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Gerard Turley

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List of Abbreviations

ACIR	Advisory Commission on Intergovernmental Relations
BEEPS	Business Environment and Enterprise Performance Survey
CBR	Central Bank of Russia
CEE	Central and Eastern European
CIS	Commonwealth of Independent States
CIT	Corporate Income Tax
CMEA	Council for Mutual Economic Assistance
CPI	Consumer Price Index
CPI	Corruption Perceptions Index
EBRD	European Bank for Reconstruction and Development
E/S	Effective/Statutory
EU	European Union
FIGs	Financial–Industrial Groups
FSU	Former Soviet Union
GDP	Gross Domestic Product
GKO	Short-term Government Bonds (Treasury Bills)
IBFD	International Bureau of Fiscal Documentation
IMF	International Monetary Fund
MPS	Material Product System
NBF	Net Bank Financing
NNT	Net New Taxes
NTE	Net Tanzi Effect
NTY	Normalised Tax Yield
OECD	Organisation for Economic Co-operation and Development
OFZ	Treasury Bonds
POF	Private Ownership Fund
PSAL	Private Sector Adjustment Loan
RA	Régies Autonomes
RTS	Representative Tax System
SAL	Structural Adjustment Loan
SBC	Soft Budget Constraint
SME	Small and Medium-Sized Enterprises
SNA	System of National Accounts
SOEs	State-Owned Enterprises
SOF	State Ownership Fund
SST	Social Security Tax

STS	State Tax Service
TEs	Transition Economies
UN	United Nations
VAT	Value-Added Tax
WB	World Bank

Foreword

Revenue erosion and lax payments discipline, manifesting itself in low revenue mobilisation, ineffective tax collection and widespread non-compliance, have been a problem in many ex-socialist countries since the start of transition. This book examines the problems of tax payments discipline and collection in the transition countries of Central and Eastern Europe and the former Soviet Union in the context of economic transition from a centrally planned economy to a market economy, the transformation of a socialist state to a capitalist state, the nexus between government and business, and the persistence of the soft budget constraint. Much of the literature on the revenue decline in transition countries has focused on either economy-wide transitional phenomena or on taxpayers' non-compliance. In contrast, this monograph examines the problem from the position of the tax collector, that is, the state, and its ability or willingness to collect taxes. Using the concept of János Kornai's soft budget constraint, the book examines the problem of budget softness and tax payments discipline in the postsocialist transition economies during the first decade of transition. Appropriate methodologies are applied to new data for the transition economies with the purpose of revealing incidences of budget softness (or hardness) and, more generally, measuring the degree to which the enterprise sector in postsocialist countries is not tax compliant. Tax collection problems, arising from economic, administrative or political factors, are investigated in the context of transition. The results indicate tax collection problems arise for a number of reasons, including budget softness but also because of a general poor payments discipline, corruption and bribery, ineffective tax administration and low tax capacity and tax effort arising from both economic and political factors. Furthermore, our evidence indicates that cross country differences are not small, state control matters and, for many transition countries, tax administration and political constraints, as opposed to tax design and economic constraints, are more pressing problems. *Transition, Taxation and the State* outlines the tax collection and discipline problems (particularly in the context of the soft budget constraint and the state-enterprise relationship legacy of the socialist era) that the postsocialist state in transition countries experienced in the first decade of transition. As for the state (or the 'tax state' to use Joseph Schumpeter's expression) and tax revenue performance in the second decade...let us wait and see the evidence.

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To Monica

'The revenue of the state is the state. In effect all depends upon it, whether for support or for reformation ...'.

Edmund Burke
Reflections on the Revolution in France

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Chapter One

Introduction

One of the stylised facts of economic transition from a centrally planned economy to a market economy was the decline in tax revenue. Given the nature of transition where the role and size of government is reduced, a fall in tax revenue was predicted. The revenue erosion, particularly evident in the early years of transition, is often explained in the context of a change from the repressive and distortionary tax system of Soviet times where taxes (and subsidies) were the key mechanisms for fiscal redistribution from profitable to unprofitable enterprises and where tax collection from large state-owned enterprises (SOEs) was a simple task, to a more Western-style tax system where voluntary compliance and self-assessment are the norm and where confrontation between the tax collector and the taxpayer is not uncommon. Furthermore, as transition economies (TEs) witnessed a recession of historical proportions, a decline in the profitability of the SOEs (and other traditional tax bases), an expansion of the unofficial economy and a rise in tax evasion, corruption and bribery, the tax share of GDP was to fall even further. After a decade of transition, and despite a recovery in tax revenues in a number of leading transition countries by the late 1990s, the tax ratio in some TEs had fallen to levels below what is considered normal in market economies. Many regard this fall as excessive and view the decline in tax revenue as a serious obstacle in the attempts to finance public expenditure, redistribute income and, at the same time, embrace effective fiscal policy.

Much of the literature on the revenue decline in TEs has focused on economy-wide transitional phenomena (the transformational recession or the rise in the unofficial economy are two examples) or on taxpayers' non-compliance (related to, for example, rising tax evasion and a primitive tax culture) as explanations for the fall in tax revenues. In contrast, this book examines the problem of revenue erosion from the position of the tax collector, that is, the state, and, in particular, the weakness of the state as creditor, i.e. its (in)ability or (un)willingness to collect taxes. An appropriate theoretical framework for analysing the role of the state as creditor and the volatile state-enterprise relationship that exists in postsocialist times, particularly as it relates to tax payments and collection, is János Kornai's soft budget constraint (hereinafter SBC). In this context, the book examines the problem of budget softness and tax payments discipline in transition countries and, particularly in Russia, a country where tax collection is considered a problem (despite the observation that tax revenue relative to national income is not unusually low given Russia's level of economic development). In Russia and in other transition countries, the falling tax share of national income needs to be seen in the context of the fluid state-enterprise relationship that is common in the transition from plan to market, the capacity of the reconstituted state and its willingness to tax, the nexus between government and business and the persistence of the SBC in the transition setting. In respect of tax collection, the research undertaken and reported in this monograph indicates that problems arise for a number of reasons, including budget softness but also because of a general poor payments discipline, corruption and bribery, ineffective tax administration, poorly designed intergovernmental fiscal relations and low tax capacity and tax effort arising from both economic and political factors.

1.1 Paradigms of Economic Transition

The standard paradigm of economic transition that dominated in the early years of the 1990s and had the support of the international financial organisations (more notably the International Monetary Fund and, less so, the World Bank) is often referred to as the Washington Consensus.[1] This orthodox or mainstream approach views the transition from a centrally planned to a market economy as a reform process emphasising the universality of the laws of the market and the undoubted economy-wide efficiency gains accruing from the standard policy prescriptions of the trinity of liberalisation ('getting prices right'), stabilisation and privatisation. This blueprint for transition, based on the spontaneity of markets, traditional neoclassical price theory and general equilibrium theory, promotes the primacy of policy reforms and economic fundamentals and the replication or transplantation of international best-practice institutions (with the emphasis on laws and the legal and regulatory framework) of the West to the ex-socialist countries of the former Soviet bloc (a kind of utopia based on 'societal engineering').

Although the Washington Consensus emerged from a different set of conditions, it argues that these one-size-fits-all market-oriented reforms are appropriate to any setting, including the postsocialist Central and Eastern European (CEE) and former Soviet Union (FSU) countries. A knowledge or experience of the state socialist system and the centrally planned economy is not required. Policy reform strategies are implemented along a scorched-earth approach, with textbook reforms being designed by technocrats and introduced as rapidly and comprehensively as possible in view of the reform complementarities that exist. Not surprisingly, in terms of the speed of the radical reforms, this approach is often referred to as the 'big bang' or 'shock therapy' view of transition. This also applies to the economic role of the state

1 Strictly speaking, the Washington Consensus refers to a set of policy guidelines for most Latin American countries in the late 1980s for which, it was argued, a consensus was reached among Washington-based international agencies, the US government and mainstream economists. John Williamson of the Institute for International Economics, the person who coined the phrase, viewed these reforms as the lowest common denominator of policy advice by 'Washington' to Latin American countries as of 1989. The ten economic reforms focused primarily on structural adjustment policies of price and trade liberalisation, macroeconomic stabilisation and fiscal discipline, deregulation of entry barriers and privatisation of state-owned enterprises.

where what is required is a depoliticisation of the economy, a break of the nexus between government and business and a dismantling of the state, or, according to critics of the Washington Consensus approach, in the extreme case of neoliberal market fundamentalism, state desertion.

The institutional-evolutionary paradigm, more popular within academic circles, views transition as a large scale institutional transformation where the focus is on the institutional underpinnings of capitalism appropriate to the specific conditions of each country and in accordance with the initial conditions at the outset of transition. This approach is critical of the revolutionary vision of transition and, instead, views transition as a process involving systemic change in the face of great uncertainty and complexity, unlike the competitive neoclassical model and its notion of equilibrium, which is inherently static. As opposed to equilibrium processes, the emphasis of the institutional-evolutionary approach is on the dynamics of institutional change within an evolutionary perspective, based on contracting and noncooperative games in modern microeconomic theory. Here, the focus is on the gradual development of the institutional supports or arrangements for a market economy, accepting the dangers of institutional voids and that not all existing or inherited institutions, organisational forms or social capital are redundant. Transitional second-best institutions and the preservation of social capital can be both worthwhile and necessary in order to prevent further economic disruption.

Whereas the Washington Consensus view of transition is a top-down approach, the institutional-evolutionary perspective is a bottom-up view focusing on the institutional design of market economies, the importance of social norms and the organic development of the private sector. Markets and economic agents do not exist in a vacuum but in an institutional framework – 'the rules of the game' – that facilitates exchange and interaction. Institution building and the provision of a framework for well-functioning market structures and organisations is the focus of this approach and it argues for the gradual or incremental implementation of sequenced reforms (often through experimentation and learning by doing) in order to ensure growing support for policies. In the institutional-evolutionary approach, although there is recognition for the need to reduce the role of the state, the emphasis is on a reconstituted state and improving state capacity (so as to, among other things, enhance the market environment) as opposed to a weakened state. It also stresses the path dependency of system development and is mindful of the historical continuity and the communist legacy unlike the ahistorical, tabula rasa Washington Consensus approach (Clague and Rausser 1992; Roland 2000; Bönker *et al.* 2002).

Although an outline of the two major paradigms of transition is useful in the context of this book, many observers feel that the debate between the two approaches and, in particular, the controversy between 'shock therapy' and gradualism and the tendency to label countries as either one or the other, has not been very helpful and has unintentionally diverted attention away from some of the more important aspects of economic transition. One such feature of transition is the SBC.

1.2 Definition and Interpretation of the SBC

The incentive problem inherited from the socialist system known as the SBC takes its name from the budget constraint faced by households in standard microeconomic theory. The budget constraint was first extended to organisations and firms by Kornai (1979, 1980) and applied to the socialist economies of Central and Eastern Europe. The budget constraint is softened when a firm is not held to a fixed budget, but finds its budget constraint non-binding. The enterprise sector is said to exhibit a SBC when there is a recurring or persistent expectation of a refinancing or bailout of loss-making firms; firms receive financial assistance *because* they are loss making and the expectation of aid is close to certainty as the external support is more than just a once-off event. The channels or mechanisms by which the *ex post* rescue of unprofitable firms takes place vary, from budgetary subsidies and tax arrears (by government) to inter-enterprise arrears (by trade suppliers and utility companies) to overdue loans (by banks). Since transition began over a decade and a half ago, the more traditional forms of the SBC, namely, arbitrary pricing and direct subsidies, have given way to new and, often, more implicit instruments, such as tax arrears and overdue payables to banks, trade suppliers and utilities. Another mechanism that is evident in predominately FSU countries, where banking intermediation is generally underdeveloped, is non-cash payments (barter, promissory notes, offsets) by firms to its creditors. Either way, this expectation of a bailout influences and undermines the *ex ante* behaviour and incentives of firms.

The objective of the organisation that is bailed out is straightforward, namely, survival. The motive of the rescuer varies, depending on the interpretation of the SBC (as there is no consensus on a precise definition of the concept). For the purposes of this book Kornai's bureaucratic hierarchical model (1980, 1992a) is used, as opposed to Dewatripont and Maskin's dynamic commitment model (1995) and Stiglitz's gambling banks model (1994), of a paternalistic and benevolent state willing to support unviable firms in order to avoid politically and socially costly layoffs. A fourth interpretation is Shleifer and Vishny's politicians and firms model (1994), a theory that is employed in Chapter Two. Using the Kornai model, the SBC syndrome can be viewed as a theory of exit and, thus, complements Schumpeter's theory of creative destruction (Schumpeter 1911). Whereas Schumpeter focused on the birth or creation of organisations, the SBC phenomenon explains the survival (or demise) of organisations. By preventing certain firms from bankruptcy, the SBC alters the natural selection process inherent in a competitive environment (whether it be market socialism, transition or market economy).

Since the term first appeared in 1979, there have been a number of different explanations of the SBC. According to Kornai (1979, 1980), the source of the budget softness, in the context of the socialist system, is the paternalism of the state. Firms are not responsible for losses, or for profits, hence, the levelling effect. This explanation is system-specific, focuses on political considerations and is based on the vertical relationship between superior and subordinate. In contrast, the explanation advanced by Dewatripont and Maskin (1995) focuses on economic causes, namely the inability