there is demand. Increasing protection of beet production for exports will be a stumbling block for Russian-Ukrainian trade negotiations.

*Effect on the tax system*

If taxes are unified and simplified across the economy, then this tax does not present any special advantages in its unification and simplicity. The land tax exempts agricultural producers from the profit tax and from some fees and taxes to local government; meat and dairy producers and processors are already exempt from the VAT.

The principle of transparency is not observed in this tax, since there is a provision by which the tax can be paid in barter, which opens up possibilities for measurement problems, corruption, and difficulty in monitoring. This tax, in principle, can even be a conduit for government procurement, which would alter its function, purpose, and impact (Cramon-Taubadel, Theissen et al. 1998).

The width of the tax base in Ukraine may be diminished by the UAT in three respects. In principle, a low or moderate tax on real estate is standard in most countries, since a land tax based on land area or on crude productivity measures that raise some revenue can be useful to local governments, which have limited needs. Generally, governments that tax land impose a universal real estate tax, so that no special group is burdened and the width of the tax base is as great as possible. The tax base in the Ukrainian land tax is not widened, however, but narrowed, since the tax reduces liabilities for the profit tax. The exclusion of farm joint stock companies, which range in size, can be significant. Their average size is 3,000 hectares; production includes not only agriculture but also agribusiness. In future, as agribusiness becomes profitable, potential tax revenues will be lost. Lastly, because local taxes are excluded, local governments will lose a potential source of revenue in rural areas.

The auto-stabilizer effect, cushioning the variance of income, which is accomplished by commodity and export taxes, has no role in a land tax, since the tax bears no relation to income earned during a year. Farmers will be taxed exactly the same both in years of good harvest and in years of bad harvest.

*Production and consumption decisions, factor markets*

The main effect on production is achieved through the exemption from the enterprise profit tax, which supports production on large farms. As the German Advisory Group in Ukraine observed in reports to the Ukrainian government, this may compensate for the adverse affects of other kinds of intervention (Cramon-Taubadel, Striewe et al. 1998). There is further encouragement of agriculture in the exclusion from tax relief of those whose gross agricultural output is less than 50 percent of revenues. In effect, the incentive favors the reduction of agribusiness in production units. This tax will be an incentive to retain agriculture as a fundamental feature of the production structure, even though market demand might require a shift into services or other kinds of production. On the other hand, the small farming sector, which will be negatively affected by this tax, has shown itself far more dynamic over the past few years than the corporate sector. Thus, the effect of this tax may not encourage output in the agricultural sector, despite political support based upon that assumption.

Another critical clause in the UAT requires agricultural enterprises whose profits are excessive (see above) to pay tax according to the old method. This clause provides an incentive to suppress economic activity and show reduced profits. The tax for this reason fails to reward technological advancement.

Whether consumption decisions are changed as a consequence of this tax depends in part upon demand, which tends to be inelastic for food commodities. Thus, if food became cheaper, urban incomes would improve, but not necessarily agricultural prices. Despite their high price, imported foods might still be preferred, especially if the quality of domestic production worsened as a consequence of lack of competitiveness, one general result of protectionism.

*Public sector: budget, enforcement, environment*

In the short term, the UAT may not increase revenues due to the acceptability of using barter as a form of payment.. The medium term effect is also unclear. Total tax revenues may decline, as profits taxes are foregone in one sector, especially if resources shift into this sector. Farmers may dispose of some of their land, and tax revenues will diminish over time. The issue of arrears is also relevant in anticipating total tax collection. If policy continues to include debt-write-off, then this tax will not be collectable and revenues will fall.

The cost of compliance will clearly increase. Skinner (1991) underscored the importance of special administrative costs of a land tax. The requirement of monthly payments will generate the need for a new tax administration, especially since this tax is seasonally uncollectable. Producers will be required to keep two sets of books, one for the old and another for the new system, in case their exclusions and exemptions are challenged.[4] This will generate costs for producers, reducing the clarity of the system as well as their profits through extra labor. The elimination of communal and other local taxes will mean the loss in local services. Although this tax may improve the payment of pensions, equity of the tax system may be a problem, since rural dwellers are paying a disproportionate amount for pensions (67 percent of this tax is intended to fund pensions).

The environment is likely to be further affected by this decree. The incentive for diminished land quality may lead to the further depletion of soil nutrients, which will inhibit sustainable development and ecological improvement. The reason is that the situation in rural areas is already seriously threatened as terms of trade have worsened, and fertilizer usage has diminished. This tax may enhance these effects.

*Transition issues*

One of the most important problems with this decree is the corruption it may foster. Lack of land sales will lead to a differential between real values and tax assessments. Empirically, this variable can range from 10 to 100 percent of the price established by government assessments. Such a wide range will lead to misevaluation of the land or negotiated settlements, which will contribute to the lack of transparency and may be difficult to monitor.

The shadow economy is unlikely to be reduced by this tax. Unequal treatment of agricultural and non-agricultural production will be an incentive to evade by hiding non-

[4] Comment by Don Van Atta.

agricultural production in rural areas. The use of barter will add to the lack of transparency in the decree.

## Conclusion

The inter-sectoral effects of the UAT cannot be ignored. Exempting farm enterprises from profit tax will lead to a shift in employment from the more efficient services and manufacturing sectors to the less efficient agricultural sector. Favored treatment of agricultural in contrast with non-agricultural production will encourage evasion by hiding non-agricultural production and services in rural areas.

Any special tax measure for one sector should take into account its effect on the whole economy. Tax policy in transition economies must take into account the institutional characteristics in the economy. The tax systems in FSU countries should also aim to reduce abnormalities created by arrears, barter, and corruption. Tax reform should focus on bringing the fiscal structures in line with world practice

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# 10

## PROLOGUE TO PRINCIPLES OF LOCAL GOVERNANCE[1]

*Henry Teune*

A fundamental problem in establishing a democratic political system is to develop a local political system for legitimacy and at the same time to support a market economy for prosperity. A foundation of local self-governance is necessary for stable democratic national order. That is likely to be in conflict with macroeconomic policies.

The two conflicting principles of local self-governance are requirements for a democratic political community and a viable local political economy. The former favors smaller units of collective action and responsibility; the latter favors larger units for production and distribution of scale. This conflict invites a mass of smaller units with political participation for harmony and legitimacy, often villages, small towns, or traditional settlement areas, and complicated transfer payments from larger, provincial and national governments, to localities to provide resources necessary for an economic infrastructure in roads, utilities, and buildings. These relationships are strained by economic growth based on changing technologies of production and new local ecology of production as well as the consequent increased local burden of welfare.

In the push for political community, local governments are often in the front line of social and economic conflicts among groups. The means for dealing with these conflicts are repression of some groups, spatial segregation of them in neighborhoods, and negotiating differences. The burden of conflicts increases as democratic governance reduces authority for suppression and residential control, including over immigrants. Local government, of course, has always been a way for national governments to contain

[1] This paper is based on the author's papers: (1) *Who Collects, Who Pays, and Who is Responsible* (1988), published as proceedings of the International Workshop on Local Finances in the Contemporary State, Norwegian Council for Applied Social Research, and (2) *The Political Economy of Local Political Participation* (1988), presented to the XIV World Congress of the International Political Science Association, Washington, D.C.

and soften ethnic-national, regional, religious, and economic conflicts within "nation-states".

The three essential components of local self-governance with open elections to representative bodies are legal competencies, legitimacy, and resources. A local government, in other words, must have unchallenged rights to enact laws, be accepted as the leading institution to achieve publicly endorsed values, and have the capacity to generate resources from its own sources. All three are necessary and related.

**Legal competency**

A legal system is integral to the development of local self-government. The tests for legal competency are explicit laws, consistent and fair application of them, and a reliable and acceptable system of adjudicating disputes and resolving conflicts.

*Legal authority*

Local governments are territorially circumscribed and subordinate authorities, subject to higher level authority. Competencies to act legally are denied to them, shared with higher levels of government, or exclusively theirs. The two legal traditions of local governments are capacity to act only if possessing explicit legal authority to do so or can act unless proscribed by higher level authorities. Although all local political systems have mixtures of legal and traditional authority, local self-government is enhanced to the extent that powers to act reside in local governments unless preempted by higher level authority. Further, each local government should have its own public "charter" (in the U.S. "home rule"), possible even in unitary political systems.

*Independence of public officials*

Every local government should have some "responsible" individuals who can exercise authority with no questionable conflict of interest. Competence must be established by government at least ostensibly able to act fairly, "above" particular interests, especially those causing conflicts in a locality.

*Local arbitration and courts*

Probably the most distorted element of traditional local governments is the system of justice operated by them and that is a major reason that higher level national courts are focal points for expectations of justice. Localities can have both informal mechanisms of arbitration by local "notables" as well as a court system subject to review to assure claims of state sovereignty. Both systems, however, must operate openly to strengthen the public nature of local justice and to reduce potential abuse.

**Legitimacy**

The two tests of legitimacy of any organization with authority are, first, that its assertion about what it can do meet everyday evaluations of what in fact it is doing and, second, that what it asserts it is doing is congruent with the values of those to whom its authority is being applied. Business organizations must make profits and schools must educate in terms of the expectations of those who are constituents or "stake-holders". The specific criteria for self-government are responsiveness and effectiveness.

*Responsiveness*

The main means for responsiveness in constitutional democracies are competitive elections signified by open competition among groups through the mediation of political parties. Second order mechanisms for responsiveness are at least symbolic representation of groups and interests in the institutions of authority. The third tier of responsiveness is based on the accessibility of all groups and individuals to the agents of authority in scheduled meetings, easily available publications, and public meeting, extending in some countries to regular referenda. The responsiveness of local government depends on responsible and transparent authorities with protections for those losing out in decisions.

*Effectiveness*

Other than the elusive evaluations of the performance of local governing institutions, effectiveness can be facilitated by their accountability, the ultimate test for democratic governance. The weaknesses of elections come from their vulnerability to manipulation, especially at the local level. Electoral accountability must be supplemented with reporting, "independent" auditing, and surveillance by local and higher level courts. To these must be added some measure of efficiency of government. Democratic governments, including local governments. are notoriously inefficient in most democratic countries, requiring the constraints of competition from other localities for skilled people and economic organizations to sustain economic prosperity or avoid bankruptcy.

**Resources**

Autonomously generated resources are necessary for self-governance. The alternatives are grants from other institutions or transfers from higher levels of government, almost always tied to restrictions that limit the range of choices for local politics and stimulate political participation. Taxes can be obtained from monetized property, activities, and material and labor. Monetized items are a challenge for local governmental taxation because of the ease of their transfer outside of local jurisdictions. The principles that must be addressed include observability, corruptibility, and fairness.

*Observability*

Over the past century monetization of economic activities has shifted sources of revenue from property, to exchanges (sales), to income, and to value added. The critical questions are what is easily visible and not likely to move territorially. Property and its uses are the most obvious; restaurants, hotels, sporting and other entertainment events are others. It is likely that all of these already are targets of taxation by other governments, but localities can "add on" according to the relative value of their location. This, however, puts localities in competition with higher levels of governments and neighboring jurisdictions (Breton 1998). The range of increases in taxation is limited but easily observed for compliance.

*Corruptibility*

Local taxation is famously corrupt and leads to periodic political pressures for adjustments either by special initiatives of local government or by higher authorities. Corruption goes beyond overt bribing. It is the accumulation of biases over several years or even decades, which in many countries, emerge into obvious inequities and detracts from the legitimacy of local self-government. Many local governments have instituted "tax adjustment" committees or processes to offset this tendency. They too must be open and their decisions made easily accessible to public scrutiny.

*Fairness*

Collecting revenues is difficult enough given the strong incentives to justify evasion. Tax compliance depends on what taxes are used for and how. An axiom of politics is that all collective decisions have winners and losers. Politics is defined by the dynamic of who gets what, when, and how. Thus, public budgeting is necessary for local self-governments both for committed taxes (collected for specified purposes) and general revenues, for the costs of governance. All governments obscure budgets to avoid conflict and accountability. The only route to the long-term legitimacy of self-government, however, is a transparent budget.

**Local democratic governance and macroeconomic policy**

The classic question of democracy is what size polity is optimal (Dahl and Tufte 1973). Small units provide the social cohesion and the bases for participation and the resolution of conflicts. But small polities cannot address questions sufficiently significant to motivate political participation. Trivial issues are believed to dampen participation in local politics, as can be seen in differences in turn-out in voting in local and national elections. Low participation reduces legitimacy and weakens accountability.

The advantages of the local for democracy are expressed in a general belief of politicians that all politics are local and in the Federalist Papers as the principles of immediacy and visibility of the local in comparison to a more distant national. The fundamental problem is that prosperity depends on the scale of production and consumption that has driven the emergence of national economies and today is driving the formation of a global one. Reconciliation of macroeconomic policies for a single political unit with diversities and small-scale units for democracy is the challenge that can only be partially met by a reduction in the claims of national governmental authority.

Empirical estimates of the optimum size of cities in a then industrial society in the U.S. about a half century ago was between 50,000 and 100,000 based on efficiencies of governments collecting revenue and delivering public services of water, waste, and welfare. No similar calculations have been made since in the face of new and rapidly growing urban forms of governance in residential associations, quasi-private local governments in "edge cities" and around shopping malls or, indeed, in industrial and research parks (Duncan 1951).

One of the unanticipated political developments in the process of European Union integration has been the emergence of regional entities, cutting across boundaries of countries but recognizing the advantages of scale to promote special markets in trade and tourism, address problems of the environment, and develop transportation systems. Their officially recognized number is over 250, soon to approach 300 for 15 countries. Local governments have sought out greater scale through agreements and contracts with others, retaining their size for democracy and achieving scale for their well being.

Systems of scale requiring large aggregations of human activities have to be constructed in messy arrangements, along fuzzy lines. Countries are neat with boundaries, even if contested. Ways to optimize the benefits of scale and to retain small and historic local political units are "compacts" among two or more local authorities or intergovernmental agreements under contract law to provide police and fire protection, to use common water basins, to control pollution, or even to share local schools[2].

One conclusion from the foregoing is that the concept of local self-governance has to be altered from that of a local government as an agent of a provincial or national government to one of autonomous entities with a variety of external relations with their immediate neighbors and beyond (Bullman 1997). As such, local units with legitimate, collective decision capacities will also operate as entrepreneurial entities, compete with others, cooperate for gain, and, indeed, become part of one or more global political economies whether defined regionally by special problems, or local "comparative advantages".

[2] Several thousands of these were already established in the Philadelphia region by the 1960s. See Toscano J.V. (1964). *Transaction Flow Analysis in Metropolitan Areas* in Philip E. Jacob and James V. Toscano. *The Integration of Political Communities.* Philadelphia: J.B. Lippincott

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# 11

## FISCAL DECENTRALIZATION IN UKRAINE

*Wayne R. Thirsk*

This paper has three aims. First, to sketch the main characteristics of a decentralized fiscal system and establish a benchmark against which to gauge the degree of fiscal decentralization in Ukraine and indicate the broad outlines of reforms which would move Ukraine further along the road to decentralization. The second objective is to describe the progress Ukraine has achieved thus far in decentralizing its fiscal system. Finally, an attempt is made to look at some very recent reform proposals that would promote the goal of fiscal decentralization. The paper begins with a short discussion of the economic benefits of decentralization.

**Why decentralize?**

Although the rewards of fiscal decentralization are frequently taken for granted, it is useful to have the merits of decentralization firmly in sight in looking at alternative ways of achieving this outcome. The basic argument favoring some form of fiscal decentralization is that it improves the efficiency of resource allocation within the public sector. A decentralized fiscal system allows citizen-voters to more effectively choose the amount and type of public services that are provided for them. When there is a high degree of demand variation within the population for different levels of public services, a decentralized fiscal system is better able to accommodate this diversity in tastes. Those with low demands for public services can enjoy lower levels of provision while other groups with higher demands can realize higher levels of provision. These differences in tastes will be reflected in corresponding differences in the willingness to pay taxes for public services.

In catering to different levels of need and supplying public services according to the willingness of voters to pay for them, a network of local governments with clearly defined expenditure responsibilities can contribute to a higher level of economic welfare or efficiency. Pushed to its limits, the benefits of decentralization will be maximized according to the principle of subsidiarity, or assigning every expenditure task to the lowest level of government that is capable of implementing the task. Only in the unlikely event that people's demands for public services were completely uniform would decentralization fail to deliver higher levels of economic welfare. Even in this situation, a decentralized fiscal system could offer significant dynamic benefits in the form of greater experimentation and innovation in the delivery of public services.

In a transition economy such as Ukraine, decentralization of the public sector is the fiscal counterpart of privatization of the State-owned economy. Just as privatization is intended to force enterprises to be more responsive to the needs of consumers, decentralization is designed to goad the public sector into being more sensitive to the demands of citizen-voters. Both privatization and decentralization would replace a supply-driven command economy with a demand-driven economy that aligns the use of resources more closely with the needs of households and thereby contributes to a more efficient economic performance.

**Essential features of a decentralized fiscal system**

If local or sub-national governments are to provide those public services that households want and are willing to pay for, they must be given the appropriate set of fiscal tools to accomplish this mandate. Local governments must be fiscally empowered to decide on the level of total expenditures they will undertake and how that total will be allocated among different functions. That is, in a decentralized fiscal system, the decision of how much to spend and what to spend on is a locally determined decision and, in making these decisions, local governments are responsible only to local residents and not to higher level governments. To exercise this expenditure autonomy in an efficient manner, local governments require access to local revenue systems with three important attributes:

1. Local governments must have sufficient revenue autonomy to be able to adjust at the margin the amount of revenues they raise from their own revenue sources. There are four dimensions to revenue autonomy- the ability to alter tax rates, the ability to define the tax base, the ability to decide which taxes to impose, and the ability to collect taxes that are imposed locally. Of these, the ability to modify tax rates is

undoubtedly the most important because, in its absence, the power of local governments to raise additional revenue at the margin is severely constrained.

2. Local taxes should be taxes borne by local residents. Otherwise, expenditures that benefit local residents will be paid in part by non-residents and local decision-makers will be held less accountable for their expenditure decisions by local residents. Taxes on enterprise incomes and excise taxes collected at the point of production, for example, are poor candidates as local taxes because most of their burden is exported to non-residents.
3. Transfer payments received from higher level governments should be of an unconditional nature and not interfere with the expenditure priorities of local governments. The only qualification to this requirement is that, if local governments are assigned expenditure tasks that result in sizable benefits for outsiders, the interests of outsiders may need to be protected by transfers that take on a conditional nature and require the transfers to be spent in a particular way. The important issue of appropriate expenditure assignment is discussed below.

Decentralization dispenses with one of the advantages of a centralized fiscal system, namely the ability to pool revenues and to allocate them in an even-handed fashion to lower level expenditure units. Decentralization inevitably leads to the emergence of regional fiscal disparities, as some jurisdictions will by nature be endowed with richer tax bases than others. Decentralized fiscal systems therefore require an efficient equalization mechanism that reduces, if not entirely eliminates, horizontal differences in fiscal capacity among local government jurisdictions. Efficient equalization schemes are formula-based and involve either direct transfers from rich to poorer jurisdictions or, more frequently, transfer payments from higher level governments to fiscally poor lower level governments.

In addition to these horizontal transfers, vertical transfers from higher to lower level governments may be required if lower level governments generally are not assigned adequate revenue powers to meet their expenditure responsibilities. Efficient transfer programs provide stable revenue flows to lower level governments and permit lower level governments to finance a “typical” level of expenditures when “typical” tax rates are applied. Transfers of this type are divorced from the actual expenditure and revenue performance of the recipient and do not, therefore, either encourage higher levels of spending or lower revenue efforts.[1]

Decentralization is also unlikely to deliver its full range of efficiency benefits unless there is a sensible assignment of expenditure responsibilities among different levels of government and a clear understanding of who does what. According to the correspondence principle, expenditures should be assigned in such a way that the geographic scope of the benefits from the expenditure matches the territorial size of the jurisdiction that makes the expenditures.[2] Functions allocated to the national government, for example, should have a national dimension, as in the case of national defense. Expenditure assignments that contravene the correspondence principle will generate benefit spillovers among jurisdictions that are inimical to efficient expenditure behavior and would require complicated conditional transfers from higher level governments to offset them. Finally, if there is some conflict or lack of clarity over "who should provide what", it will be difficult for taxpayers to know which set of public officials should be held accountable for any kind of expenditure decisions.

**The status of fiscal decentralization in Ukraine**

Ukraine has signaled its intention or desire to fiscally decentralize in two important pieces of legislation, the new Constitution, and the recently passed Law on Local Self-Government. Both laws envision the formation of a highly decentralized fiscal system in which local governments, defined as cities, towns, villages and settlements, would enjoy complete budget autonomy in formulating and executing their budgets. They would use funds from the State budget initially and, in due course, the revenues from general state taxes transferred to local budgets. Activities with a wider geographic scope would be undertaken by district and regional councils using funds received from local budgets on a

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[1] See Ladd(1994) for a perceptive treatment of how to measure the transfer gap between expenditure needs and revenue raising capacity using standardized calculations that put the size of the transfer beyond the control of local officials.

[2] Oates(1972) is a basic pillar of the economic literature on "fiscal federalism" and contains an excellent discussion of the correspondence principle as well as the other important aspects of successful fiscal decentralization.

contractual basis. This bottom-up approach to financing the activities of higher level sub-national governments would represent a total reversal of the top-down fiscal linkages that were characteristic of Soviet times. Oblasts and rayons would wither away as important fiscal institutions and the considerable fiscal powers that they exercised in earlier periods would disappear as they became financially dependent on contractual contributions from local governments to undertake only those common projects desired by local governments.

Neither the Constitution nor the Law on Local Self Government outline a clear or coherent strategy for decentralization and both leave dangling the important issues of specific revenue and expenditure assignments among different levels of government as well as the matter of fiscal equalization. As a result, Ukraine has made only limited and halting progress towards achieving a decentralized fiscal system and the traditional budget “matroshka” continues to rule by default.[3]

Under the “matroshka” model, the budgetary process for the entire country begins with the formation of the State budget that determines the revenue and overall expenditure levels of sub-national governments as in a unitary state. The schedule of subventions and contributions to be paid by and received from the oblasts represents the marginal source of finance for oblast budgets and therefore provides an effective ceiling on how much the oblasts can spend. Once oblasts are informed of how much revenue they can expect, they prepare their budgets in a fashion similar to the State budget and finance their subordinate rayons with a mixture of shared taxes and subventions. Each rayon, in turn, uses a similar financial recipe of shared taxes and subventions to fund its subordinate cities, towns, villages and settlements. In Ukraine, very little has changed since Soviet times at the sub-oblast level where the budgets of different levels of government remain hierarchically interlinked.

[3] While the Constitution envisions a highly decentralized system of local governments, the Law on Local Self-Government offers a seemingly more limited view of decentralization by partitioning the expenditure responsibilities of local governments between delegated and own authorities. With expenditure delegation, local governments would act as agents of the central government and execute certain functions on its behalf. Although these authorities are not specifically defined in the Law on Local Self-Government, popular discussion of this topic in Ukraine makes it clear that delegated authorities would include health, education and most elements of social protection, or, in other words, the bulk of the expenditures now undertaken by local governments. In this sense, there is no intent on the part of Ukrainian policy makers to fully decentralize these important expenditure functions because of their national significance.

Fiscal relationships between the oblasts and the State government, however, have tended to follow an evolutionary path towards greater, albeit limited, fiscal decentralization. In the Soviet era, expenditure levels were established for each oblast as part of the annual budget plan and the funds needed to finance this spending were provided by a mixture of own, fixed and regulating, or shared, taxes. Because of variations in the size of the tax base among oblasts, the tax shares varied both by tax and by jurisdiction, in an attempt to equalize the fiscal capacity of different oblasts. Since tax sharing could only partially meet the need for fiscal equalization, subventions to poor oblasts, and contributions from rich oblasts, played residual roles in equalizing oblast budgets. The combination of tax sharing and positive and negative transfers suggests that tax assignment was essentially irrelevant in the Soviet system of public finance. As long as the primary objective was to provide financing for targeted expenditures, any change in the assignment of taxes was offset by changes in sharing rates and levels of subventions and contributions. Moreover, given any tax assignment, any change in sharing rates would be matched by changes in the levels of contributions and subventions as the Ukrainian experience illustrates.

In Ukraine, the mixture of shared taxes and subventions as the fiscal tool for balancing and equalizing oblast budgets has shifted from year to year. In 1994, all income taxes were shared at a 50 percent rate with the oblasts and both the VAT and all excises were shared at the uniform rate of 20 percent. The result of uniform sharing rates across all oblasts was a high degree of dependence on subventions as the residual balancing mechanism for oblast budgets. Twenty-two of the twenty-seven oblasts received subventions and the other five were contributors.

In 1995 and 1996, more emphasis was placed on the VAT as the primary regulating mechanism. The VAT shares varied inversely with the relative fiscal capacity of the oblast. Poorer oblasts were allowed to retain all of the VAT proceeds collected in their jurisdiction while the richer oblasts, such as the city of Kyiv kept only a small portion of their VAT collections. Because variable VAT sharing rates did much of equalization task, the number of subvention recipients among the oblasts declined to fourteen in 1995 and twelve in 1996.

With the passage of the 1997 national budget, Ukraine largely abandoned the practice of tax sharing and embraced the notion of tax separation between central and oblast budgets. Revenues collected from the VAT were assigned exclusively to the central budget and revenues from the personal and enterprise income taxes were transferred to the oblasts for their exclusive use. This new revenue assignment did not greatly enhance the revenue autonomy of oblast governments since control over the tax rates and definition of the tax based continued to rest with the central government. In another sense, however, tax separation gave oblast finances an additional degree of freedom as the amount of revenues received became much more dependent on the performance of tax collections.

In 1997, and also in 1998, revenue collections from income taxes exceeded expectations and oblasts, as a group, were able to over-execute their planned budgets. In this sense, a greater degree of fiscal decentralization was achieved, as oblasts were successful in adjusting the amount of revenue they received from their own separate revenue sources. However, this decentralization initiative has been severely blunted with the passage of the 1999 budget. This would return to the former Soviet system of sharing both income and excise taxes with oblasts and using negotiated subventions and contributions as the marginal funding mechanism for balancing oblast budgets at expenditure levels determined by the central government. With the adoption of this budget, oblasts will lose what limited revenue independence and expenditure discretion they had enjoyed in recent years.

## The long road ahead in Ukraine

From the brief description of recent intergovernmental fiscal history that has been presented, it is clear that Ukraine lacks most of the major attributes of a decentralized fiscal system.[4] In particular, future fiscal reforms that would enhance decentralization in Ukraine will need to focus on the following set of issues:

[4] While this paper argued that fiscal decentralization would be a desirable step to undertake in the future, it has also neglected some of the dangers of decentralization that should not go entirely unmentioned. The questions on whether there is sufficient accountability to confidently assign more expenditure responsibility to local governments, and whether national or “minimum” standards should be applied to certain expenditure categories (such as health and education), have been deliberately sidestepped. They would need to be addressed as part of an overall strategy to achieve greater fiscal decentralization in the future. See Bird (1993) for an enlightening discussion of these and other issues.

1. Developing a significant source of own revenues that local governments, especially cities, can adjust at the margin. The most promising candidates are property tax and surcharges on personal income tax, as is currently being done in a number of Eastern European countries such as Romania. Surcharges may be the only viable short run option as it is widely recognized that it will take several years to fully implement a workable property tax. The existing array of strictly local taxes in Ukraine yield relatively little revenue, typically less than five per cent of sub-national revenues, and cannot play a major role in contributing to greater local revenue autonomy.
2. Making local taxes fall on local residents. Unless local taxes are borne by local residents, local expenditure officials will not be strictly accountable for their decisions and one of the main virtues of fiscal decentralization would be sacrificed. In this respect, the assignment of the revenues from the enterprise profits tax to local governments is highly questionable as its burden is extremely unlikely to be borne by local residents.
3. Developing a stable and transparent system of intergovernmental transfers that is formula-driven to replace the present system of ad hoc and negotiated transfers. While the current transfer system does a reasonable job of equalizing oblast fiscal capacities that is its sole virtue as it also encourages inefficient expenditure decisions and stifles revenue-raising incentives. The original draft budget for 1999 promised to introduce a new formula based transfer program but it was subsequently withdrawn by the Ministry of Finance.
4. Elaborating a sensible and clear-cut set of expenditure assignments for different levels of governments. Current assignments in the areas of communal services and social protection are particularly murky and a strong argument can be made for reassigning the major responsibility for social protection from local governments back to the central government. Social protection was devolved to local governments beginning in the early 1990’s as an unfunded mandate and the subsequent steady growth of expenditure arrears in this area provides ample testimony of the incapacity of local governments to adequately execute this function.

5. Strengthening the institutional basis of local governance and the accountability of local governments to local citizens. As the former mayors of the cities of Kyiv and Odessa discovered, they are more likely to be dismissed by the President than by local electorates.

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# 12

## THE ROAD TO INTERGOVERNMENTAL FISCAL REFORM IN UKRAINE

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**Overview**

Ukraine inherited its current system of intergovernmental finance from the Soviet era. Within that system, local budgets in the fiscal hierarchy of oblasts, rayons, and cities, towns and settlements were formulated on the basis of detailed expenditure norms and financed by an essentially arbitrary combination of shared taxes and subventions. Taxes were shared on a derivation or origin basis of where they were collected and any shortfall between planned expenditures and expected revenues was covered by a subvention from a higher level government. Conversely, local governments experiencing a revenue surplus were required to contribute that surplus to a higher level government.[1] Local governments were de facto fiscal extensions, or deconcentrated fiscal agents, of the central government having almost no control over, or influence upon, local fiscal decisions.

Despite some significant modifications that have occurred since independence, the old Soviet system of intergovernmental finance remains by and large intact today. Expenditure norms continue to be used as the basis for formulating local budgets, although in the face of shrinking revenues the central government now sets an overall spending limit for local budgets and uses the norm-based budgets to allocate this amount among different oblasts.[2] Starting in 1997, different levels of government had exclusive

[1] The expression "local governments" has a different connotation within the CIS region than the one normally ascribed to it. As used here, local governments refer to any of a variety of subnational governments, oblasts, rayons or cities and villages, rather than to a particular type of subnational government.

[2] Expenditure norms determine the financial cost of operating the existing public sector infrastructure and are used to calculate each oblast's expenditure "needs". Once the Ministry of Finance knows how much funding is available to finance these needs for all oblasts, it offers to finance a certain percentage of these needs, normally less than half, in its negotiations with each oblast. What is unclear from the murky budgeting process is whether this percentage varies much from oblast to oblast.

revenue assignments, with the revenues from the VAT and excises flowing into the central treasury and all revenues from the personal and company income taxes going to local governments. However, the 1999 budget reintroduced the traditional method of sharing all income taxes and excises between the national and subnational governments.

Strictly local taxes and charges are of minor importance, accounting for less than four percent of total local revenues. Negotiated subventions remain the instrument of choice for filling in any gap between local government spending and local revenues. Since the central government determines both the base and the rates for the income taxes and narrowly limits the rates that may be imposed for purely local taxes, local governments perceive, correctly, that most of the important fiscal decisions, those concerning total expenditure, total revenue and subsidy levels, are made at the pinnacle of the intergovernmental hierarchy.

However, once local governments are disaggregated into oblasts, rayons and cities, towns and settlements, the apparent rigidity of intergovernmental fiscal relations disappears and is replaced by considerable scope for discretion. That is, the central government initially allocates subsidies among oblasts in the manner described above. This is the first step in the consolidated budget process. Once oblasts know what their total resources are going to be, they must decide how to allocate that amount between their own budget and the rayons and cities which are subordinate to the oblast. Some rayons will receive subsidies and others will make contributions to the oblast budget. Rayons, in turn, after their budgets have been struck, must balance the budgets of cities, towns and settlements operating within their jurisdiction using some combination of shared taxes and transfers to finance the expenditures of these most basic units of local government. At each step, the degree of tax sharing and the amount of subsidy are subject to intense political bargaining.

This system of sequential budget formulation, starting at the top and working down to the bottom of the intergovernmental hierarchy, is widely known as the budget “matroshka”. This “budget within a budget” system is remarkable for the economic and political power which it concentrates in upper-level governments, and the opportunity it affords to “reward your friends and punish your enemies”. Because discretion prevails over clear-cut rules in the determination of how much local governments receive, city level governments in recent years have pressed their demands for a new set of fiscal arrangements that would enhance their fiscal independence and reduce their reliance on higher level governments. These aspirations are reflected in the new Constitution and the recently adopted Law on Local Self-Government, both of which envision a withering away of the fiscal powers of the oblast and rayon levels of government and the creation of fiscally strong city and town governments making their own expenditure decisions and financing them from their own revenue sources. In a complete reversal of the current system, oblast and rayon level budgets would be financed by contributions from lower level governments to provide services that were of either oblast or rayon level significance.

A serious omission from both pieces of legislation is the failure to address the problem of horizontal fiscal imbalances among oblasts, rayons and cities and the consequent need for a method of fiscal equalization to correct for these imbalances. That is, if cities and settlements were entitled to keep the income tax revenues generated within their boundaries, some would be able to finance an extremely generous level of public services while others would find themselves unable to provide for even a minimum level of public services. Without an explicit equalization program, the new decentralization initiative would prove to be unworkable. Despite its numerous flaws, the current system of budget determination has at least been reasonably successful in reshuffling budgetary resources from richer to poorer fiscal jurisdictions.

However, its success in achieving a reasonable degree of equalization may be the current system’s only redeeming virtue. In most other respects this system is seriously deficient. Besides being highly non-transparent in allocating resources, it sends out the wrong incentive signals to local officials. Because subventions represent the marginal revenue source for local governments and are intended to cover the deficit between total expenditures and total own-source revenues, local governments at all levels are encouraged to overstate their expenditure needs and understate their revenue means. Instead of rewarding expenditure economy and revenue mobilization, the current system penalizes these virtues in the form of either a smaller subvention or a larger contribution.[3] Moreover, the practice of using supply-based norms as a method of allocating available resources among regions, encourages local governments to maintain excess capacity rather than to try and rationalize the use of that capacity. Health care budgets, for example, are calculated on the basis of what it costs to operate the current number of hospital beds in a region with no reference to the use, or effective use, of that capacity. A more rational approach to budget formulation would consider the demand for health care services and cost effective ways of meeting those demands.[4]

Budget execution and formulation at the local level is highly questionable under the current system. While norms are used to prepare subnational budgets, and reflect the national policy priority attached to subnational expenditures on health care, education and social protection, there are no restrictions on how subnational governments actually use the funds at their disposal. In other countries, norms are frequently used to monitor the expenditure performance of subnational governments and ensure that local spending in areas of national importance is consistent with the provision of minimum levels of service. Effective local budget execution is also hampered by unstable funding levels that reflect the efforts of the central government to, in part, solve its deficit problem by shifting the deficit pressure downwards to lower level governments, often in the form of unfunded expenditure mandates. One consequence of downward deficit shifting has been a growing volume of local expenditure arrears due to the inability to pare expenditure commitments as fast as revenues, in real terms, have declined.[5]

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[3] To be fair, however, the penalty may not apply with a great deal of force under current fiscal conditions in Ukraine. There is a general impression that desperate, cash strapped local governments collect as much they can when they can and worry about future revenue losses only later.

[4] The situation in Ukraine has been slowly changing since 1996 as the central government and more and more oblasts have turned to per capita forms of funding for health care and hospitals have begun to close down some of their underutilized facilities. But as more hospital staff has been put on part-time and medical supplies have dwindled, the general impression is that, while the quantity of health care services has been falling gradually, the quality of health care has been deteriorating rapidly.

[5] For example, as part of its ongoing efforts to reduce the national fiscal deficit the Ministry of Finance announced that in the second quarter of 1998 subventions payable in this period would be scaled back by 85 per cent. Such an abrupt about-turn in subnational funding is likely to trigger a rash of new expenditure arrears at the local level.

An additional source of financial instability for local governments is their dependence on a volatile enterprise profits tax as one of their primary revenue means.

The current system also nearly eliminates local budgetary autonomy apart from the ability to decide how much to spend on particular expenditure functions. Deprived of a significant marginal revenue source, local governments cannot make meaningful incremental adjustments in the overall size of their budgets and realistically cannot be held accountable for the amount of services that they provide. Yet under the present system citizens will ordinarily be aware of any discrepancy between the volume of services mandated by the use of norms and the smaller level of services that revenue constraints permit. This perception fosters disenchantment with local governments and frustration among local government officials who find themselves unable to accommodate the demands of their local electorates for more services. No mechanism exists at present that would allow citizens of local communities to choose among alternative tax and expenditure bundles. Local governments now have their total spending limited to what the central government decides is appropriate.

**The basic objectives of intergovernmental fiscal reform**

This brief discussion of the shortcomings of Ukraine's intergovernmental finances serves to define a list of three basic objectives that should guide the reform of these financial relationships. Reform measures need to be adopted which will achieve the following set of goals:

- A larger degree of local revenue autonomy; at the same time local autonomy may need to be restricted to allow recognition of a strong national interest in health-care and education undertaken by subnational governments;
- An appropriate realignment of expenditure responsibilities and revenue powers among different levels of government;
- A system of formula-driven transfers to lower level governments to replace the use of expenditure norms and negotiated transfers;

Local governments in Ukraine, until they are endowed with a significant marginal source of revenue, will never be able to be responsive to the demands for public services by local residents and accountable for their expenditure decisions to local electorates. It is not essential that local governments have sufficient revenues of their own to finance all, or even most, of their expenditures. Few, if any, local governments in the world are in the comfortable position of not having to depend on transfers from higher level governments to balance their budgets. What is important is the ability to supplement any transfers received with additional own-source revenue if local residents demand, and are willing to pay for, more public services. If local officials use their revenue-raising powers to provide services that local residents are unwilling to pay for, these officials will pay a political price for misreading the collective will of their voters. Some degree of revenue autonomy is required is if the provision of local public services is to be governed by local preferences working through the local political process.

Perhaps the most important component of intergovernmental fiscal reform is the replacement of expenditure norm budgeting with a system of formula-based transfers. If the formula chosen were simple, and based on objective criteria, it would make the transfer system considerably more transparent than at present. A formula approach would dispense with political bargaining over the share of transferable funds to be received and eliminate the adverse incentives that are inherent in a deficit-filling method of funding lower level governments. Formula-driven transfers would be perceived by local governments as lump sum in nature and as an infra-marginal source of revenue in contrast with norm-based transfers that are seen as a local government's marginal revenue source. Given some meaningful measure of revenue autonomy, local governments' own revenue sources would constitute their marginal revenue source. In these altered revenue circumstances local governments would have better incentives to tax and spend wisely. Any gains from local expenditure economies would accrue directly to local governments and any increase in local expenditure would have to be financed by local taxpayers.

As long as the central government honored its formula based expenditure commitments, announced its schedule of payments well in advance of the time for local budget preparation, and paid them in a timely fashion, formula-driven transfers would impart significantly greater stability to subnational revenue flows.[6] In turn, a more predictable revenue stream should help to arrest the growth of local expenditure arrears.

How the formula should be structured depends critically on whether transfers are to be conditional or unconditional in nature as well as on the exact assignment of expenditure tasks and tax instruments among different levels of government. Two alternative formulas are discussed below under different assumptions regarding the scope of conditionality and the assignment of fiscal powers.

The current assignment of fiscal powers to local governments is not optimal. On the revenue side, there is neither logic nor international precedent for making the enterprise profits tax a local tax instrument. Linking the availability of local funding for health, education and social protection to the profitability of local enterprises is singularly inappropriate. In addition to the funding fluctuations created by the volatility of the profits tax base, this base is difficult to apportion among local jurisdictions in the case of multi-regional enterprises and offers undesirable opportunities for tax competition among localities. Moreover, the basic attribute of a good local tax that it be paid by local residents who benefit from the expenditures it finances, is missing in the case of a local profits tax because a major portion of its burden is borne by nonresidents.[7] These problems would not occur if the profits tax belonged exclusively to the central government and the proceeds from the tax were used to help fund a stable system of transfers to local governments.

On the expenditure side, there are no convincing arguments for making expenditures on social protection a local government responsibility. In Ukraine it has come about as a matter of fiscal expediency. In coping with its deficit the central government has delegated social protection spending to local governments in the form of

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[6] A major institutional weakness of the current transfer system is the absence of a formal payments procedures. As a result, oblast financial officers are known to spend an abnormal amount of time travelling back and forth to Kyiv to lobby for the funds they are owed.

[7] The personal income tax is more suitable as a local revenue instrument because its burden resides on local residents and enhances local accountability for local expenditure decisions. However, in Ukraine the personal income tax only imperfectly satisfies this criterion for a good local tax because it is assessed on the basis of where a taxpayer works rather than where he or she resides. This is a complicated matter, however, since a large city such as Kyiv both exports expenditure benefits to residents of surrounding communities and collects taxes from them at their places of work. Whether these two effects are mutually offsetting is unknown.

an unfunded expenditure mandate that has increased the deficit pressure on local budgets. Unlike health and education expenditures, expenditures on social protection are highly variable and local governments do not have the revenue flexibility to adequately respond to these variations. Moreover, localities where the need for social protection spending is greatest are likely to have the least financial capacity to meet this need.

A further argument for centralizing social protection spending is based more on principle than practicality. If transfers to individuals are viewed as negative income taxes and the income tax-transfer system is one of the principal means of redistributing income, redistributive objectives cannot be properly pursued unless both taxes and transfers are operated by a single level of government. Otherwise, the equity goals sought in the income tax system by one level could be compromised by the social protection policies of another level. Since the personal income tax in Ukraine is a national tax, with its proceeds assigned to subnational governments, it follows that social protection should also be a national rather than local responsibility.

Health and education spending in many countries is also a national responsibility, perhaps delegated to subnational governments acting as agents for the national government, and, where they are not national responsibilities, national governments frequently exercise an oversight role by imposing minimum standards of service provision. The rationale for national government involvement is that health and education spending is of national, as well as local, importance because the benefits from these expenditures spill over regional boundaries and affect the welfare of residents in all parts of the country. No country can afford to neglect its investment in human capital if it wishes to prosper in the future. Conditional grants, or targeted transfers, to subnational governments to finance minimum levels of provision for health and education represent one method of safeguarding the national interest in these areas. Subnational governments, if they had the means and the will, would be free to spend more than the minimum amounts but would not be entitled to spend less. In a sense, the system of targeted transfers is equivalent to the purchase of an insurance policy by the national government. Left to their own devices, subnational governments might very well provide at least the minimum level of provision but if for some reason, for example, short-sightedness or unanticipated revenue declines, they were fail to do so, the system of targeted transfers would prevent this outcome from happening.

A system of per capita grants, or, in the case of education, per student grants would be the preferable embodiment of a targeted transfer system. To the extent that regional differences in need and unavoidable cost of provision could be identified and measured with reasonable accuracy, the size of the grant could be, and should be, tailored to incorporate these inter-regional differences. Capitation grants would replace norm-based budgeting as the method for determining how much subnational governments receive in total from the central government and how that total is allocated among subnational units.

As argued previously by Martinez (1997), adoption of a capitation grant system offers several advantages over needs-based budgeting. Capitation grants provide efficiency incentives that are missing under a needs-based approach. With capitation grants a recipient retains any savings which may be realized from delivering services more efficiently.[8] By contrast, needs-based budgeting encourages grant, or subvention, recipients to inflate their costs of service delivery and preserve their existing infrastructure. Moreover, because each recipient knows exactly how much it will receive in grants, capitation grants impose a harder budget constraint on subnational governments and make it less likely that expenditure commitments will exceed available resources. Significant expenditure arrears, which characterize the current needs-based approach, should occur with less frequency under capitation grants. Provided that they are announced in advance of the subnational budget preparation and paid in a timely fashion, capitation grants should also facilitate subnational budget planning by lending greater predictability to funding levels than occurs under the current system. The ability of subnational governments to plan their budgets with greater certainty contributes to more efficient expenditure execution and the avoidance of expenditure arrears.

More or less uniform per capita, or per student, grants that are financed from centralized tax collections are highly equalizing across different regions or recipient units. If subnational governments were relieved of their responsibilities for social

[8] Largely for equity reasons, a number of oblasts have begun to experiment with per capita funding for health and education in allocating resources within their regions.

protection and income taxes were shifted back to the center, capitation grants for health and education spending would go a long way towards equalizing the fiscal capacity of subnational governments.

A potential objection to a system of capitation grants is that they would perceived as a serious intrusion on local fiscal autonomy and as basically inconsistent with the decentralization initiatives contained in the Constitution and the new law on local self-government. While both the Constitution and the law are unclear in delineating expenditure assignments among different levels of government, both documents explicitly envision local governments, in this case cities, towns and settlements, as having their own separate and independent revenue powers. Re-centralization of social protection spending and centralized transfers imposing minimum service level standards, when combined with the central government's need to reclaim access to the income taxes in order to finance these expenditures, may be seen to conflict with these revenue separation goals.

If concerns about the erosion of local fiscal autonomy are sufficient to rule out a system of targeted transfers, a different approach to funding subnational governments will be needed, one based on formula-driven equalization transfers of an unconditional nature that would leave the current revenue and expenditure assignments in place. This approach would resemble the current system in that it would "level up" poor regions and "level down" rich regions. That is, a non-uniform per capita transfer, adjusted for differences in needs and costs and the inter-regional variation in the size of tax bases, would be made to, or received from, every region. The formula would call for negative, as well as positive, transfers as long as the revenues from the profit tax continued to be assigned to local budgets. The important difference between this formula-based approach and the current system is that, in the former case, the transfer would be of a lump-sum kind and therefore represent an infra-marginal source of finance for recipient units and an infra-marginal obligation for contributor units. Therefore every unit would operate with an unimpaired incentive to both mobilize more revenue at the margin and to achieve greater expenditure efficiency.

Given the urgent policy priority of containing, even reducing, the central government deficit, whichever approach is chosen must take place within a balanced budget context that does not alter the size of the central budget deficit. An additional constraint on reform is that it should not result in a "significant" redistribution of regional budgetary resources.

**Outstanding issues in intergovernmental fiscal reform**

While the adoption of either an unconditional or conditional formula-based grant program would go a long way towards putting subnational government funding on a sounder financial footing, there are a number of other policy issues that need to be addressed and resolved before the task of intergovernmental fiscal reform can be considered to be satisfactorily completed. These unsettled policy matters are briefly discussed next in the form of a series of questions for which, in some cases, only tentative answers can be provided. In other cases, answers are missing.

*1. What should be done to develop a significant marginal revenue source?*

Local governments in Ukraine will be unable to exercise meaningful fiscal autonomy unless they can independently adjust the amount of their total spending at the margin. To do this, local governments will require a significant marginal revenue source. Probably, the best candidate for this task is the personal income tax because it is a tax whose burden is borne by local residents and whose yields are relatively large compared to other local taxes. Given this choice of revenue instrument, local autonomy would require that local governments have some discretion in setting personal income tax rates for their residents. In the absence of an adequately functioning property tax, this step would be in line with the so-called "Nordic Model" of local public finance in which local governments are allowed to apply personal income tax surcharges to the national personal income tax base.

The other option is the creation of a viable local property tax but the underdeveloped state of Ukraine's real estate markets implies that the institutional structure needed to successfully introduce a property tax will take several years to develop.

*2. How should the investment needs of local governments be met?*

Neither the conditional nor the unconditional grant program makes any provision for financing the investment needs of local governments, although it should be possible to finance the maintenance of existing facilities under either program. Funding for new facilities will require establishing a separate arrangement, the form and structure of which is not discussed here.

*3. Which level of government should be the grant unit – oblast or rayon?*

If the rayon rather than the oblast were designated as the unit of local government, with which the central government interacted directly, either grant program would be more consistent with the decentralization provisions of the Constitution. In this case, oblasts would become passive administrative agents for passing through grants to their respective regions. Such a fiscal arrangement raises two questions, first, how oblast budgets would be financed, and, secondly, whether the Ministry of Finance would be able to develop sufficiently detailed data on the fiscal situation of all the rayons to implement the formula-based transfer programs.

*4. Are regional differences in expenditure needs important?*

Neither of the grant programs outlined above explicitly takes into account the possibility that there are significant differences among the regions in expenditure needs and costs of public service provision.[9] Should, for example, the uniform per capita health grant be tailored to fit differences in the overall health environment of different regions? Heavily industrialized regions may have greater needs for health care than rural regions for instance. Moreover, how much more does it cost more to educate a student residing in a rural area than one living in an urban setting? In principle, the grant formulas should recognize these inter-regional differences. In practice, it is extremely difficult to quantify these differences and build them into the formula in an objective manner that does not distort expenditure decisions.

[9] If differences in expenditure needs are fundamentally rooted in regional variations in demographic characteristics, it is not apparent that regional needs vary widely in Ukraine. The demographic structure is remarkably similar across Ukrainian oblasts

*5. What kinds of minimum standards are needed in Ukraine?*

Under a conditional grant program, the central government is interested in providing minimum standards of service provision. But which ones? In education, for example, should there be accreditation standards for all teachers and standard curriculum requirements? What standards are needed in the provision of health care to ensure accessibility to treatment for all residents? Once standards are established, what sort of monitoring mechanism is necessary to ensure that the standards are adhered to? In the event of non-compliance with the standards, what types of penalty should be applied?

*6. What should be done about social protection?*

On the one hand, it has been argued that the responsibility for social protection properly belongs to the national government. On the other hand, it has also been suggested that the national government, in its present fiscal circumstances, does not have the required fiscal capacity to undertake this renewed expenditure obligation. This conflict leaves social protection as an abandoned stepchild in the process of intergovernmental fiscal reform. Perhaps the only silver lining that can be discerned as a result of leaving social protection in the hands of local governments is that it may force grudging reform in the delivery of these services as financial pressures compel more effective targeting of household subsidies.

This lengthy set of unanswered questions makes it clear that the design of workable formula-based grant system is only an important first step in implementing a satisfactory and comprehensive reform of intergovernmental fiscal relations in Ukraine. Much more work remains to be done in this area.

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# APPENDIX

## Two Alternative Formula-Based Transfers

Two alternative grant formulas are considered here. One of these formulas outlines a method for calculating a system of unconditional transfers to subnational governments. The other formula describes how a system of targeted or conditional transfers for health and education spending might work. Both formulas would create a stable and transparent funding mechanism for subnational governments and provide adequate resources to meet the minimum budget needs of these governments. Each formula respects the macro-economic constraint imposed by the central government deficit.

Both formulas are based on measurements of fiscal variables that are relatively simple and which redistribute resources from high tax capacity regions to low capacity regions. Unlike the current system, the grants determined by either formula would represent an infra-marginal source of finance for subnational governments. In contrast to the current system, cost-cutting efforts and improvements in the efficiency with which public services are delivered would not be penalized in the form of a lower grant. Greater stability in funding the expenditure needs of subnational governments will facilitate better budget planning at this level and create a new budgetary environment of enhanced revenue predictability that will help to curb the appearance of new expenditure arrears.

Under the unconditional grant formula, each region would receive a grant, or make a payment, that would enable it to achieve a standard level of per capita expenditure. Here, this standard is take to be the average level of per capita expenditure for all subnational governments. For grant recipients, no strings would be attached as to how the funds could be used. Under the conditional grant formula, each region would receive a grant requiring it to achieve at least the same minimum level of per capita expenditure on health and education. In the case of the unconditional grant, the central government must choose annually what the average level of per capita total spending will be at the subnational level. For the conditional grant, the central government must instead establish what the minimum levels of per capita expenditure on health and education will be for the budget year ahead.

The **unconditional transfer formula** has the following form:

$Ti = \{a[\, E - RFi]\}Pi$ where,

*Ti* = positive or negative transfer to the i'th oblast

*E* = standardized(average) per capita expenditure

*R* = average own revenues per capita for all oblasts

*Fi* = index of the i'th oblast's fiscal capacity relative to the average

*Pi* = population of the i'th oblast

*a* = the degree of fiscal equalization; $0<a<1$

The formula stipulates that the size of the positive or negative grant depends on the extent of the fiscal gap between a region's expenditure needs and its revenue means. The structure of this formula, and others of a similar nature, is discussed more fully by Courchene(1984). Expenditure needs are measured as average per capita spending times a region's population. A region's revenue means are measured as the amount of revenue a region could potentially raise if it taxed all of its tax bases at average rates. Potential revenues are determined as the product of average per capita own revenues, an index of regional fiscal capacity, and a region's population. The parameter designated as *a* determines the percentage of any fiscal gap which is eliminated by the transfer program. The value of this parameter will reflect the overall fiscal constraints on the central government and its ability to finance a transfer program. According to the formula, regions with above average revenue means would make a contribution to the central government; similarly, regions with below average revenue means would receive a payment from the central government. After these transfers have been made, different oblasts should be able to provide a reasonably comparable level of public services on a per capita basis at reasonably comparable levels of taxation.

When structural and environmental factors give rise to different needs and costs in providing a comparable level of service, the formula should recognize and take into account these differences. However, practical application of this principle is never easy. Accurately measuring differences in needs is empirically difficult and incorporating differential costs of service delivery into the formula could enshrine and encourage inefficiency. For example, if one region had two schools both of which operated at half of their capacity, its per student costs of education might be twice as high as another region which provided education for the same number of students in a single building.

Efficiency considerations would call for consolidating the two schools in the first region but if this region received a transfer to cover the higher costs of its school operation it would be robbed of any incentive to consolidate. On efficiency grounds, only unavoidably higher costs, such as the higher cost of heating buildings in colder regions, should be reflected in the provisions of the formula. Because of the difficulty in distinguishing between avoidable and unavoidable costs, the formula above errs on the side of caution and makes no attempt to explicitly allow for differential costs. However, as explained further on, the use of an average expenditure standard in fact makes a rough allowance for cost differences between rural and urban oblasts.

A possible virtue of the preceding unconditional grant program is that it would not require any restructuring of revenue and expenditure roles among different levels of government. Maintaining the status quo has some appeal for a country such as Ukraine where a great deal of tax and expenditure upheaval has occurred during the past five years. On the other hand, it has been argued that the current set of revenue and expenditure assignments is far from ideal and the adoption of a system of conditional transfers would give legislators an opportunity to correct some of these assignment anomalies.

A **system of conditional transfers** would contain the following important features:

- Each region would receive a per capita health grant and a per student education grant and be required to spend no less than these functional amounts in executing their budgets;
- To finance these additional responsibilities in a deficit neutral manner, the central government would discard its current system of subventions and contributions and reclaim all of the proceeds from the enterprise profits tax as well as 25 per cent of the revenues from the personal income tax;
- A separate equalization pool, modest in size, would be established and funded by the central government to bring fiscally weaker regions up to the national average of per capita own revenues;
- Both the equalization pool and the conditional transfers would be explicitly funded from the amount of revenues generated by an earmarked VAT.

The conditional transfer formula would take the form shown below:

$Gi = G^*Pi + G^{**}Si + aR\{1 - Fi\}Pi$ where

$Gi$ = total grant paid to the $i$'th oblast

$G^*$ = per capita health grant

$G^{**}$ = per student education grant

$Si$ = total number of students in the i'th oblast

$R\{1\text{-}Fi\}>=0$

The first two terms in this conditional grant formula calculate the cost of targeted transfers for health and education. The third term captures the explicit equalization element in the formula. According to this term, a region would be entitled to receive an equalization payment if its measure of fiscal capacity, relative to the average for all regions, was less than one. The amount of the equalization payment would be equal to some fraction *a* of the difference between average per capita revenues for all regions and the amount of per capita revenue which it could potentially raise by taxing its tax bases at national average rates. If full equalization were not affordable, the value of the fiscal equalization parameter, *a*, would be less than one.

# 13

## DEFICIT: THE BLACK HOLE IN THE STATE BUDGET OF UKRAINE

*Vladimir T. Lanovoy*

Budget deficit, state debt, and current budget arrears are the main indicators of the state of public finance and its influence on the country's overall monetary system. To say that Ukraine's' public finance is in an unsatisfactory condition is to say virtually nothing. The deplorable shape of the budget is one of the key reasons for the ongoing economic crisis. In fact, each fiscal year witnesses a significant budget deficit that continues to yield the same negative economic developments. The budget deficit and arrears lead to a continued depletion of the nation's financial wealth that should have been used as a foundation for securing economic growth. However, time and again, Ukraine's political establishment makes the same mistake and seems to do its best to avoid learning from errors.

On top of the budget deficit, there is a Pension Fund deficit. Prior to 1996, the Pension Fund saw its revenues exceeding expenditures, and therefore served as a donor for the budget. However, for the last three years, the Pension Fund recorded a deficit, which needed to be covered by allocations from the government budget. Nevertheless, at present, the government fails to finance the Pension Fund's deficit, at best, applying various methods to extract additional payments to the Fund from enterprises and individuals.

A determinant for the formulation of public finance policy must be ensuring economic growth, not satisfying the needs of bureaucracy. In this respect, re-capitalization of the exhausted Ukrainian economy is essential.

**Sources and methods for re-capitalization of the economy**

We believe that the sources and methods for re-capitalization of economy are the following:

a) at the level of non-financial enterprises:

- self reproduction and profitability of existing enterprises;
- prevention of extraction of capital and capital increments from enterprises;
- prevention of artificial depreciation and/or loss of the capital value (due to inflation and devaluation);

b) at the level of banks and other financial companies:

- ensuring of payments, including repayment of bank loans;
- increased sources of funds for the credit-banking system (savings of enterprises and deposits of households);
- reducing interest rates to a "realistic level"

c) at the level of state finance:

- financing all budget liabilities, including allocations and repayment of loans;
- encouraging innovations and infrastructure investments;

d) at the national level:

- inflow of foreign credits and investments, repatriation of profits from abroad, less expensive making hryvna, full-fledged liberalization of markets, reduced taxes to achieve a relatively higher profitability of capital;
- encouraging exports;
- liberalization of imports without their financing or crediting by the state.

**Types of deficits in Ukraine**

The negative impact of the budget deficit on the economy can be summarized as follows: the deficit is a suction pump that is extracting from enterprises and households their profits and incomes which could have been the economy's capital. Budget deficit can be broken down into the following:

a) planned deficit, with no sources for its financing;
b) non-planned additional deficit without sources for financing, due to arrears of tax and narrowing of tax base;
c) deficit of the Pension Fund which had no sources to cover it during 1997-1998.

Overall, the above deficits amount to 10 % of GDP. The degree of the negative impact depends upon the methods used to finance the deficit, its amount and expenditure categories.

The leading method used in Ukraine is direct financing of the deficit by the National Bank of Ukraine. Its negative consequences are well known - inflation depletes money supply, capital of enterprises, and savings of households.

The second method is loans from domestic market. This method implies that there should be a critical “loan margin” which prevents the extraction of capital required for enterprises and households. This critical margin, appearing as risky increases of interest rates, should not be exceeded under any circumstances. This was ignored in Ukraine, and government domestic borrowing led to a deficit of credit resources in the economy, lack of working capital, insolvency of households, as well as to the growth of state debt pyramid and its inevitable collapse.

The third method of financing the budget deficit is loans from international capital markets. These loans can have a positive effect only when a borrowing country has credibility in the creditor community. With its current level of decapitalization, Ukraine’s economy is unlikely to have any credibility.

**The real budget deficit in the 1999 Budget**

The comparison of the alternative 1999 State budgets drafted by the Government and the Verkhovna Rada Budget Committee would be particularly interesting if considered in terms of the economy’s capitalization.

The government’s version of the budget plans the state budget deficit of UAH 0.7 billion and the Pension Fund deficit of UAH 2 billion. The “non-planned” budget deficit can be estimated at additional UAH 3 billion. Therefore, the consolidated budget deficit is about UAH 6 billion. There exists no real means to cover this “hole”: the domestic loan market is dead, and restrictions on privatization imposed by the Cabinet of Ministers and the Verkhovna Rada mean that even fairly low privatization revenues incorporated into the budget can hardly be collected. Hence, one can expect either a financing of the budget deficit and current arrears through emissions or continued accumulation of budget arrears for the public sector, pensioners, household subsidies and welfare benefits, which would also imply deeper de-capitalization of the economy.

The version of the budget presented by the respective committee of Verkhovna Rada and approved by the Parliament in the first reading claimed no deficit, even though the revenue categories include direct credits and loans: a direct credit emission by the NBU to agriculture and ship-building industry (UAH 1.5 million) and foreign loans ($ 700 million or UAH 3 billion). The “non-planned” deficit component is much higher. Hopes for a repayment of budget “loans” to enterprises (UAH 2.5 billion); income from sale of material resources from the state reserve (UAH 4.1 million); payment for a transit of oil and gas (UAH 0.8-1 million); payment for uses of budget funds by banks (UAH 0.1 million) are very unlikely to materialize. Hence, the consolidated amount of budget deficit could reach UAH 8.6 billion. A draft budget proposal to partially cover this deficit through promissory notes issued by energy companies can not stand any criticism.

Therefore, we can see that the second version of the Budget proposes an increase of the “planned” and “non-planned” budget deficits from UAH 0.7 to 4.5 billion and from UAH 3.0 to 8.6 billion, respectively. If the deficit is financed through direct and quasi monetary emissions, as the budget committee of the Verkhovna Rada in effect proposes, the damage for economy will be too high: prices will rise 2 to 2.5 times, real average incomes will decline one third, and money supply may shrink from 13 percent to 8-9 percent of GDP.

**Conclusion**

The key point is to ensure a balance between budget revenues and expenditures both during preliminary budget planning and in the course of detailed quantification of revenues and expenditures. This depends mostly on reliable macroeconomic forecasting and capability of the tax system to accumulate a certain portion of the national economy’s profits. The Government’s obligation to execute the budget must be enforced constitutionally. The goal of balancing revenues and expenditures should be reached through active microeconomic reforms (liquidation of loss-making enterprises, providing for liquidity of their current arrears, encouraging competition, extensive privatization, reform of tax and budget payments system), rather than through increasing budget pressure. Re-monetization of the economy should also be promoted to achieve balanced budget.

The second most important point is to resolve the State debt problem to reduce the pressure on the current budget expenses. The crucial issues are accumulation of resources to redeem and service the State's domestic and foreign debts, a restructuring and prolongation of those debts, and preventing increases in illiquid budget arrears (with respect to wages of the public sector employees, savings of households, pensions). This would require formulation of a surplus budget, encouraging a positive foreign trade balance, implementing a program of conversion of short-term state debts into the long-term ones, and securing the inflow of "productive" foreign capital.

# 14

## HIGH PUBLIC CONSUMPTION AS A FACTOR IN UKRAINE'S ECONOMIC INSTABILITY

*Viktor I. Lysytsky*

### Introduction

The share of public consumption in the economy of the erstwhile Soviet Ukraine (and in the economy of the whole USSR, for that matter) was quite high. Public consumption continued to be high even after independence. The economy has continued to be very centralized. The process was accompanied by a deep decline in Ukraine's output which, in turn, led to an increase in the tax burden on businesses and enterprises. Significant increase in the share of taxes in the gross value added by economic entities narrowed the space for economic adjustment within the official economy. "Crony" business and the unofficial economy have flourished. The official economy proved unable to meet the government's budget needs and social liabilities. The law enforcement structures and essential services do not receive sufficient funding. This raises serious concerns about the nation's security. Efforts "to improve budget revenue collection" push the state into a jeopardous spiral: any attempts to compensate the narrowed tax base by a more severe control over the tax collection, and introduction of new taxes, face growing public discontent. Tax evasion and avoiding all enforcement agencies (especially state tax authorities) become a matter of survival for economic entities. Today's low living standards have made tax evasion the only way to survive for a large section of the population. Under these conditions, any apparent stability is bound to be virtual and temporary, and not conducive to real economic growth. A significant reduction in public consumption seems to be the main remedy for Ukraine to get out of this situation.

**Dynamics of centralization of official economy in Ukraine, 1990-97**

Given the rapid decline in real GDP, the real growth in consumption[1] looks rather extraordinary (Table 14.1). In 1997, budget-sphere consumption was, in nominal terms, 72,743 times greater than in 1990. This was higher than the cumulative inflation over the period (GDP deflator was 67,536). Therefore, budget-sphere consumption of 1997 exceeded those of 1990 by 7.7 percent in real terms[2].

Table 14.1. Centralization of the official economy in Ukraine, 1990-1997

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 |
|---|---|---|---|---|---|---|---|---|
| Real GDP,1990=100 | 100 | 103 | 92 | 80 | 61 | 54 | 49 | 47 |
| Budget-sphere consumption, UAH million | 0.28 | 0.52 | 8.84 | 237 | 2,101 | 11,595 | 17,738 | 20,368 |
| Real budget-sphere consumption,1990=100 | 100 | 97 | 169 | 132 | 111 | 119 | 111 | 108 |
| Public consumption, UAH million | 0.3 | 0.6 | 11 | 295 | 2,484 | 14,557 | 21,650 | 24,616 |
| Real public consumption, 1990=100 | 100 | 94 | 182 | 144 | 115 | 131 | 119 | 114 |
| Household consumption, UAH million | 0.9 | 1.6 | 21 | 654 | 5,801 | 27,094 | 43,469 | 52,771 |
| Real household consumption, 1990=100 | 100 | 89 | 124 | 112 | 94 | 86 | 84 | 86 |
| Economy Centralization Index* | 1.00 | 1.06 | 1.46 | 1.29 | 1.22 | 1.53 | 1.42 | 1.33 |

*Data source: State Committee of Statistics of Ukraine*
** Economy Centralization Index is the ratio of real final public consumption to real final household consumption*

We classify public consumption to include budget-sphere consumption plus consumption of non-budgetary statutory funds run by government agencies. Public consumption also grew faster than prices (the index of public consumption in 1997 was 76,925 times

[1] The term 'budget-sphere consumption' has been used here to mean government consumption expenditure through the budget sphere, and does not include non-budgetary consumption of statutory funds which are run by government agencies.

[2] (72,743/67,536)-1=7.7 percent

greater than in 1990). This means a 13.9 percent rise in public consumption in real term[3]. This trend was accompanied by a reduction in real consumption of households. The nominal growth of final household consumption was 57,990 times, i.e., 85.9 percent of its 1990 level in real terms.

The growth in real public consumption, and the corresponding decline in real household consumption, suggest that the period 1990 to 1997 witnessed increased centralization of the official economy in Ukraine. The ratio of real public consumption to respective household consumption is significantly greater than one from 1991 onwards (see the last row in Table 14.1).

**Public consumption in GDP**

The analysis of GDP uses shows that the period 1993 to 1997 has recorded a steady increase in public consumption. From 19.9 percent of GDP in 1993, it grew to 26.6 percent in 1997, growing by 33.7 percent. The fast growth of the budget-sphere consumption was mostly responsible for this, increasing from 16.0 percent to 22.0 percent of GDP, a growth of 37.5 percent (Table 14.2). The relative growth of public consumption was accompanied by a decrease in gross business and interest incomes.

Table 14.2. Public consumption as % of GDP

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 |
|---|---|---|---|---|---|---|---|---|
| Public consumption, of which: | 19.2 | 19.4 | 21.6 | 19.9 | 20.6 | 26.7 | 26.6 | 26.6 |
| - Consumption of non-budget state organizations | 2.4 | 2.0 | 4.0 | 4.0 | 3.2 | 5.4 | 4.8 | 4.6 |
| - Consumption of the budget sphere | 16.8 | 17.4 | 17.6 | 16.0 | 17.5 | 21.3 | 21.8 | 22.0 |
| *Reference information*: Gross business and interest incomes | 38.3 | 44.8 | 47.9 | 54.0 | 43.0 | 37.4 | 30.3 | 30.0 |

*Source: State Committee of Statistics of Ukraine*

[3] Public consumption decreased in real terms during the 1994-1997 period. Yet, compared to the decline in GDP, decrease in public consumption was slower.

**GDP structure**

The share of household consumption in GDP increased in 1997 compared to 1990 only by 2.6 percent[4], while that of public consumption increased by 7.5 percent. Of this, budget-sphere consumption as a share of GDP increased by 5.3 percent and non-budget statutory funds increased by 2.2 percent. At the same time, as a share of GDP, gross accumulation of fixed capital (investment) declined by 4.5 percent and net exports declined by 2.6 percent.

Table 14.3. GDP Structure, %

| | 1990 | 1997 | Growth: 1990-1997 |
|---|---|---|---|
| Household consumption | 54.5 | 57.1 | 2.6 |
| Consumption of non-budgetary state organizations | 2.4 | 4.6 | 2.2 |
| Budget sphere consumption | 16.8 | 22.0 | 5.3 |
| Gross accumulation of fixed capital | 22.8 | 18.3 | -4.5 |
| Change in inventories | 4.2 | 1.7 | -2.5 |
| Net exports | -1.2 | -3.8 | -2.6 |

*Data source: State Committee of Statistics of Ukraine*

It is quite understandable that the share of GDP used for replenishing business inventories also fell significantly. The economy of Soviet Ukraine was notorious for its excessive inventory accumulation, both in production and in turnover. Continuous attempts to reduce excessive stocks had little success. The first three years of independence witnessed a rapid growth of inventories in enterprises[5]. The hyperinflation and lack of confidence in the *karbovanets* had an adverse impact and enterprises tried to ensure their own future by the accelerated accumulation of inventories. Thereafter, between 1993 and 1997, excess inventories were being used up, as production fell sharply.

Thus, we observe that increase in public consumption led to a reduction in the share of investment, which, in turn, hampers economic growth. Given how obsolete the

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[4] Given the significant decline in real GDP, there was a considerable decline in the real consumption of households within the official sector of economy.

[5] "Money: Supply and Demand Development in Ukraine"; Viktor Yuschenko, Viktor Lysytsky; Skarby, 1998, pp.178-202.

fixed capital inherited from the USSR is, and how badly Ukraine needs new private investment, we can conclude that excessive consumption by public authorities is one of the key factors for the economic decline in independent Ukraine.

**Net taxes and compensation of employees**

The GDP structure by categories of income shows a rapid growth in the share of net taxes on production and imports during 1993-97 (Table 14.4). At the end of 1993, net taxes amounted to only 7.6 percent of GDP. However, the share of net taxes grew to 22.4 percent in 1997, i.e., an increase of 194.7 percent. The threefold growth of net taxes was responsible for the reduction in the share of gross business income.

Table 14.4: Breakdown of GDP by revenue categories, %

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 |
|---|---|---|---|---|---|---|---|---|
| Compensation of employees with social security charges | 53.3 | 58.9 | 51.1 | 38.5 | 39.7 | 43.5 | 47.8 | 47.6 |
| Gross income | 38.3 | 44.8 | 47.9 | 54.0 | 43.0 | 37.4 | 30.3 | 30.0 |
| Net taxes on production and exports | 8.4 | -3.7 | 1.0 | 7.6 | 17.4 | 19.1 | 21.9 | 22.4 |
| Overall | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 |
| *Negative net taxes occurred in 1991 because retail prices were administratively kept below wholesale prices* | | | | | | | | |

*Data source: State Committee of Statistics of Ukraine*

The rapid growth of taxes as a share of GDP forced enterprises to “turn on” their survival instinct, and encouraged them to shift to a shadow economy.

**Net taxes and shadow economy**

The rapid increase in the share of money held outside banks in recent years is an indicator of the large shift to the shadow economy (see Table 14.5). The increase in budget-sphere consumption from 16.0 percent of GDP in 1993 to 22.0 percent in 1997 spurred an increase in the share of money held outside banks from 26.5 percent to 48.9 percent. A regression analysis for the period 1995 to 1997 establishes a rather close correlation in Ukraine between public consumption and the share of money held outside banks ($R^2$ = 0.6325).

Table 14.5. Relationship between share of money held outside banks and public consumption

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 |
|---|---|---|---|---|---|---|---|---|
| Public consumption, % of GDP | 16.8 | 17.4 | 17.6 | 16.0 | 17.5 | 21.3 | 21.8 | 22.0 |
| Share of money held outside the banks, % of total | na | 12.6 | 19.2 | 26.5 | 24.7 | 38.3 | 43.1 | 48.9 |
| Ratio of growth of money outside banks to growth of share of public consumption | ,,, | | 33.3 | -4.6 | -1.3 | 3.6 | 9.7 | 22.1 |
| Annual Index of public consumption | ,,, | 103.6 | 101.1 | 91.0 | 109.2 | 121.9 | 102.3 | 101.2 |
| Annual Index of share of money held outside banks | ,,, | ,,, | 152.1 | 138.4 | 93.0 | 155.4 | 112.4 | 113.5 |

*Source: NBU bulletin*

The regression results in the following equation:

$$Y = 0.0153e^{15.211x}$$

where Y is the share of money held outside banks; and x is public consumption.

The high exponential (a=15.211) shows that, at the end of the examined period, the share of money held outside banks was growing more rapidly than at the beginning of the period. There is an impression that the critical limit of taxation of economic entities' was exceeded in 1995. The growth of money held outside banks was higher than growth in public consumption: in 1995, the increase in the share of money outside banks exceeded the increase in share of public consumption 3.6 times, in 1996 it was 9.7 times, and in 1997 it became 22.1 times. Moreover, the annual growth indices of the share of money held outside banks substantially exceeded 100 percent beginning from 1995. It seems that, the growing tax burden caused a rapid growth of the shadow economy and, subsequently, an increase in the amount of money circulating outside banks, which, in turn, was manifested by an unprecedented growth in the share of money held outside the banking system. Growing levels of public consumption unintentionally turn into a tool for the destruction of the official economy and the growth of the shadow economy.

**Net taxes and the level of government monopolization of money**

The share of domestic credit monopolized by the government is also constantly growing. By the end of 1994, it reached 31.6 percent, by the end of 1997 it was 50.8 percent. The extremely high cost of money becomes evident: the government, a monopolistic purchaser with high demand, prevents the private sector from getting commercial banks loans (“crowding out”).

Table 14.6. Banking System Outlook, end of period

| | 1994 | 1995 | 1996 | 1997 |
|---|---|---|---|---|
| Domestic credit, UAH bln, including: | 2,909 | 8,460 | 12,041 | 15,950 |
| Claims to the Government (net) | 920 | 3,989 | 5,974 | 8,107 |
| Claims to non-financial state sector | 1,432 | 3,663 | 4,932 | 5,549 |
| Claims to the private sector | 557 | 804 | 1,129 | 2,294 |
| Money (as a medium of exchange), UAH bln | 1,860 | 4,682 | 6,316 | 9,050 |
| Quasi-Money (as a store of value), UAH bln | 1,356 | 2,232 | 3,046 | 3,485 |
| Broad money = money + quasi-money | 3,216 | 6,913 | 9,361 | 12,535 |
| Share of claims to the Government (net) in money + quasi-money, % | 28.6 | 57.7 | 63.8 | 64.7 |
| Share of claims to the private sector in money + quasi-money, % | 17.3 | 11.6 | 12.1 | 18.3 |
| Share of claims to the government in the overall domestic credit, % | 31.6 | 47.1 | 49.6 | 50.8 |

*Source: NBU bulletin*

## Conclusion

A significant reduction of public consumption should become the main priority for the macroeconomic management of Ukraine in the coming years. This would require careful cost-benefit appraisal of existing expenditure commitments, in order to evaluate which of them are the best candidates for cutbacks. A simple reduction of all government spending by an arbitrary percentage is neither efficient nor effective. Expenditure reduction has to be closely coordinated with a well thought out plan for social safety net retraining programs for the redundancies that would result. Strengthening programs for small business development could help absorb many of the laid off workers.

# 15

## MONETIZATION AND MONEY EMISSION IN UKRAINE

*Gerard Duchene, Apostolos Papaphilippou*
*and Alexei Sekarev*

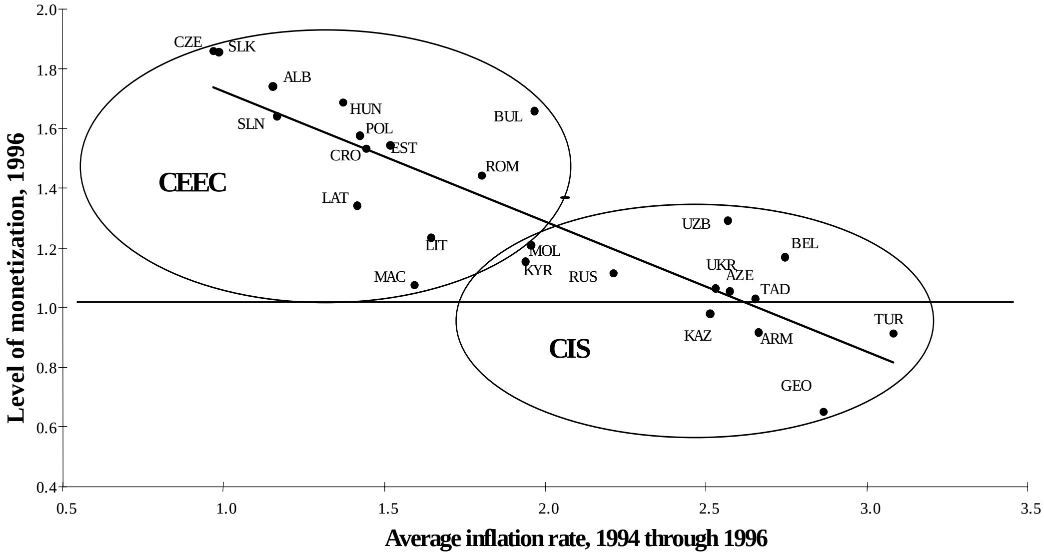
### Introduction

The initial stage of post-soviet transition is characterized by high levels of inflation accompanied by a significant decrease in the rate of money circulation. This inverse relation may be explained by transactional arrangements, such as barter and inter-enterprise arrears, that arise as alternatives to standard monetary trade. These arrangements constitute an autonomous system of trade credit that remains in place and even consolidates during stabilization. As a result, the degree of monetization[1] in transition economies is often lower than could be expected. Figure 15.1 shows the negative correlation between the degree of monetization and past inflation in the CIS and in CEE countries. The pronounced difference between CIS and CEE countries becomes evident when one examines the country's clustering pattern.

There is growing concern in transition economies, especially in Russia and Ukraine, that monetary supply is overly restricted and that emission is necessary for re-monetization. In this paper, we consider the monetary emission in Ukraine and its expected effects. Ukraine makes an excellent study case for exploring monetization and emission. It has one of the highest levels of inter-firm arrears and barter. It has experienced very significant declines in output. Also, Ukraine has succeeded with a fast stabilization following hyperinflation.

Our main conclusions are the following. The monetization level in Ukraine is not abnormally low, when a narrow money aggregate is taken. This level is a reflection of structural characteristics of the Ukrainian economy, most notable of which is the underdevelopment of the banking system. Without a change in these characteristics, a significant monetary emission will result in a severe inflation.

Figure 15.1. Relationship between monetization and past inflation




*Source: EBRD (1996)*

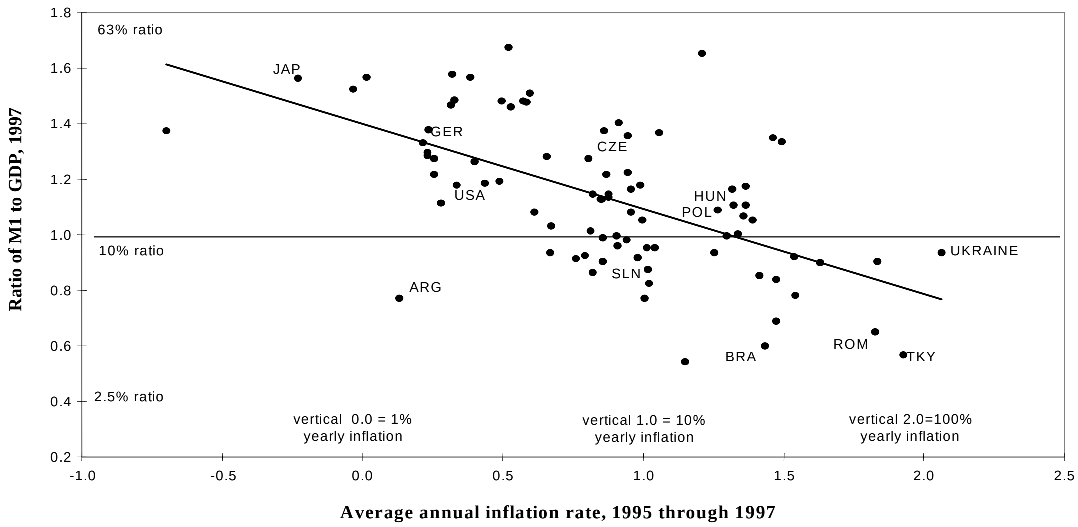
## Characteristics of money demand in Ukraine

Well in accordance with the liquidity preference theory, money demand reflects transaction needs as well as speculative and precautionary motives. Various formulations of this theory emphasize both the service provided by money as a medium of exchange in financing transactions and the opportunity cost of money holding.

For instance, Ukraine, the opportunity cost of holding hryvnas is related, among other things, to the (expected) loss of purchasing power due to inflation and currency depreciation. Also, the system of payment has an effect on money demand.

Many economists and policymakers in Ukraine frequently allege that the level of monetization is low. This assertion may well be true when, to calculate the monetization coefficient, one uses a broad money aggregate such as M3 (which includes currency in circulation plus time deposits and repurchase agreements). However, if one uses narrow money aggregate, such as M1 (which includes currency in circulation plus demand deposits), the level of monetization in Ukraine appears quite normal at the level of 8.6 percent in mid-1997 and nearly 10 percent in mid-1998. From a panel of over 79 countries, for which comparable estimates were calculated in 1997, 20 countries have a lower M1-base monetization coefficient than Ukraine. They are neither the smallest, nor the poorest: Argentina, Brazil, Chile, Indonesia, Israel, South Korea, Mexico, Thailand, and Turkey. Of course, highly developed economies have relatively high monetization ratio, yet many transition economies (which were not included in the panel) remain in the same range as Ukraine. Figure 15.2 shows the place of Ukraine among this panel of 79 countries extended by six transition economies. Ukraine is clearly well above the regression line relating monetization to past inflation.

Figure 15.2. Relationship between monetization (M1) and inflation for 85 countries



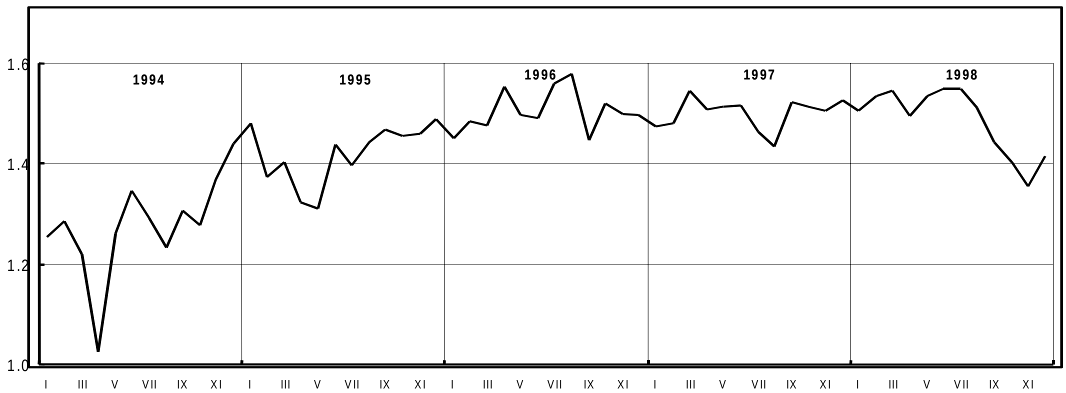

*Source: International Financial Statistic, 1998*

In contrast, all these countries have much higher M2 coefficients than Ukraine. The low monetization in the case of broad monetary aggregate such as M2 (currency in circulation and demand plus time deposits in domestic currency) reflects the following structural characteristics of the Ukrainian economy:

*1. Weak banking system.*

It is caused by many factors: weak balance sheet of commercial banks (frequently arising from bad loans arising due to directed lending), high risk of conducting business in Ukraine, high credit risk due to weak contract enforcement, weak bankruptcy procedures, poor collateral legislation, pervasive distrust of the banking system, fear of restrictions (real and perceived) on the use of bank accounts, and concerns about the traces left therein (which can be used by the tax authorities). Overall the financial intermediation and deposit creation capacity are very low in Ukraine. As a result, currency in circulation accounts for as much as a half of the broad money aggregate, which is very high. The low level of monetization of broad money aggregates thus reflects, to a large extent, the weakness in deposit creation. This is indicated by the low value of the money multiplier in Ukraine, i.e., the ratio of M2 to money base (currency in circulation plus currency in vaults of commercial banks plus reserves of commercial banks at the central bank). The changes in the money multiplier are shown given in Figure 15.3.

Figure 15.3. Money multiplier, January 1994 through December 1998

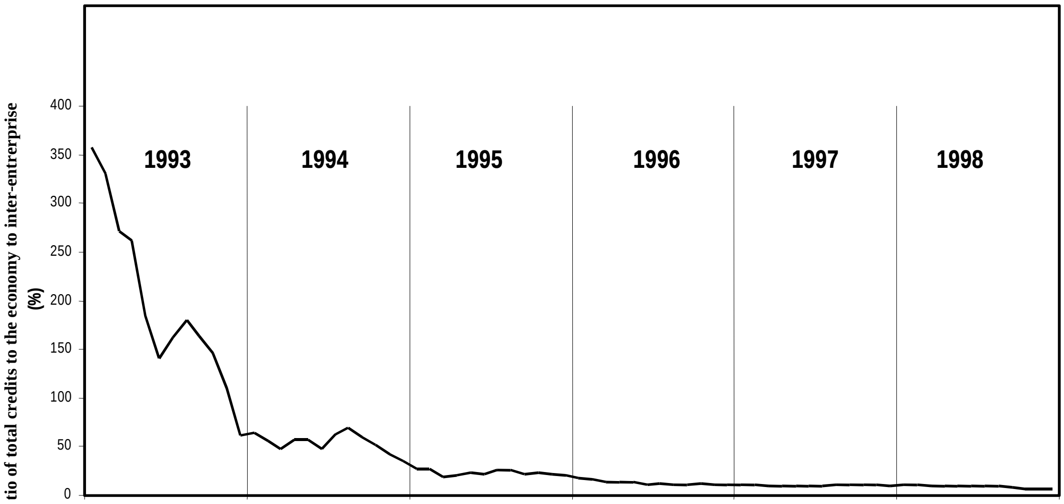



*Source: TACIS data*

*2. The pervasive use of barter and arrears in financing transactions.*

This characteristic implies that, other factors being equal, in order to finance a given level of transactions, a less money is required in countries with no barter and arrears. The reasons behind the wide use of barter and arrears are complex and inter-connected. Barter collateralizes transactions. Arrears reflect soft budget constraints and frequently serve as trade credit. They co-exist in a risky environment, where contract enforcement is weak and the capital market is underdeveloped. They also provide a means for tax evasion, especially in a tax system that remains, to a large extent, cash-based. Thus, it is incorrect to conclude that enterprises resort to barter because there is “not enough money available”. Rather, the volume of credit is low partly because enterprises use barter and arrears as an alternative banking system. Figure 15.4 traces the dynamics of the ratio of credits granted by commercial banks to the stock of payables between enterprises in Ukraine.

Figure 15.4. Ratio of bank credits to inter-enterprise payables, %

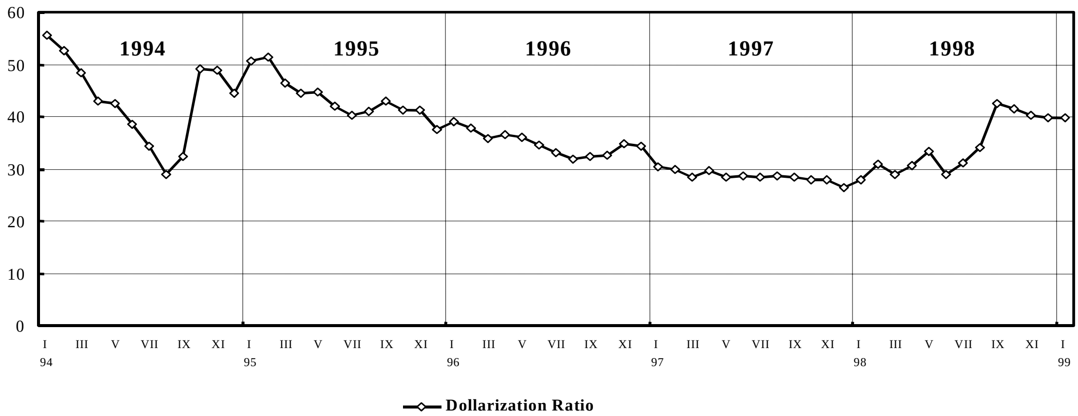



*Source: TACIS data*

*3. The wide use of foreign currency.*

An unknown amount of foreign currency circulates in parallel with the national currency and is used as a means of exchange, a unit of account, a store of wealth and a standard for deferred payments, thus fulfilling the definition of money. [This is particularly the case in transactions involving expensive assets such as apartments and cars]. Hence less national currency is used to finance a given amount of transactions (total economic activity). Before devaluation, foreign currency deposits amounted to around 30 percent of all deposits (both in national and foreign currencies); after the devaluation, this proportion increased to 40 percent. It is quite possible that the amount of dollars in circulation in Ukraine will be greater than the amount of hryvnas in circulation. An indication of this is the amount of net purchases of foreign currency by households. From July 1995 to February 1999, $ 3.6 billion have been accumulated through exchanges at kiosks. Of course, a portion of that amount has been taken out of the country (to finance shuttle trade or tourism), thus, it is impossible to estimate the exact amount of dollars in circulation. However, it is difficult to imagine that the dollarization ratio for cash is lower than the one for deposits. It is, thus, perfectly possible that this ratio reach 50 percent, meaning that there would be an equal amount circulating in dollars and in hryvna. The monthly dynamics of the dollarization ratio (for non-cash) is illustrated in Figure 15.5.

Figure 15.5. M2 and dollarization ratio, January 1994 through January 1999

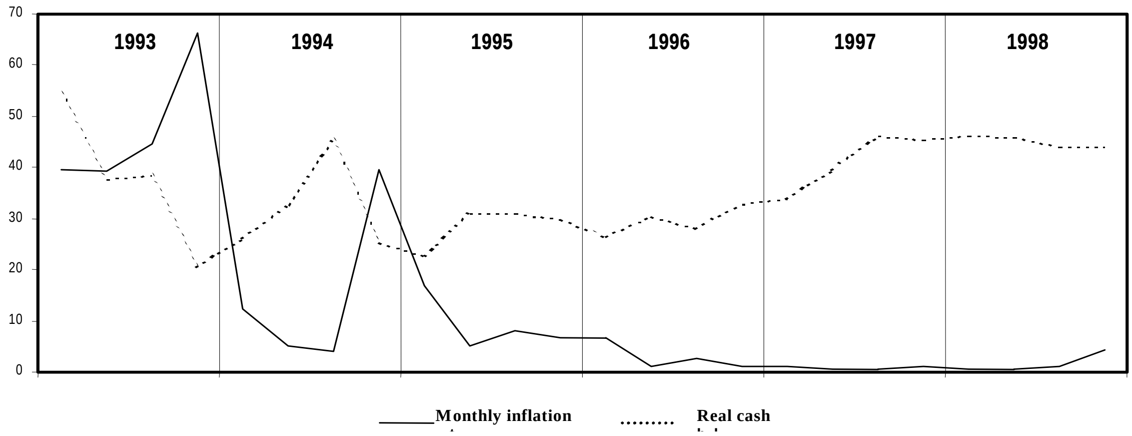



*Source: TACIS data*

*4. The time lag between an increase in money demand and monetary stabilization.*

In an economy that experienced hyperinflation, a certain amount of time is required for confidence and expectations to adjust to financial stability. The problem is that confidence is difficult to build but easy to destroy. Thus, it has taken two years for economic agents in Ukraine to begin holding more hryvna, but this willingness could quickly be destroyed for a long time by an emission accompanied by a new whirl of inflation, devaluation, and cash substitution.

Figure 15.6. Relationship between real money balances and inflation, 1993-98, quarterly




*Source: TACIS data*

**On the fallacy of emission**

This brings us to what we argue to be the underlying fallacy in the proposed emission as a means to finance budget deficit and settle pension and wage arrears in Ukraine. The fallacy may be summarized as follows: the low ratio of broad money to Ukraine's GDP is frequently perceived as providing leeway for an expansionary monetary policy presumably to increase the ratio towards a level comparable with a number of fully-fledged market economies. However, as the previous section has demonstrated, the low level of monetization: 1) occurs only in the case of broad monetary aggregates; 2) typical for many CIS economies; and, 3) strongly related to the past high inflation.

A significant increase in the money stock is likely to result in a decline in confidence and an increase in the rate of circulation and the rate of currency substitution. This will bring about higher prices and increase pressure on the exchange rate (as economic agents will make efforts to reduce their hryvna holdings and substitute them for goods or foreign currency). The increase in prices is likely to be reinforced by the existing wage and pension indexation in Ukraine. Thus, a vicious circle of wage and price increases may be triggered up. The eventual result of emission is likely to be an even lower monetization than the current one.

It, of course, comes as no surprise that more money leads to higher prices. Inflation, in turn, has adverse social and economic consequences. It hits the hardest the most vulnerable segments of society (i.e., the unemployed and people with low hryvna incomes, most notably pensioners). In contrast, wealthier groups are in a position to safeguard their wealth by converting their hryvna balances to foreign currency or other assets.

It may be also worth reminding that relatively low and stable level of inflation is conducive to economic growth. It reduces the level of uncertainty and promotes stable and predictable environment. This is conducive to domestic wealth creation, the reversion of capital flight and the attraction and retention of foreign investment. It helps a sustained supply-side response that is still lacking in Ukraine.

## Conclusion and Policy Implications

Ironically, rather than "providing liquidity to the economy", emission will lead to currency substitution and further de-monetization, as the real amount of money in circulation declines (even if, in nominal terms, the stock of money increases). This has been the experience of many countries where monetary emission led to a vicious circle of increases in prices and wages, followed by additional emissions. This indeed has been the experience of Ukraine itself in 1993.

The solution lies in tackling the macroeconomic imbalances and structural distortions of the Ukrainian economy that lie behind the low monetization. One component is related to country's fiscal policy. There is need to significantly reduce the budget deficit, especially, since in the wake of the recent turbulence on the capital market, financing deficit through external or domestic loans is limited and very expensive. On the revenue side, necessary measures include the increase in excise taxation, the broadening of the tax base and strengthening compliance through the elimination of exemption and simplification of the system. However, the adjustment should come primarily through a reduction of expenditures; especially the reduction of subsidies and the expenditures tied to the maintenance of a government sector.

This brings us to the issue of administrative reform, which is one of the structural policies aimed at the sustained improvement of the economy's supply side. There is an urgent need to facilitate the creation of an environment that is conducive to the normal functioning of a market economy. This includes licensing and deregulation, as well as a legal framework that would ensure the enforcement of contracts. Bankruptcy, collateral and banking legislation are long overdue.

Table 15.1
Degree of monetization and associated inflation rates of 25 transition economies in 1996 and 1997

| | Ratio of broad money to GDP (%) | | Average inflation rate (% per year) | |
|---|---|---|---|---|
| | 1996 | 1997 | 1994-96 | 1995-97 |
| Albania | 55.0 | 64.4 | 14.2 | 17.1 |
| Armenia | 8.3 | 8.9 | 460.9 | 55.3 |
| Azerbaidjan | 11.3 | 13.4 | 376.3 | 85.1 |
| Belarus | 14.8 | 17.9 | 557.8 | 172.8 |
| Bulgaria | 45.7 | 28.1 | 92.1 | 249.5 |
| Croatia | 34.1 | 42.3 | 27.8 | 3.0 |
| Czech Rep | 72.2 | 73.8 | 9.3 | 8.8 |
| Estonia | 35.0 | 39.0 | 32.9 | 20.8 |
| Macedonia | 11.9 | 14.1 | 39.3 | 6.5 |
| Georgia | 4.5 | 5.5 | 732.0 | 57.9 |
| Hungary | 48.6 | 47.4 | 23.5 | 23.3 |
| Kazakhstan | 9.5 | 10.4 | 324.5 | 65.2 |
| Kyrgyzstan | 14.3 | 14.3 | 87.0 | 35.6 |
| Latvia | 22.0 | 26.0 | 26.0 | 16.8 |
| Lithuania | 17.2 | 19.0 | 44.1 | 23.7 |
| Moldova | 16.2 | 19.2 | 90.5 | 21.6 |
| Poland | 37.5 | 39.6 | 26.5 | 20.8 |
| Romania | 27.7 | 24.9 | 63.2 | 67.3 |
| Russia | 13.1 | 14.2 | 162.6 | 71.5 |
| Slovakia | 72.0 | 69.0 | 9.7 | 7.3 |
| Slovenia | 43.8 | 47.7 | 14.7 | 10.6 |
| Tadjikistan | 10.7 | 8.5 | 448.8 | 310.1 |
| Turkmenistan | 8.2 | 11.8 | 1206.5 | 505.5 |
| Ukraine | 11.6 | 13.1 | 339.5 | 115.0 |
| Uzbekistan | 19.6 | 16.4 | 370.3 | 120.5 |
| **Average** | 26.6 | 27.6 | 223.2 | 83.7 |

*Source: EBRD Transition Report, 1998*

# 16

## DEMONETIZATION OF UKRAINE'S ECONOMY AND A NEW ECONOMIC POLICY DESIGN

*Ihor B. Zhylyaev*

The world community continues to show great interest in the experiment of economic transformation in the countries that abandoned the controlled economy model. However, the actual dynamics and patterns of reforms in some post-soviet countries made experts to revise their views on both the approaches to, and the pace of, reforms. If earlier, experts used terms like "transition", "undergoing transformation" to describe these processes, presently they define transition economies as "unknown" and "virtual". The financial crisis that hit transition countries in 1997-1998 has added more confusion to our understanding of economic transformation in the region.

To a considerable extent, this confusion results from the failure to understand specific features of each country's economy and to integrate these features into transition policymaking. In this article, I attempt to address this problem by focusing on some special features of Ukraine's economy.

### Ukraine's economic structure and its weaknesses

Ukraine's economy has a complex fragmented structure that includes the following segments:

- monetary (financial sector)
- commodity-monetary (normal money-based economy)
- commodity-commodity (demonetized economy)
- natural economy

The zones of the demonetized economy (DME) may be compared to parallel adjacent worlds. So far, there has been no research on the full life cycle of each of the DME zone. Nevertheless, each DME zone has its complex network configuration with its specific institutions. The design of economic policy requires a quantitative and qualitative knowledge of the rules of the game for each zone, as well as understanding of inter-zonal relations and of inter-zonal competition.

The following are the systemic zones of the DME:

1. Barter
2. Mutual settlement
3. Arrears (current and overdue)
4. Money surrogates, quasi-money (promissory notes, corporate and regional money substitutes).
5. Write-offs (tax and budget arrears, and arrears of the government to the NBU).

Each illness requires a specific medicine and method of treatment. A design for future economic policy must incorporate both general measures and measures developed specifically for each zone of DME. There should be a precisely designed policy for each DME zone. Such an approach to economic policy will allow for better decision-making compared with the existing approach where money of different values ("multicolored" money) is just summed up arithmetically.

DME is a systemic phenomenon. It can exist or be liquidated only as a system. Its very existence requires the ability to sell products below cost. When rigid prices make reducing cost to an equilibrium level impossible, and fiscal authorities prohibit selling below cost, the only way out for economic agents is to use DME. The economy continues to function due to the establishment of mutual price parity.

The behavior of economic agents varies in different DME zones. Therefore, if the economic agents move from one zone to another, their behavioral patterns change accordingly. To a considerable extent, the behavior depends on a set of constraints (budget and non-budget, direct and indirect, monetary and non-monetary) imposed at any given point in time. It also depends on the expectations of these agents. For instance, the behavioral patterns of large enterprises-buyers differ from those of weak enterprises-sellers. When there is a possibility to operate at equilibrium rather than generate losses in a system of rigid prices, the opportunistic behavior of economic agents become universal.

The explosive development of DME zones is, therefore, determined by the opportunistic reaction of economic agents to irrational economic policy.

If the government tightens control over utilization of monetary resources, it encourages the participants to use mutual settlements on a wide scale. This implies that the government loses control over transfer of resources. In the absence of effective bankruptcy procedures, it becomes more beneficial to be a “bad agent” (i.e., poorly adjusted to market rules) than to stay competitive. The rule of substitution (Grasham’s law) holds: “Bad money is crowding out good money.”

Various measures taken by the government during transition have led to the institutionalization of DME. Each zone has its own rules of the game and a complex structure of institutions, technologies, instruments and networks.

The size of the demonetized segment of Ukraine’s economy exceeds the size of the money-based economy. For instance, the share of monetary payments in overall sales of industrial products was 45 percent in 1997 and 42 percent in 1998. In agriculture, the degree of demonetization was even higher.

Table 16.1. Size and dynamics of the DME sectors

| | 1997 | 1998 (10 months) |
|---|---|---|
| 1. Barter | Industry- 42.4%<br>Agriculture - > 50%;<br>Export-10.5%;<br>import 10%;<br>Wages-6.0 %; | Industry- 41.4%<br>Agriculture - > 50%;<br>Export- 8%;<br>Import- 6%;<br>Wages- 11%; |
| 2. Mutual cancellation with the state budget | Revenues-23%<br>Expenditures - 16.3% | Revenues- 23%<br>Expenditures - NA |
| 3. Overdue arrears | Accounts payable - UAH 74 billion<br>Accounts receivable – UAH 52 billion | Accounts payable – UAH 90 billion<br>Accounts receivable – UAH 65 billion |
| 4. Money surrogates, quasi money | Bills of exchange – UAH 780 million (01.01.97); T-bills– UAH 77 million. | Bills of exchange – UAH 1619 million (01.01.98); T- bills– UAH 42 million. |

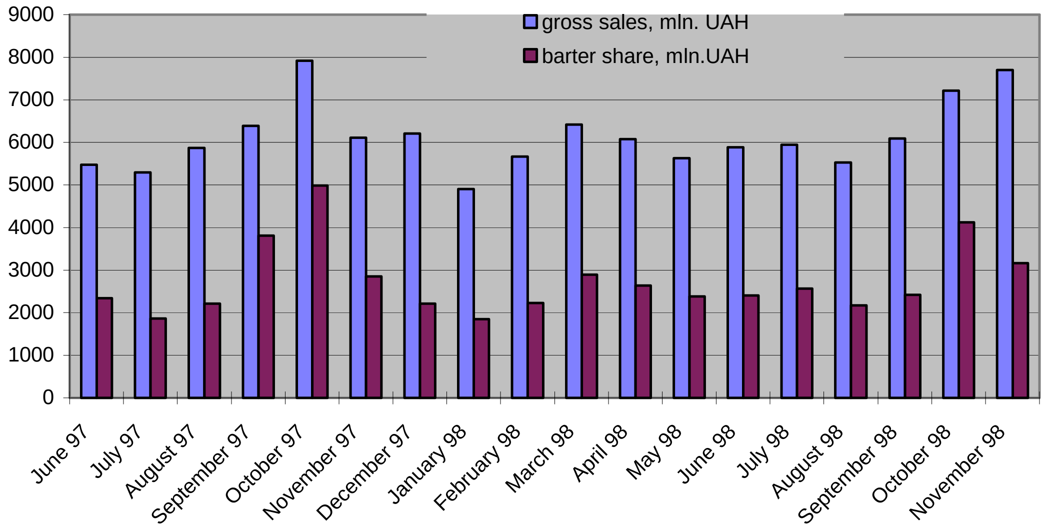
*Source: State Statistics Committee of Ukraine*

Let us now consider some of the DME zones in greater details.

## 1. Barter

*In industry* **-** In 1997, the share of barter in overall sales of industrial products in Ukraine was 42.4 percent**,** whereas in January-September 1998, the barter share amounted to 41.4 percent. Monetary payments accounted for 45.3 percent of gross sales of Ukraine's industrial products in 1997, and for the first nine months of 1998, monetary payments constituted 43.3 percent (Figure 16.1).

Figure 16.1. The volume of barter in overall sales of industrial products in Ukraine in 1997-1998, mln UAH.



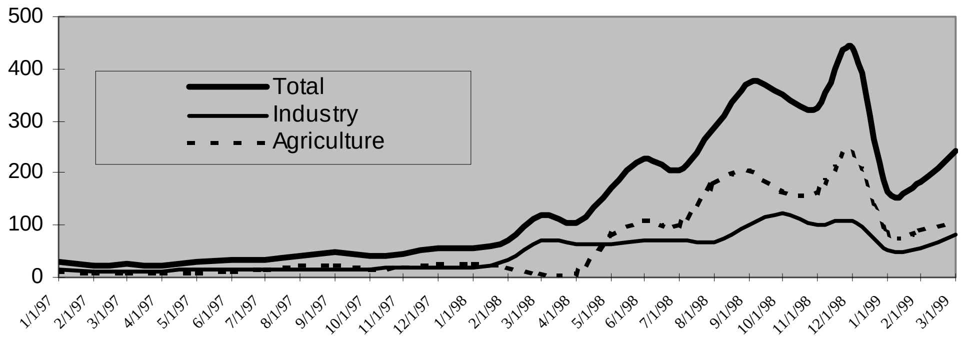

*Source: State Statistics Committee of Ukraine*

*In agriculture* - Between June 1997 and November 1998, barter transactions as a percentage of gross sales varied from 25 percent to 60 percent. Some agricultural enterprises also transfer a certain share of agricultural products to the processing industry and receiving processed product as a payment. During the first ten months of 1998, such transactions constituted 4 percent of sales of milk and diary products to wholesale organizations, 5 percent of sales of grains, 29 percent of sales of vegetables and 25 percent of sales of sunflower seeds.

*In trade* - In 1997, the share of barter decreased to 10.5 percent of the country's gross exports (from 22 percent in 1996). During the first 10 months of 1998, it declined even further to 7.9 percent (compared to 10.8 percent during the same period of 1997). The same trend is observed in imports - for the first ten months of 1998, the share of barter dropped to 6.3 percent compared to10.8 percent for the same period in 1997.

*Wage payments in kind* **-** The government considers the payment of wages in kind (with products that the enterprise produces or receives through barter) to be one of the most effective measures to curb the growth of wage arrears. In 1997, the wage payments in kind amounted to UAH 1.6 billion, which is 5.8 percent of total wages earned, and 6.0 percent of wages actually paid, in 1997. In the first nine months of 1998, the wage payments in kind increased to UAH 2.0 billion, which accounted for 9.9 percent of total wages earned, or 10.7 percent of wages actually paid in the same period (Figure 16.2).

Figure 16.2. Wage payments in kind in 1997-1999, mln. UAH



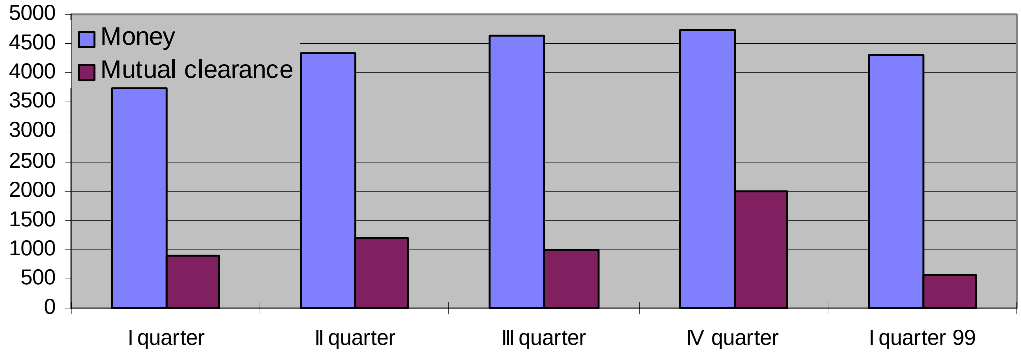

*Data Source: State Statistics Committee*

## 2. Mutual cancellation

Mutual cancellation, which is becoming quite widespread, takes place when both the budget and the economic agents fail to meet their obligations. The mechanism of mutual cancellation works in the following way: the government "agrees" to a given price level (often much above the market price) for the goods or services it had purchased from the enterprise but not paid for. It then liquidates the corresponding amount of tax arrears of the enterprise. Consequently, amounts charged on banks under kartoteka#2 (overdue tax arrears of enterprises) cancelled.

The 1997, the state budget recorded revenues of UAH 15.7 billion and expenditures of UAH 22.0 billion. Mutual cancellation amounted to UAH 3.6 billion, which was 22.9% of revenues and 16.3% of expenditures (Figure 16.3). In 1997, 13,500 cases of mutual cancellations were registered, of which 6,000 were registered in December alone. (These figures do not include mutual cancellation at the level of local budgets or the Pension Fund). Mutual cancellations took place in almost all categories of revenues and expenditures.

Figure 16.3. Monetary and non-monetary state budget revenues of Ukraine in 1998 and Q1 of 1999, mln.UAH




*Source: Finance Ministry of Ukraine*

### 3. Current and overdue arrears

As of January 1, 1998, gross accounts receivable and accounts payable of Ukraine's enterprises constituted UAH 77.2 billion and UAH 107.7 billion, respectively. 70.0 percent of receivables and 72.1 percent of payables were overdue. Gross amount of tax arrears to the budget was UAH 8.2 bln, of which 80.7 percent was overdue.

As of October 1, 1998 gross accounts receivable and accounts payable of Ukraine's enterprises increased to UAH 96.9 billion and UAH 132.6 bln, respectively.

70.1 percent of receivables and 74.1 percent of payables were overdue. Gross amount of tax arrears increased to UAH 12.2 billion, of which 81.5 percent was overdue.

**4. Money surrogates, quasi money (promissory notes, corporate and regional money substitutes).**

The structure of Ukraine's money supply has changed considerably. Promissory notes are being used on a large scale as a mechanism for easing the payments crisis. These promissory notes are fundamentally different from legal tenders issued by the National Bank of Ukraine. At present, promissory notes are being issued by the Ministry of Finance, regional authorities, banks and large companies. In fact, a parallel, "second class" monetary system has emerged, which compensates for the shortage of NBU money.

Money surrogates play a double role. On the one hand, they are a medium of exchange through endorsement. On the other hand, they are interest-carrying (discount) securities. In other words, money surrogates not only provide for accounts' settlement but also contribute to adjustment of prices and profits. And since these debt liabilities are accounted (and paid) for by buyers at market prices (usually stock exchanges' quotes), which are much lower than manufacturers' prices, the issuer automatically receives a lower price and hence a lower profit. Therefore, the system of financial surrogates adjusts manufacturers' prices to a market clearing level, which enables the resolution of the problem of insufficiency of working capital, without resorting to monetary emission.

Liquidity of Ukrainian promissory notes is weak. They attract economic agents mostly as a cost-minimizing means. The treasury promissory notes (discount as of October 1998 was 10 percent of purchase value) can be used to pay off taxes, pension promissory notes to make payments to the Pension Fund (discount 20-50 percent), energy bills of exchange (discount 10-80 percent) to pay for electricity.

**5. Write off**

In 1997, the gross amount of restructured and written off arrears to the budget was UAH 5.4 billion (5.8 percent of GDP). Writing off of arrears create incentives for enterprises to accumulate more arrears with the expectation that these too would be written off.

**Conclusion**

The formulation of economic policy in Ukraine requires a better understanding of the non-monetary and non-market incentives created by the DME. Research should cover both techniques and the life cycle of the operations in the DME zones. Policy measures should aim at creating right incentives for producers to move out of the DME. Authoritarian measures to collect taxes and end tax evasion, rather than helping to solve the problem, aggravates other problems, including that of DME.

The CIS economies (including Ukraine) have developed an unusual "vicious circle". Government's fiscal policy makes prices inflexible, where the production cost is determined by the tax authorities. Inflexible prices lead to a disequilibrium GDP. Disequilibrium GDP leads to a crisis of payments (including arrears to the budget). Arrears to the budget cause further tightening of state fiscal policy which in turn results in less flexible prices, and so on. This leads to a serious contradiction – government's struggle against inflation involves more price controls that lead to an even higher inflation as the crisis of payments (and fiscal crisis) gets worse.

# 17

## LINKAGES BETWEEN ECONOMIC POLICY AND FINANCIAL CRISIS

*Mirosław J. Gronicki*

### Introduction

The first signs of the financial crisis in Ukraine were visible in the fall of 1997. The crisis in South East Asian economies and, following it, a deflation of major commodities (including fuel oil) caused first, an outflow of portfolio capital from Ukraine and then put a lot of strain on the underdeveloped financial market in this country.

The origins of the recent crisis lay in irresponsible fiscal policies and slow process of structural reforms. In political terms, it meant the absence of sufficient political will of both executive and legislative branches to introduce painful decisions which would contribute to a reduction of the State's financial liabilities, broadening of the tax base, and removal of various bureaucratic regulations for entrepreneurial activity. These led to a lack of sustainable economic growth, which further exacerbated fiscal difficulties.

This paper consists of three sections. In the first section, an analysis of microeconomic foundations of the financial crisis is given. The second section presents macroeconomic foundations of this crisis. In the third section, possible scenarios for future development are discussed.

### Microeconomic foundations of the financial crisis

In any economy in transition, initial weakness of the economic system lies in weak regulations, mixed and often conflicting incentives, and the absence of property law. Transition countries, which introduced reforms to overcome these weaknesses, like Hungary and Poland, are now the leaders in economic reforms. In Ukraine, the regulatory and institutional reforms have been very slow. As a result, the microeconomic base for economic development is weak and fragile.

The vague notions about what property rights mean, the presence of a huge state sector in industry and weak private sector in distribution and services (and, at the same time, a huge shadow economy) have led to a relative separation of institutional sectors in the economy. In the state sector, barter transactions prevail; in the private distribution and services sectors, cash transactions prevail and, in the shadow economy, hard currency (dollar) based transactions are the norm. Moreover, the initial hardship imposed on citizens by hyperinflation in 1993-94, resulted in the development of natural economy (in agriculture and services).

Prices of energy, basic food and services are controlled by the state and reflect neither costs nor their value for consumers. This is a major cause for the deepening of disequilibrium on Ukrainian markets. It is also a major source of implicit and explicit subsidies in the economic system which, if prolonged, may lead to a significant upward correction of prices.

The most significant microeconomic limitations for consistent economic development are the lack of a proper price system, absence of hard-budget constraints for state-owned enterprises, and weak budget and tax law.

The private sector could not develop properly because there are significant barriers to entry into the official system. In Poland, one of the initial successes of reform was the creation, in a very short period, of over 2 million small firms. This was the immediate effect of the decision of the Polish government to grant three-year tax holidays to small firms. It helped in a relatively smooth restructuring of the economy, which cushioned the effects of layoffs in the state sector. Due to this decision, in four years (between 1990 and 1994), the private non-agricultural sector increased employment from 1.5 million to almost 4 million. At the same time, unemployment increased from zero to 2.9 million. This means that about 5 million persons were laid off in the state sector.

In Ukraine, small and medium size enterprises are practically negligible in the official sector, and this has been a major obstacle for implementing efficient and significant microeconomic changes in the economy. Given weak microeconomic foundations, any piecemeal reform of the state sector may lead to significant shift from the hidden to open unemployment, without offering any alternative. The Polish case shows that opening of the economy for small and medium size firms even at the costs of lower revenues from direct taxes (taxes paid by these firms) might be crucial for future successes of the economic reforms.

**Macroeconomic foundations of the financial crisis**

The major macroeconomic causes of the financial crisis were inconsistency between monetary policy and fiscal policy. As we stressed in the previous section, fiscal policy was undermined by the lack of both proper microeconomic fundamentals and regulations.

From the very beginning of Ukraine's economic transformation, weak tax regulation led to lower than expected tax revenues. At the same time, the budget law was either inconsistent or in some cases envisaged expenditures that could not be covered given low tax revenues. Under the loose fiscal policy (government kept high budget deficit and allowed increase of pension and wages arrears in the budgetary sector), the only possible solution could have been a strict monetary policy. However, it is not possible to run such a policy-mix forever, as that could improve the situation only for a short time period.

Nevertheless, in Ukrainian monetary policy, in the years preceding the financial crises, significant changes took place. From the end of 1995, financing of budget deficits was switched from the Central Bank's emission to private loans and the domestic treasury T-bills. Such a policy slowed down expansion of the monetary base, stabilized exchange rates and lowered inflation. It should be stressed that such a policy did not deal with fundamental causes responsible for macroeconomic disequilibrium. It only provided a certain kind of "breathing space" for the government. Unfortunately the "breathing space" proved to be rather short and was not used to implement the necessary reforms.

Low monetization level in Ukraine quickly exhausted the possibility of increasing domestic debt. This happened in the second half of 1996. Between the second half of 1996 and the autumn of 1997, financing of the budget deficit relied mostly on non-residents purchase of treasury bills. Relatively high interest rates, and stable hryvna, attracted a significant amount of portfolio capital.

On the shallow monetary market, it also increased money supply. With weak domestic demand, it pressed interest rates down on the inter-bank market. However, average credit rates were very high through crowding out effect and unwillingness of banks to lend money to high-risk creditors. On the other hand, the government forced some credits especially for big state-owned enterprises and this was responsible for increase of bad debts in commercial banks' portfolio.

The relatively low interest rates on deposits and low propensity to save in hryvna bank deposits prevented a faster increase in money supply, but it helped in stabilizing exchange rate and lowering inflation rate. Paradoxically, the main success of previous reforms, that is low inflation, was at the same time one of the causes of troubles. With low inflation, low interest rates on deposits and low propensity to save in hryvna, the government could not count on fast increase of monetization. Thus, the main available source of financing budget deficit was undermined.

This inconsistent policy-mix became unsustainable when the Asian crisis emerged. In November 1997, non-residents initiated the flight of portfolio capital. Residents followed them. Consequently, it caused difficulties with the budget deficit financing, restructuring (rolling-over) of old debt, and finally led to fast depletion of currency reserves. To defend the currency, central banks would increase treasury bills yield rates. High interest rates on public debt further worsened the budget performance.

A significant depletion of Ukrainian currency reserves down to $ 760 million at the end of August 1998 has damaged the confidence in the stability of the national currency. It was also an additional impetus for residents to switch from hryvna to dollars. Responses of the monetary authorities proved to be inadequate to prevent a strong devaluation.

The National Bank of Ukraine has practically resumed wide scale budgetary deficit financing through purchasing of bonds of state domestic loans (domestic T-Bills) on the primary market. It should be stressed that this was the only choice the government was left with, since the refusal to roll-over T-bills would have led to the government's default. Now, more than before, the monetary policy has become a hostage of fiscal imbalances.

**Possible scenarios of development**

Ukraine's prospects depend on how soon the government introduces painful but necessary changes in its fiscal policy. This should be a first step in consistent reforms.

Other reforms should be introduced simultaneously. New regulations should allow freedom of entry and exit for small and medium size enterprises. The tax structure should switch from taxing incomes to taxing consumption. This will allow for at least partial incorporating of the shadow economy back into the official economy.

Initially, this may lead to decrease of overall GDP and price adjustment. However, lower GDP does not necessarily mean proportionally lower satisfaction from consuming goods and services. Simply, unwanted goods – often traded in barter – could be substituted by goods of better quality and market value. Price adjustment may cause some pain but is necessary for establishing proper relative prices and removing implicit and explicit subsidies from the economic system.

If these reforms are consistently introduced, then the Ukrainian economy will take-off. Otherwise, the slow process of shrinking of the state-controlled economy will conflict with growing shadow economy. This will lead to a gradual weakening of the state with all its consequences.

# 18

## FINANCIAL CRISIS IN UKRAINE AND POSSIBLE SOLUTIONS

*Marek P. Dabrowski*[1]

The fundamental causes of the recent collapse and devaluation of Russian ruble and Ukrainian hryvna are identical. They are the result of a long brewing budgetary crisis and slowdown of the process of structural and systemic reforms in both countries. In the political realm, this means the absence of sufficient political will, of both the executive and legislative branches, to take decisions which would contribute to reduction of State's financial liabilities, consolidation of the tax base, and lifting of various bureaucratic restrictions on entrepreneurial activity. Failure to make these changes prevented the economic sphere from getting into the process of economic growth. The absence of economic growth constitutes an additional independent factor contributing to the crisis.

In the absence of a balanced budget, strict monetary policy was instituted. This could improve the situation only for a rather short time period. Both Russia (starting early 1995) and Ukraine (late 1995) switched from central bank's emission to loans in the domestic market to finance the deficit. Russia used treasury bills (GKO) and federal loans bonds, and Ukraine used treasury bills. Such a policy made it possible to slow down the expansion of the monetary base, stabilize the national currencies rate, lower the inflation (in Ukraine more effectively than in Russia), as well as hold off the decline in GDP. It should be underscored, though, that such a policy was characterized by one serious drawback. It did not deal with the fundamental causes of the macroeconomic imbalance but only provided a "breathing space" for both countries, and a chance to implement the required fiscal and structural reform, coupled with intensive privatization. Unfortunately

[1] The author is grateful to Pavel Kovalev, Vadym Lepetyuk and Malgorzata Markiewicz of CASE, Kyiv for their contributions in the preparation of this essay.

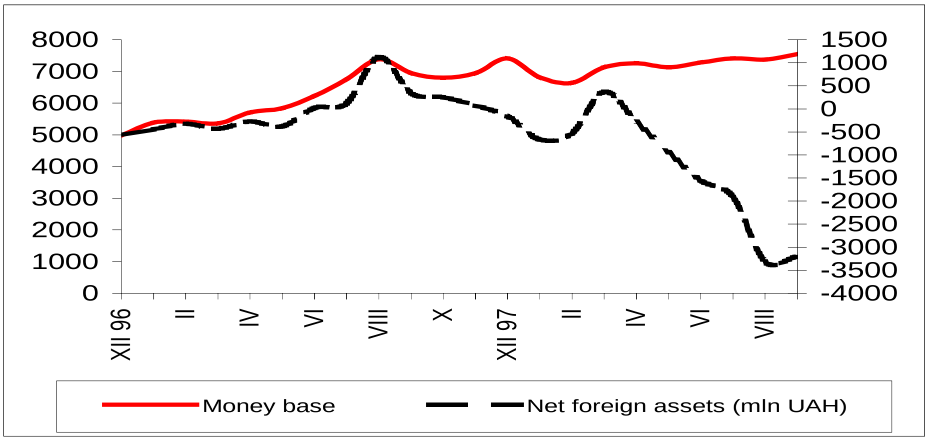
the “breathing space” proved to be rather short and was not used to implement the reforms required.

With low level of monetization in both countries, the potential for mobilizing internal resources for debts was increasing getting exhausted. Starting with the second half of 1996, an another opportunity presented itself in the form of non-residents’ interest in T-bills. During the “emerging markets euphoria”, both Russia and Ukraine attracted finance relatively easily. The euphoria proved to be short-lived and investors soon realized the fragility of the macroeconomic foundations in both countries. The crisis in Asian countries proven to be an extra factor in lowering the general confidence in “emerging markets.” As of November 1997, both countries began to witness large-scale withdrawal of capitals, first by non-residents, and then by residents. This caused difficulties in budget deficit financing and in rolling over of old debt. It also led to a fast contraction of currency reserves. Doubts regarding the country’s potential to repay its debts entailed a surge in T-bill yield rates, which further complicated the budget situation.

The abrupt depletion of currency reserves damaged the confidence in the stability of the national currency, and this served as an extra impetus for residents to switch from ruble/hryvna to dollars. It should be underscored that neither the Central Bank in Russia (CBR) nor the National Bank of Ukraine (NBU) undertook monetary base sterilization, through reduction of the net internal assets, when capital inflow and currency reserves were growing. The correlation between currency reserves and money base remained low, making it less possible to secure sufficient support for the national currency in the event of any speculative attack.

When currency reserves started draining out, the central banks began to fill in the money base with additional domestic credit. The NBU resumed large-scale financing of budget deficit through purchase of domestic T-Bills on the primary market (Figure 18.1). It should be emphasized, though, that this was the only choice the government was left with. Inability to roll over T-bills could have led to the government’s default. It is difficult to accuse the government of a strict monetary policy precisely because the monetary policy was not sufficiently strict. The monetary policy has actually remained a hostage of fiscal imbalance.

Figure 18.1. Relationship between net external assets of NBU and money base, UAH million




*Source: NBU Bulletins*

**Differences in situations in Russia and Ukraine**

In spite of similarities in fundamental causes of the crisis, the situation in Ukraine did not turn out to be as dramatic as in Russian. What are the differences? The first stage of crisis revealed that, compared to Ukraine, Russia was more vulnerable due to the following reasons:

1. The stock of accumulated state debt in Russia was higher compared to Ukraine, firstly because Russia inherited the debts of the Soviet Union, and secondly because it launched T-bills earlier. High budgetary deficit speeded up Russia getting into a debt trap.
2. Federal-local relation, in Russia, is more complicated.
3. The structure of foreign trade is distinctly different in Russia compared to Ukraine's. Russia has suffered significant losses due to the lowering of world's prices for oil, natural gas and other primary resources. Ukraine, on the other hand, has actually benefited from such change in prices. Greater reliance of Russia on consumer imports implied that devaluation affected consumer price inflation much more than in Ukraine.

4. Ukraine has actually received a “bonus” for procrastinating in financial sector reform. Ukrainian banks, unlike Russian ones, have not managed to take enough loans in the international market, and have not entered large-scale derivative operations. This made Ukraine less vulnerable to devaluation.
5. Likewise, an underdeveloped stock market helped Ukraine avoid excessive drain on capital.
6. The financial oligarchy in Russia is much more powerful than in Ukraine, making the Russian government and the economy hostages to this oligarchy.

Following August 15, 1998, significance differences were observed in the methods the two countries chose to manage the crisis:

1. Ukraine did not declare an official default on T-bills and the Russian experience actually helped to “convince” investors of the need of restructuring debt.
2. Russian government enhanced the panic by interfering in banks’ portfolios and asking all deposits to be transferred to the Savings Bank. NBU and the Government of Ukraine avoided such decisions. On the other hand the NBU used monetary policy to control inflation.
3. Financial crisis in Russia quickly turned into a political crisis because of the sacking of the Prime Minister. This contributed to enhancing the panic in the currency and financial markets. Ukraine has so far has managed to avoid serious political problems.

As a result of these differences in approach, Ukraine’s moved along the same crisis spiral much more slowly compared to Russia.

**Possible variants of the course of economic situation’s**

Forecasting the future course of the macroeconomic situation, under present conditions of financial crisis, is not an easy task, particularly because psychological factors have tremendous significance. Based on the various assumptions regarding to the measures adopted, we shall try to discuss two possible scenarios (pessimistic and optimistic) of the macroeconomic situation. The main premises of budgetary and monetary policies shall be identical for both scenarios:

*a. Deficit financing*

1. Access to the private sources of external financing is not available.
2. Internal financing, such as T-bills or other securities, is not available.
3. Net credits of international financial institutions (World Bank, European Union etc.) are negative or, at best, zero.
4. Non-zero budget deficit is financed by NBU credit.

*b. Money base and reserves*

1. Financing of deficit through NBU credit will lead expansion of the money base, unless a certain portion of foreign currency assets of enterprises and households are transferred into hryvna.
2. NBU currency reserves will not increase on account of external loans. In the best case, the acquired credits will only be sufficient to repay old loans.

It should be noted that the pessimistic variant, in its practical implementation, may prove to be even more destructive than presented here. Further slip along the crisis spiral may evoke changes of political and psychological nature which were not considered in our model. For example, the velocity of money circulation (divergence from hryvna) may prove to be much higher compared to our assumptions; budget revenues may drastically reduce, expenditures may increase (e.g. due to indexation); there may be a banking crisis.

**Variant 1 (pessimistic)**

Ukraine' gradual slip into crisis. In this scenario changes required to overcome the crisis situation were not implemented. This, first of all, means immediate adoption of zero deficit or even budget surplus.

*Main characteristics of the variants:*

- Budget deficit amount to 2.5 percent of GDP in 1998, and 1-2 percent of GDP in 1999. In the absence of external and internal financing the budget deficit is covered by the NBU's credit to the government. This will promote an increase of net domestic assets. In the absence of ability to sterilize, this will cause expansion of the money base, which through monetary mechanism, will cause high inflation. A drop in confidence in the hryvna will further raise inflation expectations.

- Continued devaluation of the hryvna along with inflation expectations provoke fast retreat from national currency, increases the velocity of money circulation and exacerbates inflation.
- Further contraction of the real sector and decline in GDP are stipulated by the financial system crisis. There will be reduction in normal functioning of enterprises due to administrative controls (on exporters and importers) and scarcity of investment. There will be decrease in household incomes caused the reduction of private consumption.

Potential paths of macro economic indications (Variant 1)

| Parameter | 1998 | 1999 |
|---|---|---|
| Budget deficit, % GDP | 2.5 | 1.2 |
| Exchange rate HR/ $, end of the period | 4.5-6.0 | 6.0-9.0 |
| CPI, %, December to December | 45 | 60-100 |
| Money base growth, % | 10 | 20 |
| Monetization level, % | 10 | 8 |
| Real GDP change, % | -2,5 | -3 |

**Variant 2 (optimistic)**

The variant is based on the assumption that rapid implementation of reform measures may produce a real “change” in the situation. Such measures must be aimed at curtailment of the further expansion of money base and inflation rate during the course of return to a balanced exchange rate (look further down).

The implementation of strict budgetary adjustment and structural changes must form the key conditions of both short and medium range stabilization. Pension reform and reform of social protection system is financed by accelerated privatization.

*Variant’s main characteristics:*

- Balanced budget. Restraining the expansion of the money base and strict policy aimed at liquidity of the banking system may prevent inflation and keep the exchange rate from rapid devaluation. Simultaneously this will stimulate the resumption of demand for national currency.

- Achieved stabilization will restore confidence into the hryvna, which will, in the medium term, secure the transfer of foreign currency assets into hryvna. This will stimulate the supply of foreign currency and will help NBU to replenish its currency reserves.

Therefore, declaration of a reform program, along other market auto-stabilizers will contribute to likelihood of hryvna's stabilization within the limits 3.5-4 per dollar by the end of 1998.

Potential paths of macroeconomic indications (Variant 2)

| Parameter | 1998 | 1999 |
|---|---|---|
| Budget deficit, % GDP | 2 | 0 |
| Exchange rate UAH/$, end of period | 3.5-4.0 | 4.0-4.5 |
| CPI, %, December to December | 30 | 10-15 |
| Money base growth, % | 5 | 10 |
| Monetization level, % | 13 | 13 |
| Real GDP change, % | -1.5 | -1.0 |

**Short term anti-crisis measures**

Short term measures (several weeks perspective), which may slow down the further exacerbation of the financial crisis, include actions aimed at normalization of the currency market, restructuring of T-bill liabilities, achieving zero-deficit budget, and launching of large-scale cash privatization.

The most urgent measure is to return to the free-floating hryvna, which would imply annulment of administrative restrictions introduced in the currency market in September. To avoid volatility in the exchange rate, when restrictions are annulled, the NBU should take short-term measures aimed at "contraction" of the liquidity in the banking system. This can be carried out by introducing stricter reserve requirement, carefully observing the sequence of its implementation and arranging of depositary auctions.

The administrative restrictions on the currency market prevent its normal functioning. Absence of a market-based exchange rate deprives economic agents of information regarding existing tendencies and the state of the market leverages in the management of these tendencies. Hence, the required measures are: the liberalization of trade operations, abolishing of the tender committee of the NBU, canceling of the compulsory conversion of export earnings, and annulment of restrictions on repatriation of non-residents' income. These measures are essential in order to assuage the currency market and to bring the exchange rate back to market balance.

Launching the process of cash privatization would simultaneously contribute to the realization of several goals such as: advancement of structural reforms, replenishment of the budget, replenishment of currency reserves of the NBU (assuming that foreign investors participate in the process) and resumption of confidence in economic policy of Ukraine.

**Medium term program**

According to our estimates, zero-deficit budget in the short and medium term perspective is a prerequisite to surmount the crisis. Purely technical measures such as sequestering of budgetary expenditures and mobilization of tax levy may not be adequate, since they only result in increasing budgetary indebtedness and undermining fiscal discipline. The measures should aim at a systematic reduction of State's financial liabilities, including the ones in the social sphere. That will require, to a large extent, the implementation of pension reform: raising of retirement age, imposing of limitations on the right of pre-term retirement, annulment of the other privileges granted to various industries and professions, reduction in the number of disability pensions, reduction in the amount of pension of working pensioners, and reduction in the amount and number of individually entitled pensions. Other social benefits must also be narrowly targeted. Budgetary sphere reform must include the contraction of the network of health care, educational and cultural establishments, along with the partial introduction of paid services and a competitive mechanism for delivering such services.

Lifting of political restrictions on the privatization process is necessary in order to accelerate structural changes in the Ukrainian economy. Large-scale deregulation and tax reform must constitute the impetus for private business development and consequently help Ukraine to achieve economic growth.

The reform package must include measures that will resume the confidence in the national currency and secure its stability in the long-term perspective. One possible approach could be to introduce the currency board system. Under the currency board regime the money base must contain 100% funds covered by the central bank's foreign currency reserves. The central bank is prohibited from making any credit to either the government or commercial banks, or to perform open market operations. The currency board regime eliminates the possibility of political pressure on monetary policy and enhances the confidence in the national currency. The experiences of Argentine, Estonia, Lithuania and Bulgaria demonstrate that the currency board regime promotes low inflation, enforces fiscal discipline, promotes confidence in the national currency and helps create an environment conducive for economic growth.

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# 19

## THE GLOBAL FINANCIAL CRISIS AND MARKET REFORMS IN BULGARIA : LESSONS FOR UKRAINE

*Rumen V. Gechev*

The world financial and economic crisis reached a critical level in late 1998 and indexes of the stock exchanges in many emerging markets dropped down 40 to 50 percent. During this period, the yields on medium-term and long-term securities decreased considerably. There were significant changes in the structure and the direction of both short-term and long-term investment flows. The increase of business risk provoked large-scale withdrawal of capital from these markets, particularly from transition countries in Eastern Europe.

Bulgaria and Ukraine are two examples of countries where the economic transition has been particularly painful. The burden of servicing government debts has compelled the two countries to finance their budget deficits mainly through issuing of securities. The international financial institutions have restricted direct cash financing of the budget deficits by the central bank. In order to attract sufficient funds, the governments in these countries were compelled to offer exceptionally low prices for government securities. These prices initially attracted foreign portfolio investors. However, when the crisis appeared, they sold their securities in panic.

Short-term investment has been a predominant feature in both Ukraine and Bulgaria. Its large volume, until recently, has been important for achieving equilibrium on the currency market. Stable exchange rates have always been one of the conditions for a stable financial and economic system. In theory, trade surplus provides sufficient currency backing for a stable exchange rate (Halpern and Wyplosz 1997). In practice, however, the typical phenomenon for most countries in transition is trade deficit. The difficulties in adjusting to new market conditions, the inherited economic structure, and the collapse of COMECON, have created immense problems for export. In Bulgaria, a steady trend of increase in imports has emerged, due partly to the country joining the World Trade Organization and partly to the Central European Free Trade Association and its association with the European Union.

During the first nine months of 1998, compared to the same period of 1997, Bulgaria's foreign trade turnover declined from $ 7.2 billion to $ 6.81 billion. An increase in imports by $ 76 million, combined with a decrease in exports, resulted in a trade deficit of $ 466 million. Such a large deficit is alarming, considering that the GDP is only about $ 10 billion. Now 47 per cent of Bulgaria's trade is with the European Union and only 24 per cent with the Eastern European region. Exports to Russia dropped by over $ 100 million, but imports from Russia remained unchanged, consisting mainly of power resources and raw materials.

A serious drop in the world prices of ferrous and non-ferrous metals and chemical products, including fertilizers and petroleum products, proved unfavorable for the countries in transition. These commodities form a substantial part of exports from most East European countries. The decline in these prices drastically reduces export receipts and, simultaneously reduces the interest of foreign investors in investing in the privatization of large metallurgical and chemical companies. Meanwhile, the losses and the debts of these companies grow and turn the market reforms into a vicious circle.

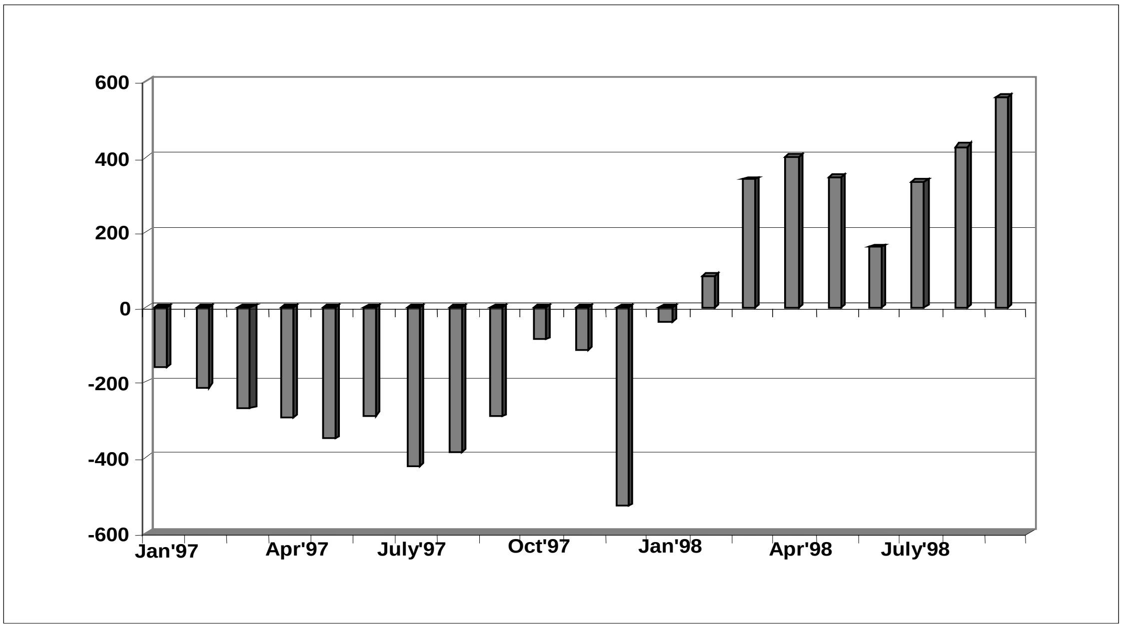
Some economists and politicians are trying to support the thesis, that privatisation of such enterprises should be frozen until price goes up. However, further delay in privatisation could worsen the situation, because, after a year or two, most of these state-owned companies would become practically impossible to sell due to the large amount of accumulated debts to suppliers, banks, the budget and the social security.

The budget equilibrium is exposed to great risks. In accordance with the principles of the currency board[9], introduced in Bulgaria on July 1, 1997, the deficit during 1998 and 1999 should stay within 1.5 to 2 percent (Figure 19.1). According to the budget laws for these years, the receipts from privatization are one of the main sources of budget revenue. Until 1997, almost half of these revenues were used for supplying the State Fund for Reconstruction and Development (financing investment projects) and to support agriculture. From the middle of 1997, the entire cash receipts from privatization

[9] Under the currency board arrangements, 1000 levs equals to 1 DM

are remitted to the budget. The rationale was that this would provide resource for the servicing and the buying-back of government debt. The collapse of the banking system and the central bank's policy of high interest rates, implemented in the middle of 1996, (the annual interest rate reached almost 1500 percent) required two revisions of the approved 1996 budget. This became necessary because the payments for the interests on government securities reached 70 percent of total budget expenditures. In order to reduce costs of servicing the internal debt, the government turned to a second instrument - keeping interest rates low by basing Central bank discount rates on the yield on three-month government securities (Manchev 1997).

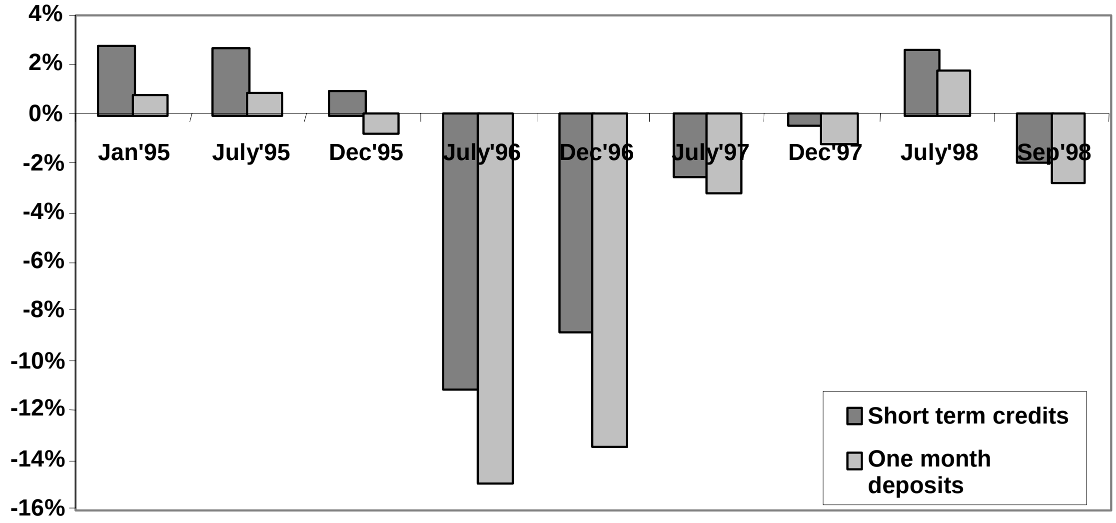
Figure 19.1. Bulgaria: Consolidated Budget- Budget balance, levs billion




*Source: Bulgarian National Bank. Information Bulletin. No.10/1998, p.34*

Interest rates in Bulgaria remain low (Figure 19.2), but because of the weak response of foreign investors, prospects of large receipts from cash privatization are bleak. Several consecutive tenders for some large industrial companies in the chemical industry, machine building, metallurgy and others failed due to the lack of serious buyers. If the crisis in the world economy continues to worsen, foreign interest in privatization will continue to decline, with dire consequences for the financial and economic systems. Despite the high budget surpluses thus far, particularly in the second half of 1998, problems are expected in 1999 with the budget balance mainly due to the anticipated sharp drop in privatization receipts. The tightening of the budget expenditure has already reached its limit, and taking it any further may result in a collapse of the public sector.

Figure19.2. Bulgaria: Real Monthly Interest Rates

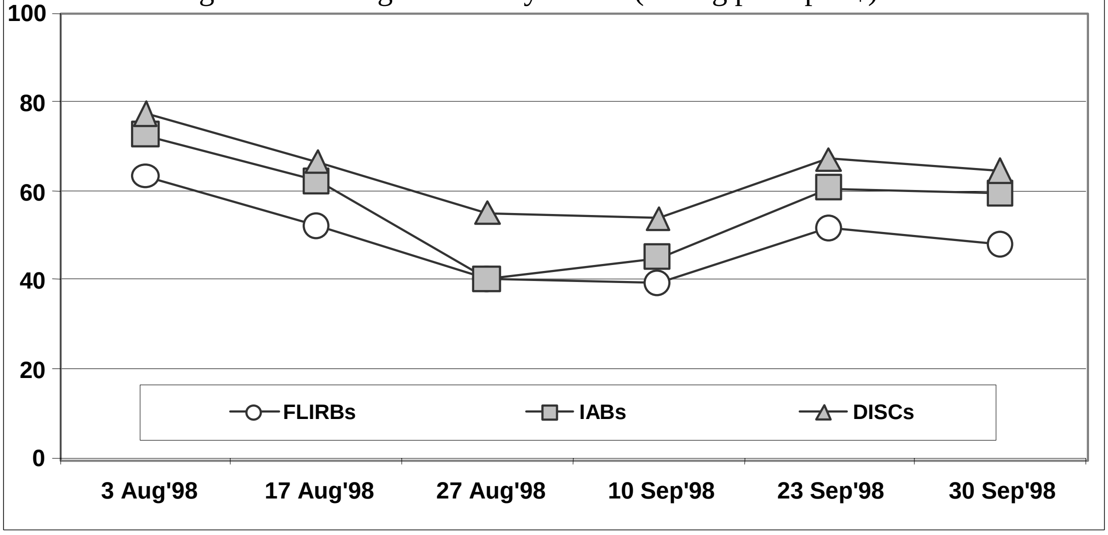



*Source: Bulgarian National Bank. Information Bulletin. 1995-98*
*Note: The real interest rates have been calculated on an average monthly basis deflated by the inflation rate for the same period.*

The Bulgarian economy is developing rather unfavourably. Sales of manufactured goods dropped 19 percent in October 1998 compared to October 1997. For the period, January-September 1998, over 40 per cent of sales receipts were overdue. Likewise, 45 percent of liabilities of state-owned industrial companies to suppliers were overdue. In the third quarter of 1998, the profits of these companies have decreased by 43 billion levs (about $ 25 million), showing a downward trend. Thus, the combining of the two unfavourable factors - the world financial crisis and the postponing of structural reforms - makes further market reforms difficult. On average, only 60 percent of production capacities in the Bulgarian economy were utilized without prospect for quick improvement.

Along with this, serious problems arise because of the combination of the structural problems with foreign trade liberalization. Even the use of currency board does not reduce, with a magic wand, the potential danger of a new currency destabilization caused by capital outflow (Schwarz 1993). At this stage, we have no grounds to reckon that this outflow will cease.

Figure 19.3. Bulgarian Brady Bonds (selling price per $)




*Source: Bulgarian National Bank. Information Bulletin.No.10/1998, p. 60*

The decrease in the prices of Bulgarian securities is serious. The collapse of financial markets in many parts of the world, and particularly the "storm" in Latin America, has seriously hurt the volume of trade in Brady-bonds[2]. For Bulgaria, the Brady-bonds are of special importance, because Bulgarian law allows them to be used to pay for privatization purchases. Price movement of this type of debt securities has been an important indicator for judging the intentions and behaviour of foreign investors. Foreign debt denominated in Brady-bonds amounts to $ 5 billion. However, there has been a lack of investor interest in using these bonds for privatization transactions.

The views of some economists that the financial crisis and the shrinkage of the price of Brady-bonds favor reverse buy-out of debt seem unfounded. At the current state of balance of payment and budget balances in transition countries, such reverse buy-out would be unreasonable to expect. The lower price of the Brady-bonds cannot compensate for the advantages of extended payment. The Bulgarian government does not consider such operations expedient at this stage since advance payment of a large part of debt would place the financial system in a difficult situation. Other Eastern European countries

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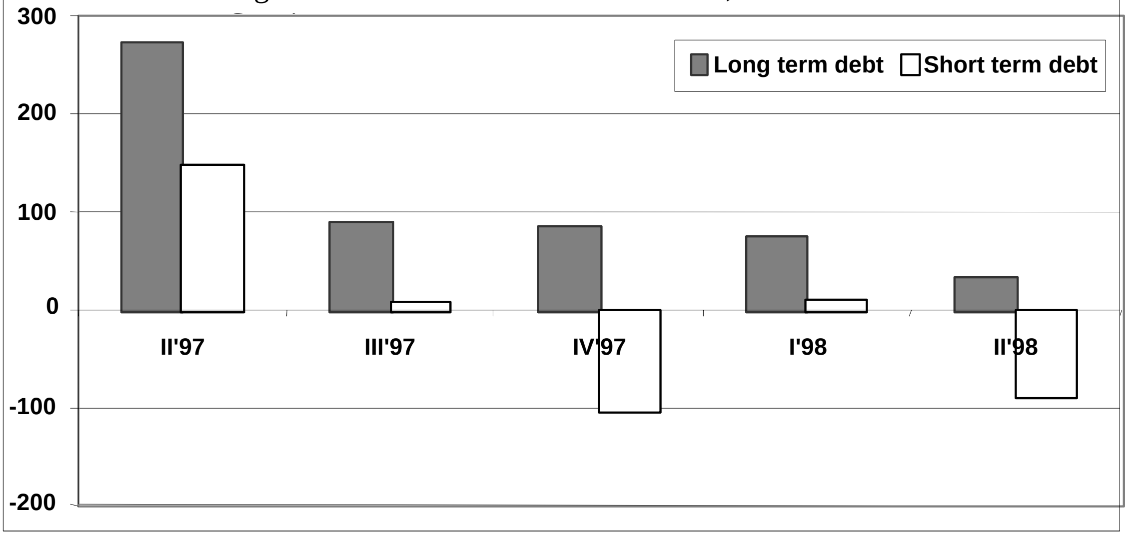
2 Brady Bonds are named after the former US Secretary of Finance Mr Brady who proposed conversion of the foreign debt into a special bonds, tradable on the financial markets; FLIRBs: Front-Loaded Interest Reduction Bonds; IABs: Interest Arrears Bonds; DISCs : Discount Bonds.

are not likely to undertake large-scale reverse buy-outs either. The world financial crisis influenced the scales and directions of movement of considerable amounts of currency deposits. In Bulgaria, about $ 1 billion (10 percent of GDP) has been transferred as deposits to foreign banks. The economy, lacking investment resources for itself, thus turns into a creditor for developed countries. Instead of being a net importer of investment funds, Bulgaria actually turn into net exporter, restricting the ability for intensive restructuring of the economy.

The economic turmoil in South Korea, Indonesia, Malaysia, Russia and some other countries required urgent intervention of the IMF. The resources of IMF were severely stretched in extinguishing these "fires" - South Korea alone blocked $ 40 billion. For this reason, the capacity of the IMF for financing Eastern European countries has been constrained. Considering the unpredictable development in Russia, the situation may get worse in the short-term. The annual IMF loan for Bulgaria is now less than it was two years ago. At the same time, maintaining a sufficient level of the currency reserve is obligatory for the success of the currency board (Iotsov, et al.1998).

Figure 19. 4. External and Internal Debt, $ million.




*Source: Bulgarian National Bank. Information Bulletin. No.10/1999, pp.34 -35;*

In the next three years, Bulgaria has annual foreign debt payments of about $ 0.5 million. It appears that expected available funds will be less than funds required for debt payments. This will place the financial system under a severe test. The shrinkage of the currency reserves, that may end up below the required minimum, would raise panic among depositors, and destabilize the banking system again. Through juggling the interest rates, the Government considerably lowered the cost of servicing government debt. Debt servicing now accounts for only 20 percent of budget expenses compared to nearly 80 percent in the second half of 1996. But this creates serious problems for the banking sector and for the entire economy. Since real interest rates are negative, the propensity to save is low. This impedes investment and places financial constraints on structural reforms.

The global financial destabilization may lead to significant fluctuations in the exchange rate of the US dollar vis-à-vis other convertible currencies, including the euro. The problem is that the capacity of the Eastern European economies to absorb such fluctuations is modest. In countries such as Bulgaria, where one of the key aims of financial stabilization is a stable national currency, mixed effects are produced. The cheap US dollar allows economizing on foreign debt service. This restricts government’s participation on the credit markets and provides cheap credit resource for the private sector. Yet, the expensive national currency causes decrease in export revenues.

Cheap import leads to large trade deficits and narrowing of the market for national producers. Thus, the role of the currency board in Bulgaria is to provide stabilization of various macroeconomic parameters including prices, incomes, and currency market. It lessens business risk, but above all, its harsh conditions restrict the field for manoeuvring in an unstable foreign economic environment. Under a pessimistic scenario, the currency board may not survive sharp foreign exchange fluctuations.

Under a growing financial and economic crisis, of special interest is the relative liberalization of government regulation. Over the past years, the Eastern European countries have moved towards liberalization in their foreign trade policies. Most of them are members of WTO and CEFTA, and are associated with the EU. In principle, trade liberalization is an important condition for successful transition to market economy. Unfortunately, the effects of such action are difficult to predict during a global financial crisis. Under these conditions, even developed countries approach trade policy cautiously and make possible tariff and non-tariff restrictions to defend the most vulnerable sectors in their economies. A good example is the trade in agricultural goods, which are solidly subsidized in the developed countries. However, in Eastern European countries, there is little budget capacity for subsidizing, and therefore, domestic agricultural goods lose price competitiveness.

Other countries such as Russia undertook drastic measures to restrict export and import of capital. Because of high risk, until recently, trade payments with Russian importers was made mainly in cash advance. Currently, Russian markets are virtually closed to Bulgarian exporters, because the restrictions on currency payments have been added to the existing customs restrictions. This is unfortunate for Bulgaria, particularly since its annual trade deficit with Russia is about $ one billion. Bulgaria's imports from Russia – oil, natural gas and minerals and ores - have very low elasticity. The outlook becomes even more pessimistic when considering that ferrous and non-ferrous metals are a significant part of Bulgaria's exports mix, and their world markets are constantly declining.

The capital fund of the entire public sector is 8 trillion levs ($ 4.5 billion), and the accumulated debts are already 7 trillion levs ($ 4 billion). In this unfavourable situation, enterprises have limited capacity to initiate technological and product innovation. After the collapse of the banking system in the middle of 1996, and the subsequent unfavourable financial environment, the requirements of the creditors have increased manifold. Potential borrowers lack sufficient collateral.

It would be ill advised to assume turnaround in the level of debts in the coming months, because neither domestic nor foreign market conditions will allow an increase in sales. Apart from this, at the end of the third quarter of 1998, the share of the overdue payments of government enterprises is substantial: budget arrears make up 26 percent, wage arrears 29 percent, and social security arrears 42 percent of total arrears.

The global financial crisis creates additional problems for countries in transition, particularly for those that were late with structural reforms. Their economies are not able to manage external shocks effectively. The decrease in foreign investments, combined with the shrinkage of the markets and the fluctuation of the currency exchange rates, creates insurmountable barriers to development that are difficult to overcome. Given these unfavourable conditions, privatization and structural reforms become the only policy alternative for a successful adaptation to the situation in the world market.

The positive and negative experiences of Bulgaria have shown the necessity for simultaneous implementation of financial stabilization mechanisms and structural reforms. Privatization is the key component of restructuring because it is the sole vehicle that will attract substantial foreign investments and generate cash inflows for the state budget.

Special attention must be paid to loss making state-owned companies. Their liquidation and isolation from the banking system is a precondition for the improvement of budget balance and resource reallocation into profitable operations. Sustainable economic reforms are possible only if the banking system meets the international standards for capital adequacy, liquidity, credit portfolio and credit operations. Bulgaria and Ukraine have many similarities in their past and present economic developments. Large scale and dynamic reforms in all sectors are of great importance for their transition to modern market economies.

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