In Poland, as in other former Eastern Bloc countries, privatization is the carrier of change. An inefficient economy, dominated by ill-motivated, ill-managed, over-staffed public enterprises will be transformed through privatization into an efficient market system. To ease the transition, the State will need to provide the institutional infrastructure, but it will be up to the new owners to make the new system work. Private ownership is counted upon to bring better financial and technical management and better marketing. Private owners are expected to dismiss the redundant employees and motivate the ones who are retained.

Will the private owners be able to make the necessary changes? In the West the task of rationalization is usually undertaken prior to ownership transfer, on the presumption that it is easier for the State than private owners to dismiss workers and carry out other radical changes. The Polish government, in principle, could rationalize the commercialized enterprises prior to their sale. In practice, however, it lacks the necessary human and material resources, so enterprises will be transferred “as is.”

Will private enterprise be able to carry out this task? Practically no one in Poland has the necessary managerial experience, while foreigners, even if they were willing to come, would find it hard to operate effectively in an unfamiliar environment. The Mass Privatization scheme hopes to cope with the situation by promoting mixed teams. Yet, after years of work slackness, the imposition of strict discipline on the workers will be difficult. And with rising unemployment the necessary labor force reductions may be impossible. The competitive game might prove to be too difficult to play, and the private owner, in alliance with the workers, may pressure the government for tariff protection or other special favors to insure adequate profits and obviate the need for painful reforms.

We draw such a pessimistic scenario to warn against the attachment of excessively high expectations to privatization. Privatization will put an end to the virtualized State enterprises and get government out of the business of doing business. Privatization thus is essential to the restoration of a healthy economy, but it is not a miracle cure. Poland’s privately owned industry is bound to improve over the years, especially if the economy is integrated with Europe’s. Improvements from privatization, almost certainly, will be gradual and painfully slow. But privatization will break up the existing inter-enterprise connections that kept out potential new competitors, thus welcoming new entrants. New business ventures, unburdened by the past, will most probably prove to be the real carriers of change. Thus “Mass Privatization”, by breaking up the old structures, will contribute to the formation of an “even field” on which, if the current laissez-faire policies are maintained, the competitive game will be played.

NOTES

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ISSUES IN THE CREATION OF FISCAL LEGALITY IN THE ECONOMIES OF THE FORMER USSR

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INTRODUCTION

Discussions of economic transition in the former USSR often focus on four general questions: (1) How can effective profit incentives be created to encourage entrepreneurial behavior? (2) How can a politically feasible and economically viable division of regulatory power between various levels of government be implemented and enforced in the current difficult atmosphere in the former USSR? (3) How can the new governments press ahead in market reform and privatization while still providing a temporary minimum standard of living to the large segment of the population that depends on the state sector for survival? (4) How can either central or republican authorities regain control of the money supply and avoid dangerously high levels of explicit or repressed inflation?

This paper will argue that all four of these questions are closely intertwined with a single more general question that may be considered the fundamental question of economic transition: How can institutions to support fiscal legality in the former USSR be created? The first section of the paper discusses the notion of fiscal legality in the context of reform in the former USSR, and links this concept to the questions raised in the preceding paragraph. A second section considers specific problems in the former USSR for the creation of fiscal legality and how these problems may have changed since the August 1991 revolution. A final section briefly considers how the particular environment of the former USSR may support a strategy for the creation of fiscal legality that involves more than the blind importation of fiscal institutions from the developed capitalist countries.

FISCAL LEGALITY AND THE SOVIET ECONOMY

A previous paper (Lithwick, 1991b) defined “legality” as (1) A mutually consistent set of laws and (2) a belief by the population in the stability and enforcement of these laws. This concept of legality, which is vital to the functioning of a market economy, exists only to various degrees in actual economies. An important process in historical economic development has been the creation of a relatively high level of legality in much of the developed capitalist world.1 By condition (2), legality is best conceptualized primarily as a social problem, depending critically on the beliefs of the population. “Laws” can be interpreted either as explicit laws or as informal social norms that are respected and enforced by society. Fiscal legality refers to legality in taxation and the provision of subsidies (negative taxes).

Many studies of the Soviet and other planned economies emphasize the lack of fiscal legality in the traditional Soviet-type system. The distribution system is widely known under its informal title of usramilinka, meaning "equalization" or "leveling off." This features the continual discretionary equalization of incomes to guarantee "normal" profits and wages. Rather than an explicit progressive tax system based on fiscal legality, usramilinka has, as its most important distinguishing characteristic, taxation by ex post discretionary adjustments. Profits are first observed and subsequently leveled off. The incentive problems resulting from usramilinka in the socialist and formerly socialist economies are notorious and have received much attention under the titles of "ratchet effect" (discretionary expropriation of excess profits from organizations that reveal themselves to be more productive) (Bertin, 1976) and "soft budget constraint" (discretionary bailouts of failing organizations) (Kornai, 1981).

Numerous Soviet economic reforms since World War II have had the replacement of usramilinka with hard tax and subsidy schedules rooted in fiscal legality as a stated goal. With very little exception, however, none of these reforms was ever successfully implemented. Ironically, in the period of Perestroika, from 1985-91, this problem has been exaggerated, as political instability and continual policy reversals have increased fiscal instability, and the increasingly desperate financial situation of the central government has led to "emergency measures," featuring intensified expropriations (Litwack, 1991a). Consider now the first question raised in the first paragraph of the paper: How can effective profit incentives be created in the former Soviet Economy to encourage entrepreneurial behavior? Of the four questions, perhaps this one bears the most obvious connection to fiscal legality. The direct effect of the absence of fiscal legality is the presence of the ratchet effect and soft budget constraint, discussed above, which are inconsistent with effective profit incentives. In the traditional Soviet system, communist party discipline and the promotion and demotion of party cadres played a major role in providing economic incentives even in the presence of weak pecuniary rewards and punishments due to usramilinka. As the authority of the communist party and ministerial government has declined and usramilinka has not yet been replaced by profit incentives through fiscal legality, incentives have generally declined in the legal economies of the former Soviet republics, as reflected in recent statistics.

Since the August 1991 revolution, the Russian leadership has indicated a major commitment to privatization as the primary means of creating strong economic incentives. A growing number of recent economic studies address the many complicated issues surrounding an appropriate distribution of nongovernment property rights. One important question here is how a distribution scheme for property could satisfy both a social criterion for fairness and, at the same time, quickly concentrate ownership in small enough hands to support strong profit incentives. In order to distribute property rights, however, first they must be created. Economists usually define property rights by three conditions: (1) the right to use property freely, (2) the right to transfer or sell property to other individuals, and (3) the right to income generated from the use of property. It is property (3) that economists associate most closely with operational property rights and feature prominently in studies of the relationship between property rights and incentives (Grossman and Hart, 1989; Hart and Moore, 1990). This condition states that property owners must be residual claimants for income streams generated through the use of property. This is equivalent to the condition that property owners operate in conditions of fiscal legality. Tax obligations and subsidy opportunities as functions of performance must be explicitly specified ex ante and believed by the population. Without this condition, there is no theoretical reason to conclude that the distribution of private property rights on paper to individuals will constitute a genuine creation of private property. Conversely, once fiscal legality is created, many distributions of property rights can be found that could be consistent with a significant strengthening of incentives. Thus, fiscal legality is a more central issue for incentives than privatization per se. Government ownership or paper combined with fiscal legality, for example, is better for incentives than the converse.

Question (2), concerning the division of power between various levels of the government, of course, has more generality than simply fiscal legality. But the division of fiscal, as well as monetary, authority is perhaps the most central issue here for the subject of economic transition. In the past few years of the reform process in the USSR, uncertainty about the division of fiscal authority has inevitably led to the continual violation of the first condition of fiscal legality, mutual consistency. Second, the presence of multiple potential sources of taxation makes the satisfaction of the second condition of fiscal legality (stability and enforcement) more difficult.

Question (3), concerning how to simultaneously provide a social safety net and press on with market reform, in a sense, is a restatement of the question of how to create fiscal legality. It could be argued that the expanding underground private economy in the former USSR already works under a type of fiscal legality, in which property owners have no tax obligations to, or subsidy privileges from, the government. The current trend in which the underground economy is expanding, largely at the expense of the legal sector, might not be cause for a genuine economic crisis if it were not for the implied problems in distribution, and the need to protect the social safety net in particular. It is the fact that hundreds of thousands of citizens in the former Soviet republics currently depend on explicit or implicit government subsidies that makes reducing government expenditures to trivial levels an infeasible option. It is fiscal legality, and only fiscal legality, that can simultaneously provide significant government revenue and support strong profit incentives.

Alarming budget deficits and inflationary pressures in recent years have increasingly focused attention on question (4): How can the governments of the former USSR control the money supply and inflationary pressure during the transition period? The vital necessity of a social safety net, discussed above, severely limits the ability of the government to reduce expenditures in the transition period. The only answer to question (4), therefore, is for these expenditures to be supported by tax revenue as opposed to currency issue. Discussions that link
solutions to this problem with currency reform or the sale of government property to the population often miss the point that the dilemma here is how to finance continual flows of government expenditures as opposed to the one-shot absorption of accumulated currency stocks. Currently, as the state sector is collapsing and the government possesses no developed fiscal system that is consistent with both hard market incentives and significant market tax revenue, the collapse of the state budget is an obvious consequence. An examination of the rising budget deficits in recent years reveals that revenue is indeed the fundamental problem. While the Soviet government actually succeeded in substantially reducing government expenditures as a share of gross national product (GNP) from 1986-87, the share of government revenue in GNP fell even more rapidly (Litwack, 1991a). Thus, no solution to this problem exists for economic transition outside of the creation of fiscal legality.

PROBLEMS IN THE CREATION OF FISCAL LEGALITY AND THE SPECIFIC ENVIRONMENT OF THE FORMER USSR

The current economic, political, and social environment in the former USSR presents a tremendous challenge for the creation of fiscal legality. From the perspective of world history, the process by which fiscal legality has emerged has been quite slow, featuring a gradual development of requisite political and social culture. North and Weingast (1989) claim, for example, describe in detail the process by which fiscal legality finally emerged in eighteenth century England as the culmination of a gradual development of centuries. Given the political instability and growing poverty in the USSR today, however, this option may be too painful and dangerous. The hope is that, in the spirit of Alexander Gerschenkron (1962), the former USSR can use the experience and support of the developed capitalist world to rapidly accelerate this process. A natural inclination might be to attempt a direct importation of Western institutions of fiscal legality. While much can be gained through importation, it is also important to recognize that the specific situation in the former USSR requires some deviation from this strategy.

In the period before the August 1991 revolution, the obstacles to the quick establishment of fiscal legality seemed virtually insurmountable, and actually growing with time. The entire economic reform process essentially had been paralyzed due to both an impasse on the question of the division of power between the center and the republics and a general lack of credibility and legitimacy of the central government. Credibility was compromised from several sources. First, the continuing extra-fiscal power of the Communist Party made a mockery of the attempt to establish rule by law in the economic sphere. This was particularly apparent during the last political stand of the communist party apparatus in 1990-91, which included authorized interference of the KGB and the MVD (internal security police) in the activities of cooperatives and other nongovernment businesses. Second, the reputation effect of unaccountability still strongly affected the beliefs of the population, who have become used to continual government proclamations of the creation of hard incentives that carry no weight in practice. Third, this adverse reputation effect has been strongly reinforced by continual policy reversals and explicit violations of fiscal commitments by the central government in the Gorbachev period. Finally, the USSR lacked an effective internal revenue service to implement taxation effectively in the context of a market.

While the situation after the August 1991 revolution remains difficult, the prospects for accelerating the creation of fiscal legality may have improved in several respects. The pseudo-communist ideology associated with the central government under Gorbachev has been replaced by a strong commitment by the leaderships in most republics to a free market and privatization. Extra-fiscal communist power has been abolished, paving the way for the possible establishment of genuine legality in the USSR. The level of trust between the population and the government has increased. Finally, the August 1991 revolution may have helped to bridge the gap between central and republican economic goals and reform strategies.

Nevertheless, important problems remain that must receive explicit attention in the process of creating fiscal legality. First, and perhaps foremost, is the negative reputation effect. Even if weakened by the revolution, this effect still remains strong. As stressed throughout this paper, it is not enough for the government to commit to a mutually consistent set of laws and set up institutions to guarantee their stability and enforcement. This commitment must actually be believed by the population to affect incentives. Thus, explicit efforts should also be concentrated on convincing the population in as short a time as possible that a stable and enforceable fiscal system has been created. Since the August 1991 revolution, time has become even a more critical variable, as the advantages of the immediate post-revolutionary situation will fade unless they are exploited quickly. This particularly concerns reputation effects.

This problem of reputation interacts with another major dilemma that remains after the August 1991 revolution, the inherent time inconsistency of a successful transition program. This dilemma can be understood as follows: Suppose that the government has succeeded in establishing fiscal legality and convinced the population of the stability and enforcement of tax and subsidy schedules. Suppose that market incentives, in response, are significantly enhanced. In the transition period, this will lead to significant economic changes and a distribution of accumulated profits that will be largely unexpected. This will then present a major temptation for the government to 'reoptimize' and set new tax and subsidy levels that incorporate newly revealed information. Social pressure and the difficult financial situation of the government will push in the direction of higher taxes for more profitable organizations and higher subsidies for failing organizations. This reoptimization, however, is inconsistent with fiscal legality. Therefore, despite a general necessity of maintaining some flexibility to counteract the vast uncertainty of the transition period, it is crucial that the government commit to a fiscal system that is rigid and uphold its commitment even though tax and subsidy levels actually may appear to be suboptimal ex post. This is one area in which simple intuition can lead policymakers
astray. A critical element of a strategy to create fiscal legality in the USSR, therefore, is a search for mechanisms to tie the hands of government for the implementation of long-run commitment in the face of time inconsistency.

Another vicious circle related to time inconsistency that could continue to plague the Soviet reform process, as it has in past years, is the following: The government commits to a reform program involving the creation of fiscal legality. Given adverse reputation effects, the population at first doubts the credibility of this commitment. Because of this doubt, the immediate effect on incentives is weak and the economy continues to sputter. The frustrated government then goes back to the drawing board and subsequently announces a new plan to replace the old. This violates the long-run commitments of the previous plan, however, which serves to reinforce the negative reputation effects.

A third serious problem that has remained since the August 1991 revolution concerns the division of political authority in economic regulation. Although most attention before the break up of the USSR concentrated on the division of authority between the central and republican governments, the division of power among the district, regional, and local levels may prove to be an equally serious problem. A well-defined division of power is an obvious prerequisite to the creation of fiscal legality in the USSR. Uncertainty about fiscal authority is inconsistent with generating expectations among the population in well-defined stable tax and subsidy rates. As long as various levels of government fight among themselves for fiscal authority, tax and subsidy rates can be expected to change often in a largely discretionary manner.

The recent Russian economic program that has been launched by Vice-Prime Minister Igor Guidair, after extensive consultations with the International Monetary Fund, has the primary aim of monetary stabilization, together with the gradual strengthening of incentives through privatization. [Memorandum, 1992] Numerous new taxes have been introduced; those on value added, profits, and/or income are the most important. No explicit effort has been made to introduce rigidity into these taxes or subsidies. On the contrary, the Russian government is preserving a maximum degree of flexibility in this area in order to adapt its stabilization effort to unforeseen future circumstances. Part of this strategy includes regulating the growth of wages by severely limiting the amount of cash that enterprises can withdraw from banks in which they are obliged to hold their accounts. Although the Guidair program foresees lifting these restrictions on ownership enterprises, the current decree of the Russian Supreme Soviet encourages such restrictions on all economic organizations. [O besolyagatstvyykh, 1992]. Since interest rates on these accounts are held significantly below the rate of inflation and markets for "noncash" rubles are poor, these restrictions act as virtual confiscations of profits above "normal" levels, thus maintaining the ratchet effect that punishes relatively more profitable enterprises.

There is evidence, however, that the Yeltsin government may have made some progress to combat the soft budget constraint in the first few months of 1992. Enterprises that were relatively unprofitable had difficulty securing a normal-sized wage fund. Mounting social pressures, however, have forced the government into a more accommodating stance toward mid-year.

The logic and motivation of the current economic program in Russia is clear. Before the introduction of this package of emergency measures, hyperinflation, which would have destroyed any reform program, seemed to be a genuine threat. Stabilization appeared to be a prerequisite for the success of any other measures. As emphasized in the discussion of this paper, however, stabilization is not so much a prerequisite for the success of other policies, as it is a necessary condition intimately interconnected with the success of other policies. Without the creation of incentives through fiscal legality, genuine stabilization is not possible. The only means of balancing the budget remains the continual reduction of government expenditures and subsidies. Where does this process end, however? The experience of the first half of 1992 in Russia has demonstrated the degree to which these cuts can lead to strong social and political discontent and pressure. Perhaps most important, as discussed earlier, the emergency measures aimed at stabilization also contradict the very process that any successful transition must incorporate, the creation of fiscal legality.

THE FORMER SOVIET ECONOMY IN 1992 AND THE CREATION OF FISCAL LEGALITY

This section briefly discusses how the specific problems associated with the establishment of fiscal legality in the USSR discussed above might affect an optimal transition strategy in this area.

Fiscal Federalism and Political Separatism

The majority of economists support the preservation of a maximal fiscal and monetary union on the territory of the former USSR, stressing the major advantages such a union can provide from economic integration. The preservation of this union was the crusade of the working group of G. A. Lavinski in the latter half of 1991 and has been cited by Western governments as a possible prerequisite to significant international aid (Dogovor...1992, part 6, article 21, page 8). More recently, after the break up of the USSR and growing inter-republican tensions, the governments of the former Soviet republics have taken a more pessimistic attitude toward the prospects for economic cooperation. Even the very ambitious Lavinski plan did not foresee any direct federal taxation, proposing the indirect taxation of republican budgets instead. The experience of some other countries, most notably China, raises questions, however, regarding the experience of preserving a monetary union in the absence of direct federal taxation [Blesler and Sapray, 1989].

While the goal of preserving a monetary and fiscal union is important, it must be weighed against the opportunity cost of the time it would take to create such a viable union. The cost of this time includes the reputation effects discussed above as well as the human suffering and political danger that could accompany an extended
period of economic decline in the former USSR. The most important task is to establish quickly a clear division of power, even if the economic benefits from this division are limited by political constraints. It would be preferable to have completely independent economic regions, with their own currencies and fiscal systems, than an economic union without fiscal legality due to political instability. In the context of the former USSR today, independent republican fiscal and monetary systems do not necessarily imply less interregional economic integration.

**Simplicity**

Given both the primitive state of fiscal institutions in the former USSR and the imperative of affecting reputation effects through stability, simplicity becomes a vital principle for the establishment of fiscal legality. Rather than instituting multiple complicated indirect and direct tax schedules, as featured in the current Russian program, the governments of the former Soviet republics should begin to commit themselves to a few important simple tax rates for approximately five years. Different types of taxes can also be distinguished by their relative simplicity. Licensing would appear to be the simplest and might be successfully employed in some circumstances, although it has the major disadvantage of not growing with inflation or the economy. Some authors have suggested the expedience of a flat rate value added or consumption tax for this purpose [McClure, 1991; McKinnon, 1988]. Indirect distortional and individually determined taxes might best be avoided in the period of the fledgling market.

**Commitment Mechanisms**

The leaderships of the former Soviet republics should search for explicit mechanisms for tying their own hands in order to convince the population that, despite the time inconsistency problem, long-run commitments will be honored. One of the possibilities present is "proceduralism," whereby policymakers deliberately deprive themselves of the right to tamper with fiscal policy, except through a cumbersome, costly, and time-consuming political process.

Another important possibility is the use of international aid as an enforcement device. If large-scale international aid is made to depend directly on the creation and preservation of fiscal legality, the violation of commitments in taxation and the provision of subsidies would be more costly. The adoption of a program that is explicitly based on developing fiscal legality and is supported by contingent international aid could present a major propaganda boost for the Soviet leadership in its attempt to affect expectations and reverse the adverse reputation effects. A potential problem here is that some government officials incorrectly believe that international pressure to uphold specific tax and subsidy policies represents unwanted interference and a violation of national sovereignty. Ironically, the use of international aid as a commitment mechanism actually can significantly increase the power of internal policy in the economic sphere.

Presently, there does not appear to be any attempt to link Western economic aid to this type of commitment and the creation of institutions of fiscal legality. This could amount to an important foreign opportunity to accelerate the process of creating fiscal legality in the former USSR.

The measures discussed above all derive from the premise argued in this paper that, (1) fiscal legality is the central issue in the economic transformation in the former USSR and (2) the primary task at this point is to find effective measures that could accelerate this process. It is not clear that the newly formed democratic institutions in the many republics of the former USSR could survive if this process is too long and the accelerated economic decline continues.

**NOTES**

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1. This is perhaps most clearly demonstrated in North [1990].
2. The rainfall effect was first coined by Joseph Berliner and has been the focus of his studies and the work of other specialists inside and outside of the USSR. The soft budget constraint was coined by James Kornai. It is featured prominently in Kornai [1981] and virtually all of his subsequent work. Recent research in theoretical economics has explored both of these problems in the context of a Bayesian principal-agent game. Laffont and Tirole [1985, 1990] derive the strategic consumption information by more productive organizations in equilibrium if the principal has a limited ability to make long-run commitments. Diamond and Mirrlees [1984] and Shubik [1984] derive a form of this soft budget constraint from limited commitment (consumption) choices and the presence of a large monopoly bank.
3. Part II, article 8 of The Agreement on an Economic Union, authored by the group under the leadership of G. A. Verkhinin, reads, "The members of the Economic Union recognize that the leading principle for the rise of the economy is private property and entrepreneurial freedom" (Dogsarov, 1991, 4). The, for example, Leiten and Sachs [1996] and Sachs [1991] for an insightful discussion of these issues in the context of the Polish economy.
4. The article refers to the particularly apparent, Semenov and Boldanov [1992], consists of recent interviews with directors of Russian government enterprises.

**REFERENCES**


RUSSIAN ECONOMIC REFORM:
IS ECONOMICS HELPFUL?

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INTRODUCTION

Despite widespread agreement on the need for market-based reforms of the Russian economy, there remains extensive debate concerning the pace and process of reform. The stakes involved in choosing the best reform path are immense, with the lives and liberties of nearly 150 million Russian citizens surely to be affected. The additional consideration of the stability of a military superpower makes the Russian reform effort a worldwide concern. The humility requisite for entering the debate on Russian reforms brings to mind the words of Alexander Pope, "In tasks so bold, can little men engage...?"

Given that the task of Russian economic reform has fallen to men and women, sound economic advice to the decision makers becomes a high priority. A common perception, however, is that economics has little to offer when it comes to reform proposals. Western economic theory, which has found much success in analyzing the properties of various equilibrium states, admittedly has very little to say about the paths between equilibria. Furthermore, economic theory is more developed with respect to efficiency concerns than distributional issues. To the extent that successful reform depends on distributional effects, economic analysis may be less useful than political or ethical analysis. Even many economists question the ability of their discipline to add constructively to the reform debate. One leading expert on the Soviet economy sounds this theme:

Economists, Eastern and Western, excel in analyses and criticism of existing centrally planned economic systems, and in extolling the virtues of a decentralized system relying heavily on markets. But they are almost no help in devising a strategy for the transition from the old to the new system. [Howett, 1990, 18]

The contention of this paper is that economic analysis is vital to the formation of successful Russian market reform and that to date it has been misemployed regularly. 

Basic economic principles, combined with an understanding of the pre-reform conditions of the Russian economy, can be particularly helpful in informing the debate over Russian economic reform.