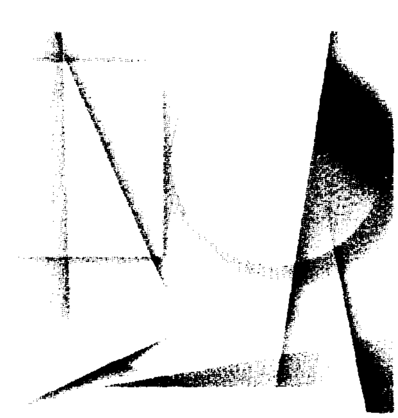
Toward Better and Slimmer Government



The transition from plan to market calls for a wholesale reinvention of government. The state has to move from doing many things badly to doing its fewer core tasks well. This means government must at once shrink and change its nature. No longer the prime economic agent in most areas, it must instead facilitate private activity. This chapter steps back from the many demands on governments undergoing transition—the array of economic and institutional reforms outlined in other chapters—to analyze the more fundamental issue of the role of the state itself in the economy and how it should evolve during transition. It goes on to analyze how the reinvention of government should proceed in practice, focusing on the need to overhaul all aspects of the public finances. In most transition economies reforms have sapped power and revenue away from governments. Continuing to finance even a shrunken government without inflationary money creation or overborrowing, while at the same time reordering spending priorities, is proving a major challenge for almost all countries. Getting the government's own house in order—achieving tighter control on expenditure, better budget management, and tax administration, while reforming fiscal relations between levels of government—is a high priority for advanced and lagging reformers alike.

Achieving fundamental change in government

Voters and policymakers around the world increasingly ask what government is for, and whether some of its tasks might be better done by private agents. In transition countries the job of redefining government is at once more urgent and more daunting. First, the role of government in producing and distributing goods and services must shrink dramatically. Public provision must become the exception rather than the rule. State intervention is justified only where markets fail—in such areas as defense, primary education, rural roads, and some social insurance—and then only to the extent that it improves upon the market. Second, government must stop restricting and directly controlling private commercial activity and extricate itself from intimate involvement in the financial sector, focusing instead on promoting macroeconomic stability and providing a legal and institutional environment that supports private sector development and competition (Chapters 2, 5, and 6). Finally, instead of providing generous guarantees to secure adequate living standards for all, governments need to foster greater personal responsibility for income and welfare. Providing social protection is a key function of government in all economies, but in a market economy it should—in principle, at least—be mainly targeted at those vulnerable groups who need it most (Chapter 4).

These shifts are guided by the mix between private and public activity in a stylized market economy. They provide a general framework, not a rigid blueprint, for changes in the role of government during transition. Deciding, for example, exactly where market failures justify government intervention is a contentious business. But four groups of goods and services have features that tend to make private markets fail, or function inefficiently, creating a potential rationale for government intervention (although not necessarily government provision):

- Pure public goods such as defense, law and order, and environmental protection cannot be provided by private markets alone. Because everybody shares their benefits automatically, no one is willing to pay for them individually. But governments can provide them and impose their cost on taxpayers.

- Goods with positive externalities, or spillover benefits, are worth more to society than to any one consumer. Public health and education, for example, reduce infection rates, add to society's knowledge base, and raise productivity. Markets tend to undersupply these goods, and complementary public funding or provision can therefore improve efficiency. Similarly, markets ignore negative externalities, such as industrial pollution; regulation to curb or clean up the activity causing the pollution can improve social welfare.
- Natural monopolies such as gas pipelines, local transport networks, and other infrastructure services are most efficiently provided by a single firm. Unconstrained, monopoly producers tend to overprice and undersupply these services. But public provision or regulation can in principle be efficient.
- Imperfect information, on the part of either consumers or providers, may make markets fail. Private commercial insurance, for example, cannot efficiently insure against risks like unemployment, longevity, and deteriorating health in old age, because these risks are influenced by characteristics and behavior of the insured that the insurer cannot observe, along with government policy, and they affect large parts of the population equally and simultaneously. Governments can regulate private pensions and insurance and complement them with basic public pensions and insurance to improve efficiency and fill gaps in coverage. Governments also inspect food, set standards for airline safety, approve new drugs, and regulate banks and securities markets to protect consumers who have insufficient information about the quality of these goods.

Where markets fail, a case-by-case judgment is needed on whether government provision—or the regulation or funding of private provision—can do better. Governments, too, may fail: interventions may be guided by political objectives, be poorly implemented, create vested interests, or give rise to rents and corruption. Well-intentioned government intervention to correct market failures may prove even worse than suboptimal private provision. In a market economy the burden of proof regarding public intervention lies with the government.

Not surprisingly, market economies in the real world differ in how much education, health, and infrastructure the state provides for free; in the degree to which higher taxes on the rich are used to redistribute income; and in the scope and design of social welfare systems, among other things. Countries make these fundamental choices depending on their circumstances—a mountainous country spends more on roads than a flat one—and on their national objectives. In the early stages of transition the state clearly needs to shrink and move toward less economic involvement, allowing more room for markets and the private sector. But as transition proceeds, policymakers increasingly confront tradeoffs between a somewhat more laissez-faire market economy (as in the United States) and a somewhat more "social" market economy (as in Germany or Sweden). However governments resolve these tradeoffs, they urgently need to improve the efficiency and quality of the services they provide, by focusing on the outcomes of government programs and their costs rather than only their inputs (see Chapter 8). An especially important task of governments during transition is that of educating the public about the necessity and process of reforms, including reform of government itself, and thoroughly explaining policy options and government decisions. This is crucial to building consensus and mobilizing support for reform.

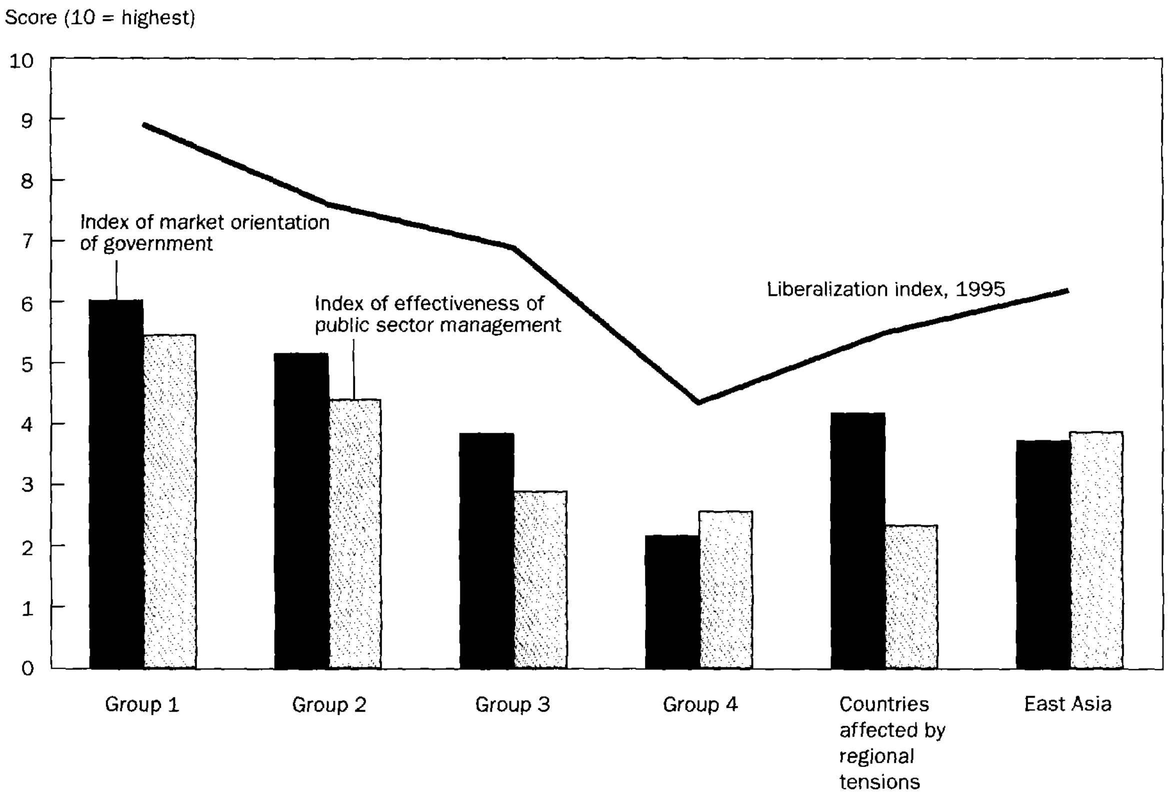
Governments everywhere have found it extremely difficult to reorient and reduce their own involvement in the economy, not least for political reasons. Only a few countries have succeeded with large-scale government reforms, Australia and New Zealand being leading examples. Typically, as in New Zealand, such reforms have followed economic crises, which helped bring about the broad consensus needed for far-reaching change. Transition countries have a unique opportunity to achieve fundamental government reform in the course of their economic transformation; the political as well as economic breakthrough in many CEE countries and NIS gives them doubly good reasons for pushing ahead with government reforms. By acting decisively, transition countries can avoid some of the major fiscal and structural problems that have long plagued developing countries and have recently emerged in many industrial countries.

Making government more market-friendly and efficient entails improving public sector management. Country comparisons show that the two usually advance together (Figure 7.1). In both areas, progress with reforms has been greater where liberalization is more advanced. The reason is that some government reforms—the retreat from production and the removal of restrictive regulations—are essentially the institutional counterpart of liberalization. Others, such as targeting social assistance and improving tax administration, require long-term institution building and tend to lag behind market liberalization.

Changes in the role and management of government also entail the development of a professional civil service. Civil servants in transition economies tend to be concentrated in the wrong parts of government, given its changing functions. They frequently have the wrong skills for their jobs and face insufficient pay differentials and other poor incentives. Contrary to general belief, however,

As governments liberalize the economy, they usually reform themselves.

Figure 7.1 Government reform and liberalization by country group



Note: The market orientation index is a composite measure of how much governments have imposed hard budgets on banks and enterprises, shifted public spending away from the productive sector and toward social services and infrastructure, withdrawn from commercial decisionmaking, divested enterprise social assets, and moved toward a targeted social security system. The index of management effectiveness combines measures of the consistency of fiscal policy and overall economic strategy; the quality of public investment planning, budget management, and tax administration; and the transparency of intergovernmental relations. Both indexes are constructed from relative country rankings, estimated based on comparative information and consultations with country specialists. See Figure 1.2 for details of the liberalization index and the grouping of countries. Source: De Melo, Denizer, and Gelb, background paper; World Bank staff estimates.

government as a whole is not vastly overstaffed or underpaid in most of these countries, and where total spending remains high, this has little to do with excessive wage bills. Data from selected CEE countries and NIS show that overall government employment and wages are broadly in line with those in industrial and middle-income developing countries—notwithstanding economy-wide declines in real wages, a rising gap between public and private wages, and often woefully inadequate staffing and pay in a few key areas such as customs, tax administration, and the police. The problem lies rather in the distribution of labor: the core central and local administrations in transition economies tend to be too small, whereas education, health, and other public services are overstaffed. Yet on balance there are too few professional and too many clerical staff. Even where average education and skill levels are high, government workers lack the accounting, tax, regulatory, and other public administration skills a market economy needs. Moreover, public sector pay is severely compressed, in both European and East Asian transition countries, and extensive and opaque systems of fringe benefits distort incentives further. Performance has little bearing on pay and promotions. Instead, personal loyalties and political considerations are still overemphasized in routine professional and career decisions. Not surprisingly, public administrations in many transition economies have been plagued by poor morale, absenteeism and moonlighting, low productivity, petty corruption, and loss of good staff to the private sector.

These problems have no quick fix, but the direction of needed reforms is clear. Pay, recruitment, promotions, and layoffs must become more flexible and merit-based. Most fringe benefits and in-kind payments need to be replaced with cash. Salary differentials must rise substantially. And, of special importance in transition economies, governments need to depoliticize the civil service, introduce systematic career development and link it to training in market economy skills, and integrate civil service staffing with wage bill and budget planning.

Rightsizing government

Governments in transition countries vary greatly in size. Most have shrunk during transition, by necessity or design, but many remain large in comparison with governments in market economies at similar levels of income (Figure 7.2). In CEE and the NIS, total government spending through central and local budgets and so-called extrabudgetary funds accounted for around half of GDP on average in 1989, about the same as in much richer countries. By 1994 average spending had fallen to 45 percent of GDP among CEE countries and 35 percent in the NIS. In the Baltics and some other NIS, nominal government spending adjusted for inflation now stands at half or less of prereform levels. Government has also shrunk dramatically in China; total spending now accounts for less than 20 percent of GDP. But in Vietnam its share in GDP has grown and now exceeds that in countries of similar income.

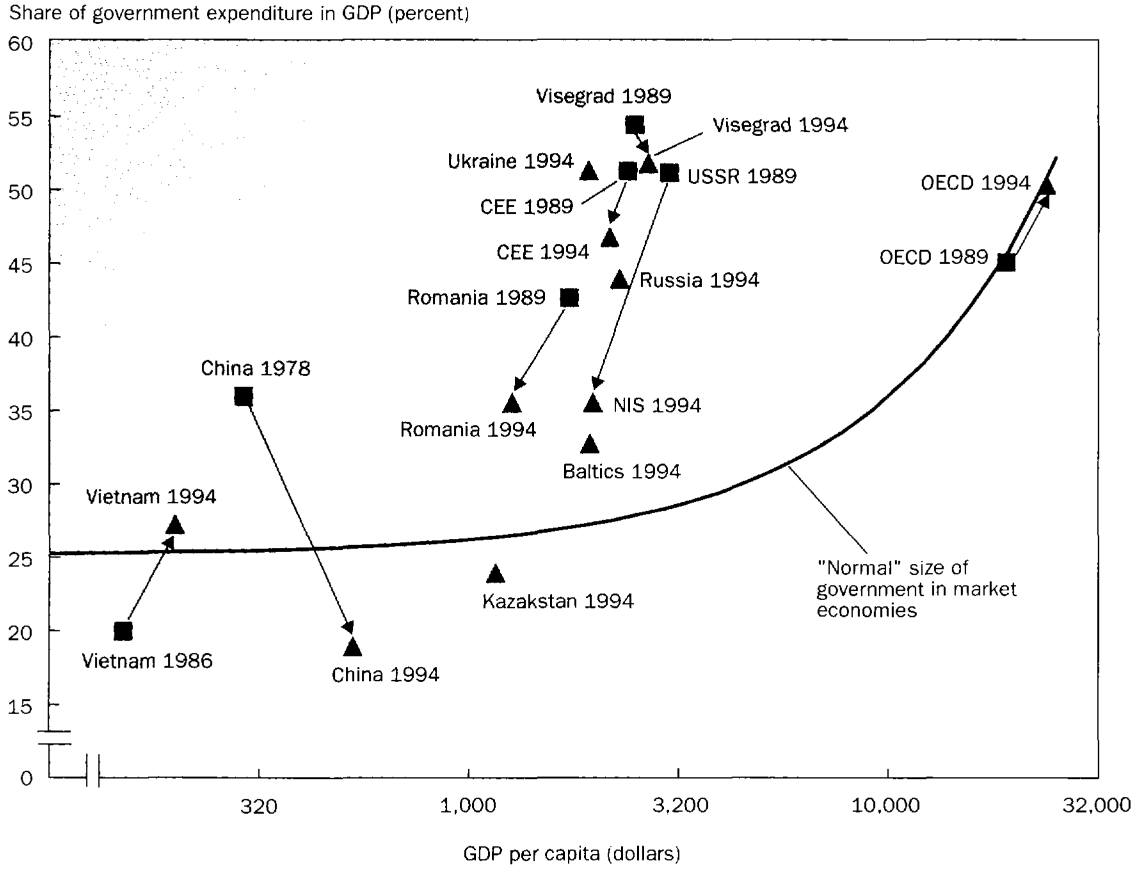
There is no systematic relationship between changes in government size and economic reforms. Both large and small governments are found among countries where liberalization and government reforms are advanced. In the Visegrad countries, for example, government spending exceeded half of GDP in 1994, compared with just above 20 percent of GDP (on average) in Chile, Colombia, the Republic of Korea, Thailand, and Turkey—countries whose incomes per capita were comparable or slightly higher. By contrast, government spending in the Baltics and Romania was around one-third of GDP in 1994, almost 20 percentage points down from 1989 levels. Turkmenistan, where market reforms are the least advanced, now has the smallest government of all transition economies, with total spending below 10 percent of GDP in 1994. But government spending in Azerbaijan and Ukraine, where reforms are also lagging, still accounted for half or more of GDP in 1994.

What explains this diversity? Levels of income and development, sectoral structure, demographics, and politics are known to influence the level and trend of government spending in all countries. In transition economies three additional economic factors also seem to explain much of the change and variation in government size: pressures for social spending, financial constraints, and the degree of commitment to stabilization. In CEE and the NIS social spending pressures have risen because of output declines. In the Visegrad countries these new pressures, along with the prospects for integration with the European Union, have reinforced strong traditions of high spending for education, health, and social services. A few countries have been able to accommodate spending pressures and sustain large or growing governments with stable or rising tax revenues (the Visegrad countries, Vietnam), income from natural resources (Uzbekistan), or external financing (Albania, Hungary). But most governments have lacked access to such noninflationary funding. Some of them, such as Azerbaijan and Ukraine, delayed fiscal adjustment until 1994–95, after keeping up spending and suffering high inflation in the interim. Others reduced spending earlier in line with declining revenues—either in connection with stabilization (the Baltics, China, Romania) or because weak stabilization combined with slow market reforms led to growing informalization, spiraling inflation, and ever steeper declines in revenues and expenditures (Kazakstan, Turkmenistan). Walking a fine line between these outcomes are countries such as Belarus, Bulgaria, and Russia, which have kept expenditures high despite slowly declining revenues, but have usually—although not always—cut them by just enough at the right time to avoid a dangerous surge in inflation.

Are governments in the Visegrad and other high-spending countries too large? The size of government in all economies depends directly on the role and functions assigned to it. This, once again, is ultimately a matter of social choice. General empirical studies relating levels of government spending to economic growth yield few robust conclusions. In transition economies, however, there are stronger grounds for thinking that large governments will hurt economic performance: government spending, especially at high levels, tends to be quite inefficient and, as a result, to contribute less to growth than

Governments in most transition economies are shrinking, but many in Europe are still too big.

Figure 7.2 GDP per capita and ratios of government expenditure to GDP in selected transition economies



Note: GDP per capita is at market exchange rates and plotted on a logarithmic scale. Government expenditure is all expenditure for central and local government plus extrabudgetary operations (quasi-fiscal and state enterprise operations are excluded). The regression line is based on a separate sample of forty-seven developing and industrial market economies. Data for country groups are simple averages. Source: IMF, various years (c); official data; IMF and World Bank staff calculations and estimates.

in market economies; also, financing government programs is costlier and poses a greater risk of inflation.

Public spending is inefficient for several reasons. First, most large governments in transition economies spend a disproportionate share of public funds on programs with little if any impact on productivity and economic growth, such as subsidies and social transfers (see below). Since these programs create entitlements or vested interests, there are strong pressures for them to expand. Second, government saving—revenues net of current spending—and public investment tend to be unusually low in CEE and the NIS. If government accounts for close to half of GDP but its saving is negligible (as currently in the Visegrad countries), even an impressive private saving rate of 30 to 35 percent of GDP can generate investment of only 15 to 20 percent of GDP, well below levels associated with rapid growth (Chapter 2). Third, the efficiency of government services such as health and education in many transition economies is undermined by entrenched spending allocations within sectors, weak implementation capacities, and high staffing ratios (see Chapter 8). Increased private participation and cost recovery are urgent priorities.

Financing government spending in transition economies tends to be costly. Only a few, such as the Visegrad countries, have been able to finance high spending out of taxes, in part because of significant tax reform. But tax systems even there remain relatively inefficient, so that the collection of a given level of revenues imposes a large economic burden on taxpayers, especially the emerging private sector. Indeed, tax revenues of nearly half of GDP in the Visegrad countries may well be unsustainable in the long run. In most transition economies revenues have been declining, so high government spending has tended to translate into large budget deficits. Around the world, large deficits often lead to high inflation and slow growth. This is an even greater danger in the many transition economies where the scope for domestic and external borrowing is limited and a large share of deficits can only be financed by printing money (Chapter 2).

Setting new spending priorities

Changes in the role of government during transition trigger shifts in spending priorities. The aim is to make the composition of expenditures consistent with the tasks of government in a market economy and conducive to long-run growth. Indeed, robust empirical evidence supports the view that government spending tends to be productive and to promote economic growth where it corrects proven market failures and truly complements private activity—as do some infrastructure investments, preventive health care, and basic education—but rarely otherwise.

The specific effects of public expenditures on growth in transition economies will vary according to initial conditions and the past composition of spending. In many CEE countries and the NIS, for example, the marginal return on general public education spending is likely to be relatively low because of historically high spending and educational attainment. But spending specifically on education in newly relevant market economy skills will have higher returns. The quality of spending also matters a great deal; the colossal capital investments under central planning were often ineffective. Finally, government spending serves multiple objectives, of which economic growth is only one. The resulting tradeoffs greatly complicate assessments of the benefits and costs of alternative compositions of spending. That said, the composition of public expenditure is at least open to economic analysis and, much more than the overall size of government, to public debate. Focusing spending decisions on the composition and effectiveness of expenditure, rather than simply their level, can help introduce economic considerations into the politics of budgeting, force a prioritization of expenditures, and facilitate reform.

The restructuring of government expenditures toward market economy patterns is well under way in most transition economies. The biggest changes—which are furthest advanced in the leading reformers—relate to spending on subsidies, social transfers, and capital investment (Figure 7.3).

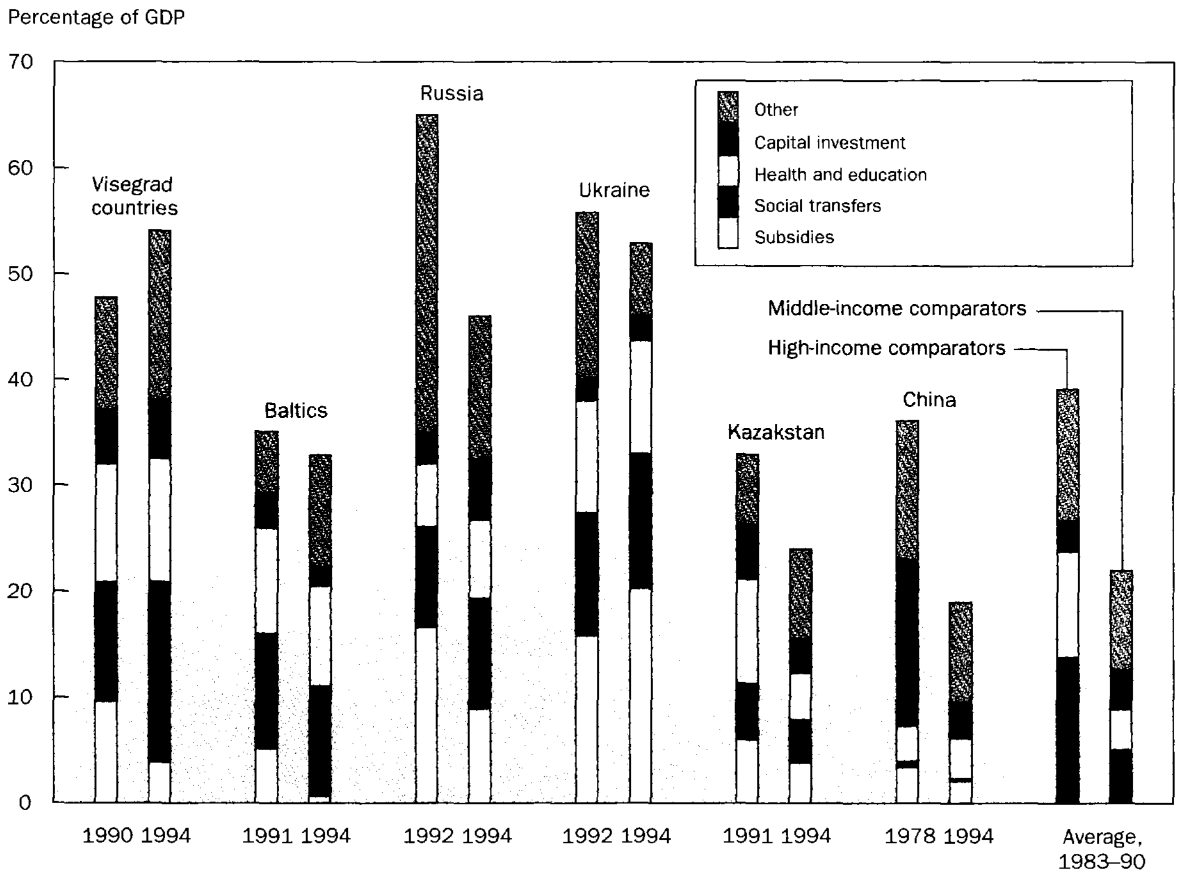
Subsidies to enterprises and consumers have generally declined during transition, as has support to industry, agriculture, construction, and other "private commercial" sectors. As usual, the extent and pace of the decline mirror progress with liberalization. Total budgetary subsidies in CEE and the Baltic countries averaged 3 to 4 percent of GDP in 1994. In Russia they still accounted for an estimated 9 percent and in Ukraine for 17 percent. Ukraine cut subsidies sharply in 1995, but total government spending on activities that market economies tend to leave to the private sector still accounted for around 15 percent of GDP.

Where subsidies remain high, they are usually used to reduce consumer prices or cushion enterprises from the competitive and financial pressures of transition. Such subsidies are inefficient and should be replaced with direct income transfers, which can provide targeted, more effective transitional relief to vulnerable workers and households and do not delay necessary enterprise restructuring. Several CEE and Baltic countries have demonstrated that many subsidies can indeed be phased out abruptly. Where subsidies have already come down, the main challenges are to reduce any remaining subsidies—often concentrated in agriculture, energy, and housing—and recover a greater share of the costs of some education, health, and local transport services. Phasing out remaining subsidies becomes easier if governments commit to a credible schedule for reducing them, carefully monitor their costs, and regularly reassess the need for them. Governments should explicitly include all subsidies in the budget to enable both policymakers and the public to evaluate their true costs, and to facilitate the management of expenditures and macroeconomic stabilization. At one time or another most transition countries have bypassed the formal budget to channel large volumes of credit subsidies through the banking system. Although there is now a trend toward bringing them back into the budget, this practice remains a serious concern in countries such as China and Ukraine (see Chapter 2).

Social expenditures have risen across the board during transition. Part of the increase is desirable: new energy and housing allowances replace subsidies being phased out; rising social assistance and unemployment benefits

Governments' changing spending patterns reflect their increase in market orientation.

Figure 7.3 Government expenditure by category in selected transition economies



Note: Data include central and local government plus extrabudgetary expenditures (quasi-fiscal and state enterprise expenditures are excluded). For the high-income comparators (Australia, Canada, Germany, Israel, Luxembourg, United Kingdom, and United States) and the middle-income comparators (Argentina, Chile, Malaysia, Panama, Republic of Korea, Swaziland, Turkey, and Zimbabwe), data are weighted averages, and the bottom segment represents subsidies plus social transfers. Source: IMF, various years (a); official data; World Bank staff estimates.

protect vulnerable households hit by income declines and layoffs resulting from enterprise restructuring; education and health expenditures increase as governments take over day care, schools, and hospitals from state enterprises. Yet the increase in social expenditures has varied enormously across countries, mostly because of diverging trends in pension costs. Sharply rising pension payments are the main reason social and total spending have remained high in the Visegrad countries. In Poland, for example, payments rose from 7 percent of GDP in the late 1980s to 16 percent in 1993–94. Permitting this cost explosion to continue not only would further crowd out other expenditures but could jeopardize stabilization. Thus, pension reform is a top fiscal as well as social priority for the Visegrad countries (see Chapter 4). Indeed, Leszek Balcerowicz, the main architect of Poland's economic reform program, has cited the failure to take on pension reform as the biggest mistake of Poland's first reform government.

Finally, public investment has fallen sharply in many CEE countries and the NIS, often to less than 3 percent of GDP by 1994, because wages and other current expenditures were protected when total spending had to be cut. Capital repairs and upgrades have typically suffered, too, and many infrastructure facilities are deteriorating fast. In addition, the move to a market economy has rendered parts of the existing capital stock obsolete. So, is it possible that, after a period of correction of past investment excesses, public investment is now too low? Recent reviews by the World Bank of investment and expenditure in selected CEE countries and NIS propose target levels for public investment of around 5 percent of GDP. Another study, relating the composition of public expenditures in low- and middle-income countries to long-run growth, suggests that growth is highest when around one-fifth of total government spending is allocated to public investment. A small increase in those transition economies where public investment now is extremely low—such as the Baltics and several Central Asian states—would be consistent with both these findings.

Yet after decades of public overinvestment and misinvestment, any increase in public investment in the CEE countries and NIS must be contingent on fundamental improvements in the way such investments are made. First, public investment decisions must be integrated with the budget process, to ensure consistency with macroeconomic spending targets. Second, public investment needs to be depoliticized, and it should not substitute for private investment or for maintenance of existing facilities, but rather complement them. For example, investments in public roads should focus on highways rather than roadside services, and to the extent that maintaining roads is more cost-effective than upgrading or rebuilding them later, it should get priority. New construction would also be wasteful in sectors with excess capacity, such as hospitals or power generation in many CEE countries and NIS. Third, to make public investment more effective and efficient, projects should be systematically screened using economic and financial criteria, including cost-benefit analysis where feasible. Public investment policy in the Baltics now broadly follows these principles.

Toward better expenditure control and budget management

Under central planning the budget was driven by two factors: politics and accounting. Preparing the budget was essentially automatic and incremental, a matter of topping off the previous year's budget. This practice is still followed in China and some other countries. During transition the budget becomes an instrument of economic policy. Its effectiveness in maintaining macroeconomic stability, implementing new spending priorities, and promoting efficient use of public resources hinges on improved budget management and expenditure control. This requires many complex institutional and organizational changes over and beyond the civil service reforms outlined above.

To begin, the budget needs to be put on a sound legal footing. The executive will usually remain the primary arbiter between competing expenditures but becomes accountable to parliament. During budget preparation line agencies will need to submit more detailed spending proposals to the ministry of finance, using a common methodology open to careful analysis. The finance ministry then needs to assess these proposals against the government's agreed policy priorities and available financing. Its capacity to carry out economic analysis and forecast revenue should also be improved to reduce the likelihood of revenue shortfalls.

Finally, many governments have initially relied on sequestration to control cash flows, imposing ad hoc spending cuts on line agencies by releasing funds in accordance with incoming revenues rather than spending commitments. This crude and inefficient practice has often led to arrears on suppliers' payments, wages of civil servants or state enterprise employees, pensions, and so on. Government arrears bring a raft of problems: not only do they typically worsen an economy-wide arrears problem (see Chapter 2), but they impede private sector development, impose high social costs, and breed cynicism about government and market reforms overall. Instead, governments need to move quickly to develop working cash-management and treasury systems—a process now under way in the Baltics, Croatia, and Kazakstan.

Poland shows the progress that can be achieved in budget management. First, constitutional amendments defined the budgetary powers of government agencies, and an "organic" budget law set out the principles for budget formulation, execution, and control. Starting in 1992, instructions to budgetary units were modified to include uniform assumptions on key economic variables such as GDP growth and inflation. Current and capital expenditures were more clearly separated, and the overall resources available to individual budget units were better specified. The Ministry of Finance has refined its economic models and strengthened its collaboration with the central bank. These steps have dramatically increased government accountability and helped focus budget discussions on the substance of proposals rather than the politics.

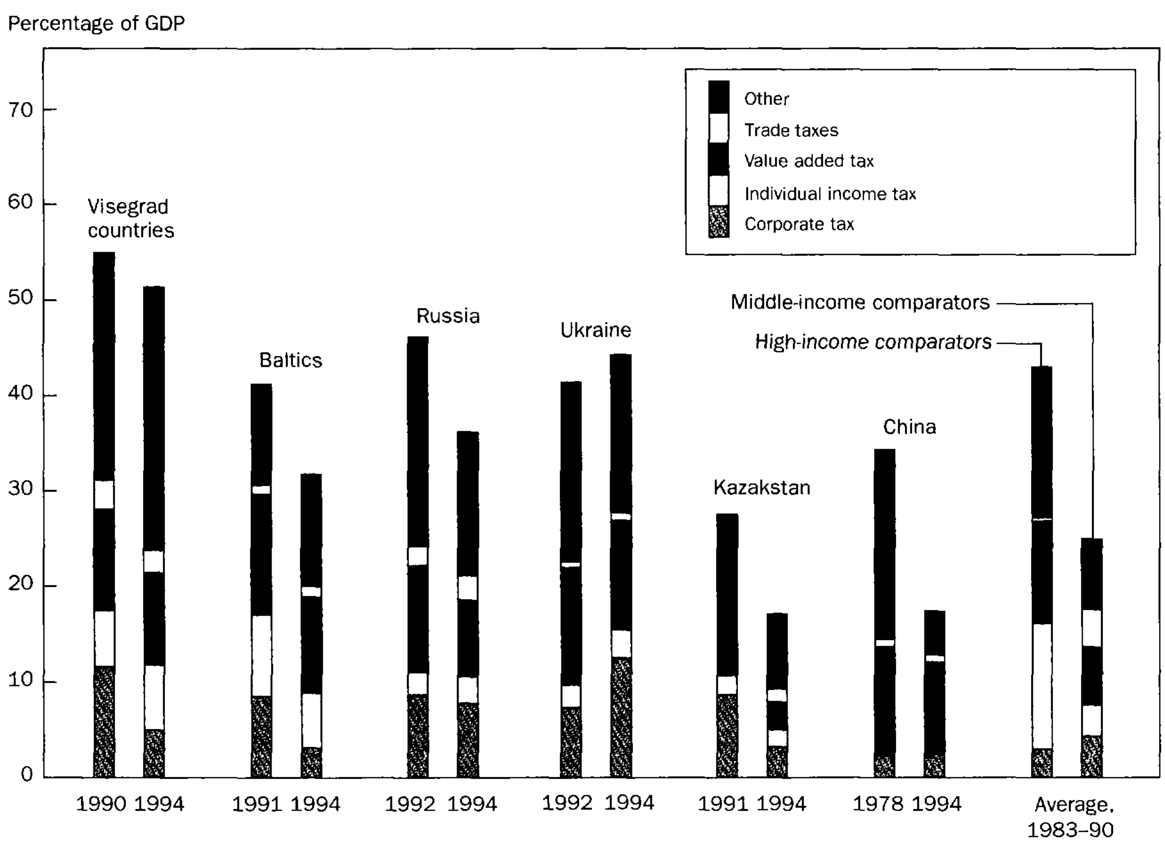
Improving tax policy and administration: The key to closing the revenue gap

In the midst of transition some reforming countries have to confront an alarming revenue gap. The sharp drop in output, together with the serious limitations of current tax administrations, has constrained the capacity of countries in CEE and the NIS to raise revenues. This has created pressure to increase tax rates and introduce new taxes or, as in the Kyrgyz Republic, to seize bank deposits for tax payments. These methods of raising revenues are particularly costly. Yet it is politically difficult to cut expenditures in countries where spending has been high and the population has come to expect a broad range of services from government. Until the economy recovers and tax administration becomes effective, some temporary external financing of the budget deficit may be warranted—in the context of policy measures to reform the tax system and reduce spending (Chapter 9).

Revenues have fallen in most transition economies (Figure 7.4). In the Visegrad countries and Slovenia, the ratio of revenues to GDP fell on average by 4 percentage points during 1989–94, although at one-half of GDP it was still high for middle-income countries. By contrast, the share of revenues in GDP dropped by an average of 16 percentage points in most of the other CEE countries and NIS (Ukraine, Uzbekistan, and the countries affected by

Tax revenues have fallen sharply in many transition economies.

Figure 7.4 Government revenue by source in selected transition economies



Note: Data include central and local government plus extrabudgetary revenues (revenues from quasi-fiscal and state enterprise operations are excluded). Data for the high-income and middle-income comparators are weighted averages (see Figure 7.3 for the countries in each group). Source: IMF, various years (a); official data; World Bank staff estimates.

regional tensions are excluded from this comparison), before stabilizing at about 29 percent of GDP in 1994. Russia's modest revenues partly reflect the political difficulties involved in taxing large and powerful state enterprises, such as the enormous natural gas monopoly Gazprom (Box 7.1). Despite rapid economic growth in China, its decline in revenues over the reform period was equally dramatic: from 34 percent of gross national product (GNP) in 1978 to 17 percent in 1994. By contrast, the share of revenues in GDP in Vietnam increased by 10 percentage points between 1989 and 1994, thanks to the greater profitability of state enterprises and the introduction of import taxes.

No one expected tax revenues to fall quite so dramatically during transition. Countries started out with high levels of taxation by international standards, and the fall in revenues was partly a consequence of market-oriented reforms and reducing the role of government. But the severe contraction in the state enterprise sector in CEE and the NIS added insult to injury, cutting revenues further by shrinking the main tax bases in these countries, namely, profits, wages, and consumption. Hardest hit have been slower reformers whose incomplete structural adjustment hurt profits and reduced tax payments by enterprises. Yet a fair part of the decline in revenues was self-inflicted. Most important, the use of taxation for economic and social "engineering" has generated pressures for exemptions and reduced rates. In Ukraine many goods, including food and consumer items, are exempt from value added tax (VAT). And excise rates on alcohol and cigarettes in the NIS are about 20 percentage points lower than in OECD countries. Meanwhile in nearly all transition countries agriculture is exempt from profit taxes, and foreign investors continue to enjoy preferential tax rates. Finally, tax administrations have generally failed to collect taxes due from the traditionally dominant state sectors or to bring the rapidly growing private sector into the tax net, and tax arrears are generally on the rise (see Chapter 2).

China's sharp decline in government revenues, despite rapid economic growth, highlights the need for a coherent tax strategy in the pursuit of market reforms. Most of the revenue decline was due to smaller contributions by state enterprises. This partly reflected government intentions. In the interest of promoting enterprise autonomy, the authorities allowed state enterprises to retain a portion of their profits, and in 1984 introduced a corporate income tax that lowered their tax burden. Revenue collection was further undermined in 1988 by the new tax contract system, which officially sanctioned "tax payment by negotiation" for state enterprises, and again in the early 1990s, when this system was extended to turnover (sales) taxes. But not all of the revenue impact of the reforms was anticipated. Greater competition from collectives eroded the monopoly profits of state enterprises. Moreover, as local governments gained economic and political strength, they began reducing their efforts to collect those taxes that were to be shared

Box 7.1 Into the lion's den: Taxing Gazprom

Gazprom, the successor to the Soviet Ministry of the Gas Industry, is the largest company in Russia and one of the largest in the world. It is a highly profitable monopoly, with estimated revalued assets of some $150 billion ($400 billion or more if gas reserves are included). Its annual gas production is 600 billion cubic meters—twice the consumption of Western Europe. After-tax profits in 1995 were about $6 billion, which would put it second (after Royal Dutch/Shell) in net profits on the Fortune Global 500 list. Debt obligations are probably the lowest of any company of its size in the world: its debt-equity ratio is below 5 percent.

In 1994 half the company's shares were exchanged for vouchers in closed privatization auctions, going in large part to managers, employees, and residents in gas-producing regions. The company itself purchased an additional 10 percent of shares at par value from the government, which owns the remaining 40 percent. Shares cannot be registered in new owners' names without management approval.

Gazprom's tremendous wealth is a source of great power. The company, which is extremely secretive, has become a "state within a state." Its tax compliance is low, and it is allowed to retain billions in a tax-free "stabilization fund" for investment. Gazprom paid taxes in 1995 of about $4 billion. Had Gazprom not benefited from tax privileges, and had it complied with all tax obligations, its tax payments would have been more than twice as large. Equivalent to 2 to 3 percent of GDP, these payments would have gone quite some way in shrinking Russia's budget deficit. Gazprom has strong links with government, and in return for its special tax status is thought to allocate some of its spending to government priorities (such as support to industry or the military). Some critics argue that the company should pay higher taxes and be pushed to seek capital on world markets, which would force it to be more open. Others argue that it should be broken up, as was Standard Oil in the United States early in this century.

with the central government and granting tax relief to "their" enterprises. At the same time they managed to appropriate considerable resources for local purposes, by channeling local surcharges on taxes into their own extra-budgetary funds and letting local enterprises "donate" funds to local schools and build local bridges. Until 1994 China lacked an effective tax administration. Reversing the resulting decline in revenues will be crucial as China proceeds with reform, and as government takes on its full set of social obligations from enterprises.

Transition economies have made considerable progress in adjusting the mix of their taxes toward patterns common in market economies. VATs have generally replaced complex turnover taxes. Corporate income taxes are beginning to substitute for profit taxes and transfers. And systems of personal income taxation are being developed. Nevertheless, the tax systems that have emerged—often in an ad hoc manner—still fall well short of what might be considered best practice. The efficiency costs of taxation (the reduction in the real income of society due to the imposition of taxes) in a number of transition economies are probably as high as in some developing countries. A study for India, for example, suggests that every rupee of extra sales or import tax revenue raised by increasing tax rates has an efficiency cost of 0.85 and 0.77 rupee, respectively.

Heavy tax distortions in transition economies come from various sources. First, base rates are often high. In transition economies with many fledgling small enterprises and weak tax administration, high rates are likely to encourage already widespread tax evasion and informalization. Second, many countries still rely heavily on payroll taxes to finance social expenditures. In Hungary more than half of every forint in additional wage income is taxed away by the payroll tax and the individual income tax combined. As many market economies are discovering, payroll taxes, levied mainly on employers, can stifle entrepreneurial effort, discourage formal hiring, and push economic activity underground. The payroll tax base has indeed shrunk a great deal in some transition countries. Third, and perhaps most important, the many tax exemptions and special tax rates described above often coexist with higher tax rates on other activities, such as banking and insurance, and on the private sector generally. Such variations in tax treatment undermine revenue performance, complicate tax administration, and distort resource allocation.

Improving tax revenues in transition countries entails reforming the structure and composition of taxes as well as the collection of revenues. The first pillar, better tax design, will be essential for delivering higher, fairly predictable revenues, minimizing distortions, and avoiding large increases in tax rates and frequent changes in legislation. The key task is to strictly limit tax exemptions and eliminate sectoral differences in tax treatment. This will mean extending the VAT to all but a few goods and services (notably exports, which should be zero-rated, and banking and insurance services, where it may be difficult to determine the amount of value added to be taxed). Major commodities such as gas and oil should be subject to the full tax regime, including not insignificant excise rates. Deductions from profit and personal income taxes need to be limited. The tax status of agriculture, especially in the NIS, will also have to be overhauled, first by lifting exemptions on major taxes and, over time, through introduction of a land tax. Small private businesses can be taxed through presumptive methods (based on selected indicators rather than actual profits), as is done in Vietnam and several other transition economies. Finally, when broadening tax bases, countries need to contain marginal tax rates and the overall tax burden of the private sector. In the Visegrad countries and Russia, for example, improving tax efficiency and reducing tax evasion will almost certainly require lowering combined corporate, personal income, payroll, and value added tax rates.

Improved tax administration is the second pillar of an effective revenue strategy. Effective tax administration in a market economy is based on voluntary compliance by a large number of decentralized taxpayers. Most transition economies have only recently started to address compliance issues and build up a modern tax administration with better overall revenue performance. China's new National Tax Service, established in 1994 with authority to collect the bulk of taxes, has helped increase the central government's share in total revenues.

A first step is to restructure how the work is organized. Tax administrations should develop around activities (such as recording or auditing), as in Hungary, rather than according to type of tax and taxpayer. More generally, tax payments need to be assessed, collected, and recorded more efficiently. Current procedures are rarely up to the job of dealing with a growing number of taxpayers, many of which—particularly private businesses and service enterprises—are tricky to tax at the best of times. Government might start by assigning identification numbers to all taxpayers, focusing its efforts on the large taxpayers who generate the bulk of revenue, and withholding wage taxes at the source. Next in line should be improved monitoring and follow-up action against those who fail to file returns or make payments. Latvia, for example, has issued regulations for an improved taxpayers' register: every taxpayer must register with the State Revenue Service; financial institutions will not be allowed to open accounts for any business or individual without a taxpayer code.

The nature of audits and enforcement must also change with the move to a compliance-based tax system. Audits need to be conducted selectively. Hungary is adopting this approach, but many NIS still conduct a full audit of every taxpayer every two years. Tax administrators in most transition countries will need to be given greater powers to enforce payment (in some NIS they are limited to calling banks for information on late taxpayers). Efforts are under way in Bulgaria and Poland to change the law so that the authorities can seize the assets of delinquent taxpayers. The new tax law in Latvia imposes various penalties on defaulting taxpayers, extending to closing their businesses.

Fiscal decentralization: Blessing or curse?

Facing political pressure to maintain or increase spending at a time of declining revenues, central governments in transition countries have shifted several spending responsibilities down to the local level. Consequently, local governments handle a large and increasing share of total public spending, including spending on some services—such as education, health, and social welfare—that have national as well as local benefits. In China and Russia, for example, subnational spending was just under 40 percent of total spending before 1989; now it is closer to 50 percent. As state enterprises are privatized, their spending on social services and infrastructure is also being shifted to subnational budgets.

The same trend toward decentralization has not taken place with regard to revenues, which remain centralized in almost all transition economies, largely for stabilization reasons. In countries as diverse as Hungary and Ukraine the center still keeps all revenues from corporate, value added, excise, and customs taxes. In Russia, revenues from all four main taxes—profit, personal income, value added, and excise taxes—are shared with local governments, but the underlying arrangements are opaque and the regional equalization mechanisms complementing them are ineffective. Meanwhile local governments' independently collected revenues are inadequate in most transition countries. Property taxes raise little revenue, and minor taxes such as those levied in Russia on dogs, used computers, logos, and horse racing are little more than a nuisance. A number of NIS inherited a tax on beards dating back to the Russian Empire.

Decentralizing expenditures while holding onto revenues has allowed central governments to meet deficit targets. This shift of spending responsibilities, without corresponding revenues, to subnational levels in the hope that they would do the cost cutting has severely squeezed local budgets. Localities have accumulated expenditure arrears and, in the case of Russia's oblasts, delayed their contribution to the federal budget. They have also borrowed from the financial sector, both directly and indirectly through "their" enterprises, and have established extrabudgetary funds. In effect, focusing stabilization policy on the federal deficit alone is leading to actions that can destabilize the economy and reduce the transparency of the budget. It can also impede privatization when local governments obtain significant resources from enterprises they own. Decentralizing spending responsibilities without decentralizing revenue authority has fueled the trend toward greater regional inequality mentioned in Chapter 4. Russia's richest oblast, for example, now spends sixteen times more per capita than the poorest.

Yet decentralization has sometimes yielded benefits. In Poland, for example, the quality of local services appears to have improved: the fact that beneficiaries play a more active part in local decisionmaking and that local officials have greater accountability may have increased the user-friendliness of service provision. Local governments have not generated deficits and have thus supported macroeconomic stabilization. In China decentralization has been important in promoting an experimental approach to reforms, with the more successful regions setting an example to the rest.

There is no single "right" system of intergovernmental relations and no "best" country experience to serve as a model for transition economies in assigning revenues and expenditures between levels of government. Revenue assignments and basic tax systems need to be relatively stable so as not to disrupt incentives for investment and growth, and to ensure that the country remains a unified economic space. This can be particularly important in transition economies where liberalization implies a trend toward decentralization and regional differentiation. Thus, national uniformity is generally deemed preferable for profit and personal income taxes, the VAT, and taxes on natural resources and international trade. Revenues that can be assigned to subnational governments include excises, supplementary rates on the national personal income tax ("piggybacking," as has been recommended for Hungary, Poland, Russia, and Ukraine), and various property taxes and fees. The assignment of expenditures is even more complex and varies across countries. Whereas the central government retains such responsibilities as national public services and defense, subnational governments can be responsible for outlays ranging from education and intermunicipal infrastructure to purely local services. Subnational governments account for 15 percent of total spending in Argentina but more than 50 percent in Canada.

Imbalances between own revenues and expenditures at lower levels of government create a need for intergovernmental transfers—both to close the fiscal gap at local levels and to ensure minimum levels of public services across local governments (equalization). Worldwide experience in tackling this issue yields four broad lessons for transition economies. First, a cooperative approach (whereby transfers are made available to all subnational governments at a given level rather than to a selected few) can help engage subnational governments in the equalization process and ensure that central government revenues are not simply appropriated by powerful subnational governments. Second, the evolving role of the state and continuing refinements of price and enterprise reforms require some flexibility in the size and design of local transfers. Third, where possible, transfers should provide incentives for subnational governments to raise their own revenues and manage their expenditures efficiently; lump-sum general purpose transfers, for example, achieve this, but automatic "gap-filling" transfers from the central government to meet local deficits do not. Fourth, any equalization system should be tailored to suit the needs and constraints of the country in question. Economies with data problems—such as China—could start, for example, with a scheme that takes into account only a limited number of factors and redistributes only part of the central government's revenue surplus.

Without effective control over subnational borrowing, even the most elaborate transfer mechanisms could fail to establish the desired incentives for efficient management of local government finances. In transition economies local borrowing independent of the central authorities should be allowed only in the presence of strong institutional safeguards.

In short, a well-designed system of intergovernmental fiscal relations, based on these guidelines, can result in more responsive, better-quality local services, which can promote private sector development and poverty reduction. Failure to design the system carefully, however, has led to macroeconomic instability in several countries and impeded the reform agenda in some.

The agenda

Most transition economies are in the midst of a comprehensive reform of their governments. Crucial laws have been passed, new taxes have replaced old ones, and subsidies have generally been cut sharply. But progress at fiscal stabilization has been mixed, spending reallocations that hinge on deep sectoral reforms are difficult and slow, and tax collection and budget management remain weak in most countries. In the short term, some top priorities in fiscal reform will be to continue improving the design of the tax system (above all by eliminating widespread exemptions and cutting high marginal rates), put in place mandatory taxpayer registration, revamp budget preparation procedures, eliminate sequestration, initiate pension reform, and reduce the often large, hidden financial burdens on government in the form of tax arrears, government guarantees, state bank losses, or rolling directed credits. Other fiscal reforms—such as overhauling the civil service and clarifying and rebalancing central-local fiscal relations—may be equally important. But because they are ambitious in their demand on scarce institutional capacities, they cannot be accomplished by today's government alone. These are priorities for the long term. Finally, governments in transition also have a more outward-looking—and probably more important—challenge. Political reforms, economic liberalization and stabilization, and new private sector opportunities all help create a demand for the many legal, financial, and social institutions discussed in this part of the Report. They will not arise out of thin air. Establishing these institutions and nurturing them over time may be the single greatest contribution to the long-term success of transition that governments can make.