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Taxation, Money and Credit in Liberalizing Socialist Economies: Asian and European Experiences

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TAXATION, MONEY, AND CREDIT IN LIBERALIZING SOCIALIST ECONOMIES: ASIAN AND EUROPEAN EXPERIENCES

by

Ronald I. McKinnon

This paper explains why price inflation and a general loss of macroeconomic control are almost endemic in a liberalizing socialist economy. In their rush to decentralize decision making, privatize, and dismantle the apparatus of central planning, reformers inadvertently upset the pre-existing system for sustaining macroeconomic equilibrium. The ability of the reform government to collect taxes and control the supply of money and credit is unwittingly undermined by the liberalization itself. Thus, the first part of the paper seeks to understand how the preexisting system of financial control under Stalinist central planning actually worked, and why it tends to breakdown once liberalization begins.

Unlike the optimistic expectations of the late 1980s, the Eastern European economies no longer appear to be a good "economic laboratory" on the transition from plan to market. They are unravelling too quickly. Because of ethnic divisions, the liberalization process per se is being confounded by the simultaneous breakup of whole countries--as in the Soviet Union and Yugoslavia. Similarly, the precipitate decline of the old CMEA trading regime in 1990-91 has severely disrupted even those Eastern European economies which are managing to hold together politically.

In contrast, the Asian socialist economies--China, Vietnam, Laos, Mongolia and Myanmar--are culturally and politically more homogeneous. Their economic liberalizations are not being confounded by simultaneous attempts to redraw national political boundaries. For China, Laos, and Myanmar, the importance of CMEA trade was more marginal and its break up of little significance. Although both Mongolia and Vietnam are severely impacted by the decline of CMEA trade and by the cessation of terms-of-trade subsidies from the Soviet Union, both are more agrarian; neither has an extensive capital stock in heavy industry so dependent on the old CMEA trading system as do the smaller Eastern European economies.

Thus, compared to their Eastern European counterparts, our five Asian economies have the option of choosing a more deliberate liberalization strategy--though Mongolia is opting for a "big bang". Because of the absence of calamitous civil disorders or unmanageable external shocks, the Asian socialist economies may well be more instructive examples for studying the "optimum" order of economic liberalization. Indeed, while serious policy mistakes--not the least of which is a tendency towards inflation--have been made in each of our five Asian economies, none are irretrievable. Without relying on massive external assistance or aid, each of the five remains capable of managing the difficult transition to a much higher productivity market economy.

In the second part of the paper, therefore, more deliberate monetary and fiscal measures for containing inflation in a socialist economy in transition are spelled out--and these may differ substantially from measures for controlling inflation in mature capitalist economies. Rather than a "big bang" where all centralized socialist controls are simultaneously dismantled, I posit that there is a natural or optimum order of economic liberalization. Moves to dismantle the apparatus of central planning, decontrol prices, privatize property, free foreign trade, and so on need to be supported by a proper sequence of fiscal, monetary, and foreign exchange measures. In this short overview, only the broad outlines of such a financial order can be sketched using both Asian and European examples;

but a fuller treatment is now available.[1]

Financial Control Under Classical Socialism

The centrally planned Soviet economy, before the advent of perestroika and the current financial breakdown, is our model of classical socialism. Although not addressed at all in this paper, the hierachical system of command and control and its institutional structure in the traditional Soviet economy is extremely complex--as nicely summarized by Richard Ericson [1991]. Here I focus on the main elements of the financial system, which were also adopted to a greater or lesser extent by the smaller countries of Eastern Europe and our five socialist economies in Asia--even in Myanmar, which, under "the Burmese way to socialism", never adopted rigorous central planning.

In the classical socialist economy, the financial system has two essential features that differentiate it from its capitalist counterpart. First, the system of taxation is largely implicit and uncodified. Second, the system of money and credit for enterprises is entirely passive. In the absence of central planning, the monetary system itself does not restrain the ability of enterprises to bid for scarce resources.

Consider the fiscal system first. Because the government owns all the industrial and agricultural property, surpluses are extracted from enterprises (and indirectly from households) with relatively little codification in formal tax law. In addition, the controlled price system is rigged to extract a relatively large economic surplus from agriculture. Rather than the government appropriating this surplus directly from agricultural procurement agencies, the

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[1]See Ronald McKinnon, The Order of Economic Liberalization: Financial Control in the Transition to a Market Economy, Johns Hopkins Press, 1991.

surplus is first gathered as "monopoly" profits in industrial enterprises which the government itself owns. Only at this point of one remove is the surplus expropriated by some combination of taxes and profit remittances.

"The pre-reform fiscal system in China...shares in common with other Soviet-type fiscal systems an overwhelming dependence on industry, and a reliance on profits of state-owned enterprises, along with taxes for government revenue. Using administrative prices that systematically discriminate against agricultural and raw materials producers in favor of industry, artificially high profits are created in the industrial sector. These are then captured for government cofers through a combination of turnover taxes and expropriation of profits." [Wong, ADB Study, 1991 p.10]

If industrial enterprises are used as tax-collecting vehicles, no system of consumer excises (sales taxes) need be formally codified if the preexisting system of price controls keeps the retail cost of consumer "luxuries"--liquor, tobacco, automobiles, and so on--arbitrarily high. Then enterprises producing these goods would run with large cash surpluses (government revenue) which reverted to the state. Of course, the government can also lose revenue if prices of some goods, say basic foods, are set below their costs of production. The implicit consumer excise tax rate on these goods is then negative.

Similarly, no law establishing a personal income tax is necessary if all enterprises essentially withhold household income at its source. As long as the state owns the capital stock, it must set or limit the wages of workers and managers to ensure that enterprises, on average, do generate cash surpluses. Otherwise, if managers or workers' councils can determine their own wages with an indirect claim on the firm's physical capital, they will pay themselves "excessive" wages that tend to decapitalize the enterprise (Hinds, 1990). With the necessary industrial wage controls already in place, maintaining a parallel system of personal income taxation is an unnecessary expense. Moreover wages can be more easily kept down relative to the prices of industrial goods if agricultural procurement prices for foodstuffs are kept low--which also "automatically" keeps the incomes of farmers low.

Correspondingly, any organized system for collecting taxes on real property is redundant. Keeping agricultural procurement prices low--however distorting that may be--obviates the need for a separate land tax. And all profits, really economic "surplus", generated in the protected industrial monopolies is already controlled by the socialist government--thus obviating the need for a separate tax on industrial property.

Under classical socialism, having enterprise "profits"--really residual cash surpluses which don't allow for depreciation of fixed capital or the drawing down of inventories--simply revert to the state is not an inefficient method of taxation. (The state must then provide financing for authorized new investments by recycling funds back to enterprises.) It can provide great revenue buoyance to the government when industry is growing rapidly relative to agriculture. Christine Wong [1991] shows that Chinese government revenue rose by about 8 percentage points of GNP during the Maoist period from 1952 to 1978.

What about adverse incentive effects to enterprise managers from appropriating enterprise surpluses? In the presence of centralized price controls, output targets, and input allocations, which enterprises generate surpluses and which generate deficits is largely arbitrary anyway. Thus, appropriating cash surpluses is the only feasible method for the government to tax enterprises. As long as all decisions for allocating resources are actually made by the central planning agency, seizing enterprise profits expost facto need not be particularly damaging to managerial incentives.

In contrast, generalized business taxes that work well in a liberalized market context, say a value-added tax, might not even be collectible in a classical socialist economy when price controls prevent the tax from being shifted forward to the final user. Similarly, levying a formal gross turnover tax directly on enterprises (as socialist governments do) may simply reduce residual profits, which would otherwise revert to the state. As long as the final prices of goods sold are controlled by the government, whether revenue is formally collected from a turnover tax or from residual profit remittances to the state is a distinction without a difference. (However, the distinction is important once prices begin to be liberalized.)

Even under centralized price and output controls, however, enterprise surpluses remain somewhat uncertain. Variability in the technology, uncertainty in the availability of inputs, unknowns in inventory accumulation, and so on make enterprise cash surpluses difficult to predict exante. Hence, enforcing revenue collection in the absence of formally codified tax law requires that these surpluses remain "blocked" as they are generated expost. Under classical socialism, therefore, enterprise deposits with the state bank cannot even be spent for domestic goods and services without permission, nor are enterprises allowed to hold "cash"--coin and currency that could be spent without being traced. This internal or "commodity inconvertibility" of enterprise money in socialist economies is much more restrictive than mere inconvertibility into foreign exchange (McKinnon, 1979, Ch. 3),[2] which of course is a more common phenomenon in nonsocialist economies as well.

Within a classical socialist economy like, say, the Soviet Union's before 1985 or China's prior to 1979, therefore, we have two monetary circuits: the (blocked) deposits of enterprises held with the state bank--sometimes in several designated accounts--and households' coin and currency. Households can spend

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[2]John Williamson (1991) further clarifies various concepts of internal and external currency convertibility.

their cash freely for goods and services without getting permission from the government (if they can find them in the shops) or deposit it into personal savings accounts that can be later withdrawn without restraint.[3] To prevent an overhang (at fixed retail prices) of domestically convertible household money which leads to more than the normal "tautness" in aggregate demand in the socialist economy, the amount of the blocked enterprise money which is converted through wage or other payments for personal services must be strictly limited. Indeed, having the state bank carefully monitor the conversion from enterprise to household money complements the system of wage controls.

By itself, the Stalinist system of enterprise money and credit is essentially passive on both the loan and deposit sides of the state bank's balance sheet. On the loan side, enterprises are restricted neither by interest rates (which are kept trivially low) nor by fixed credit lines. If any enterprise had insufficient funds on hand to purchase supplies as allowed under the plan, it could borrow without restraint from the state bank. On the deposit side, the demand for "money" by enterprises is indeterminate. Blocked cash accounts simply build up until they are expropriated or the government gives the enterprise permission to buy something. But with all spending mandated by the central planning agency, whether or not the enterprise has "cash" on hand does not affect what it can or cannot do.

Even before its liberalization policy of "doi moi" in 1986, planning in Vietnam was less detailed and comprehensive than in the Soviet Union. Nevertheless, monetary policy remained essentially passive.

"(Vietnam's) monetary policies consisted of little more than rules and

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[3]This normal monetary guideline of classical socialism was violated by the Soviet monetary "reform" of January 23, 1991, when large-denomination ruble notes were cancelled and withdrawals from personal savings accounts were restricted.

practices adopted to implement the public sector's credit and cash plans, both of which were part of annual economic plans. The credit plan set forth the amount of credit to be granted to different sectors of the economy, while the cash plan specified the banking sector's receipts and payments. The banking system was thus accomodating, and both the government and state enterprise managers paid comparatively little attention to monetary issues."

[Fford and Vylder, ADB Study, August, 1991. p. 49.]

In summary, the financial system does not constrain enterprises from bidding for scarce resources under classical socialism. However, as long as the central planning mechanism imposes a rough balance between supply and demand for each product, this absence of financial restraint on enterprises is not debilitating to the macroeconomy. Moreover, as long as the old method of implicit tax collection--based largely on the expropriation of enterprise surpluses--generates enough revenue and limits wage claims, the government can prevent inflation by limiting the buildup of liquid (unblocked) cash balances owned by households.

The Breakdown of Financial Control in the Transition

Once liberalization begins, the formal apparatus of central planning is weakened as decision-making and effective property rights devolve more to the (state-owned) enterprises themselves, and perhaps to a newly enfranchised private or cooperative sector. Price controls may or may not be removed in this transitional period. However, by giving up control over state property, the government in effect gives away its tax base! Because of the implicit nature of the old system of taxation, no formal internal revenue service exists for clawing back revenue from entities that are no longer controlled by the government. Enterprises can no longer so easily be used as revenue (cash) cows, or as vehicles for indirectly taxing households.

However, this decline in revenue involves more than just the transfer of some property away from direct government control. Indeed, with the exception of Mongolia's big bang in 1991, the pattern in China, Vietnam, and Myanmar has been for central or local governments to hang on to as many of the traditional industrial enterprises as they can after liberalization begins. Nevertheless, each government's revenue position is still severely impacted once markets for commodities and services are given freer rein. First, the price system can no longer be rigged to keep agricultural procurement prices--and thus real product wages--artificially low so as to transfer an easily captured surplus to industry. Second, industrial enterprises--owned by the central or diverse local governments that had generated monopoly profits--may now face substantial competition from each other (as among township industries in China), from newly enfranchised private or cooperative enterprises, and (possibly) from freer imports. The upshot is that the industrial profit base itself will tend to decline as the monopoly positions of the old state-owned industrial enterprises are undermined.

In a liberalizing socialist economy, "profits" taxes in any form can no longer remain the major source of government revenue once the economy becomes highly marketized. Indeed, in mature market economies, we see that total profits as share of GNP are modest, and profits taxes as a share of government revenue are tiny. In the United States in 1990, for example, before-tax corporate profits (the main profit flow in the economy) amounted to about $297 billion dollars and was only 5.4% of American GNP. On this base, total corporate profits taxes collected by the U.S. federal and state governments in 1990 amounted to $134 billion, which is only 2.3% of American GNP and 7.5% of the consolidated revenues of the U.S. federal and state governments [Economic Report of the President, February 1991].

Compare this to the consolidated revenue of the central and local governments in China under classical socialism. In 1978, Table 1 shows that revenue from enterprises in the form of profits taxes and remittances amounted to 20.6% of Chinese GNP and almost two thirds of total government revenue. But this revenue position is simply not sustainable as marketization begins and the (monopoly) profit position of socialist industry begins to erode--and enterprise profits begin to fall toward levels observed in the United States and other mature market economies. With the failure to develop a personal income tax or expand the base of commodity taxation, China, the Soviet Union and the smaller socialist economies of Asia and Europe naturally experience a sharp decline in the revenue of the consolidated government as liberalization proceeds. Starting from classical socialism before 1978, China provides the longest continuous revenue series on a decentralizing socialist economy: through the massive agrarian reforms in 1979-84 where land was leased back to households to the development of township industries and those in "free" economic zones in the late 1980s. Table 1 shows that consolidated revenue of the central, provincial, and local governments fell from over 34 percent of GNP in 1978 to only 19 percent by 1989. Table 1 also shows that virtually all of this decline can be explained by a fall in "profit remittances" from enterprises, and that revenue from business product taxes--turnover and value added taxes--held up rather better [Blejer and Szapary, 1989].

This overall revenue decline forced the central and local governments to cut expenditures heavily--so that measured fiscal deficits were only 2 to 3 percent of Chinese GNP. But this understates the "true" fiscal defcit. Because government-financed investment expenditures fell so sharply, local governments in particular pressured the banks to lend to the enterprises they owned or controlled to finance infrastructure investments in their localities. Besides

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TABLE 1
CHINA: GOVERMENT REVENUE, 1978-1989
(In percent of GNP)

	1978	1979-81	1982-84	1985-87	1988	1989[1]
Total Revenue[2]	34.4	30.0	27.0	24.8	20.4	19.0
Revenue from Enterprises	20.6	17.1	12.5	8.3	5.6	4.0
Of which:						
Profit Remittances	(19.1)	(16.1)	(11.4)	(0.4)	(0.3)	(0.3)
Profit tax	(1.5)	(1.0)	(1.1)	(7.9)	(5.3)	(3.7)
Taxes on:						
Income and Profits[3]	21.5	17.8	13.3	7.9	5.3	3.7
Goods and Services[4]	11.3	10.6	10.1	10.6	9.1	8.6
International Trade	0.8	0.9	1.1	1.8	1.1	1.1
Other Taxes		---	--- 1.5	3.2	3.0	3.0
Nontax revenue[5]	0.8	0.8	1.0	1.3	1.7	2.4

Source: China, Ministry of Finance, (1990), adapted from Mario I Blejer and Gyorgy Szapary in "The Evolving Role of Fiscal Policy in Centrally Planned Economies Under Reform: The Case of China," <u>IMF Working Paper</u> 0407, 1989.

[1]Budget. [2]Total revenue includes nontax revenue. [3]Includes profit remittances. [4]Includes product, value added, and business taxes. [5]Excluding profit remittances.

fostering unhealthy fiscal competition among governments for control over enterprises and thus revenue [Wong 1990], this "forced" extension of excesssive bank credit to enterprises throughout the Chinese economy undermined monetary control from the mid 1980s into the 1990s.

Similarly in Vietnam, we observe a sharp decline in transfers from state enterprises since the liberalization program known as "doi moi" (national renovation) began in 1986. Although the data are still very preliminary, transfers from state enterprises to the government budget appear to have fallen from 17.2% of GNP in 1986 to 7.1% in 1990 [Fford and Vylder, August 1981 p. 44].

In the same year 1986, the Lao People's Democratic Republic in November introduced their new economic mechanism (NEM) with a major decontrol of agricultural and industrial prices in 1987, the decollectivization of agriculture in 1988, and the growth of private ownership in industry through disinvestment from the state sector in 1989-90 [Vokes and Fabella, ADB Report, August 1991]. Although successful in many other economic dimensions, the fiscal consequences were highly adverse. Current transfers to the government from public enterprises declined from 9.5% of GNP in 1986 to 1.7% in 1989 [World Bank, 1990].

In the early 1990s, all five Asian economies are suffering from declining or inadequate public sector revenues as the traditional fiscal system based on the generation of high profits in the state-owned industrial sector is undermined by the liberalization itself--without being replaced by new institutions and mechanisms for collecting revenue from farms, enterprises, or households.

In the Soviet Union, the period for observing the fiscal effects of liberalization is shorter--but the (less reliable) Soviet fiscal data tell a similar story. From 1985 when Mikhail Gorbachev took office through 1989, Table 2 shows government revenue falling over six percentage points of GNP. About half

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TABLE 2
USSR: FISCAL DEVELOPMENT
(In percent of GDP)

	1985	1986	1987	1988	1989 (estimate)
State budget revenue	47.3	45.8	43.6	41.7	41.0
of which:					
From state enterprises	14.9	15.8	15.0	13.2	11.9
Turnover taxes	12.6	11.5	11.4	11.5	11.8
State budget expenditure	49.7	52.0	52.0	51.0	49.5
of which:					
Investment in the economy	8.2	8.3	8.7	8.7	7.2
Subsidies	8.9	9.4	9.3	10.1	10.6
Overall balance	-2.4	-6.2	-8.4	-9.2	-8.5
Adjusted balance[1]	---	---	-8.8	-11.0	-9.5

[1]Includes cost of extrabudgetary agricultural price support, but excludes balance of centralized fund operations.

Source: The Economy of the U.S.S.R: Summary and Recommendations International Monetary Fund, Dec. 19, 1990.

this fall is attributable to declining remittances from state enterprises; special factors, such as diminished sales sales of alcohol at home and petroleum abroad, account for the remainder. Because the Soviet government did not reduce its expenditures as revenue declined, by 1988-89 "formal" Soviet fiscal deficits had already reached 9 to 11 percent of GNP. In 1990-91, the fiscal decline in the Soviet Union became more precipitate with bourgeoning deficits on which we have little reliable information. As the struggle between the central government and the republics for control over revenue-generating enterprises intensifies, the republican governments have refused to hand over revenue to the Soviets--an important factor in the debasement of the ruble and the collapse of the power of the Soviet central government in the summer of 1991. In addition, enterprise surpluses may themselves continue to erode as prices are decontrolled and competition increases--so that the fiscal position of the individual republican governments also declines.

Because interest rates are pegged below market-clearing levels, fiscal deficits cannot be financed by the direct issue of government bonds to the nonbank public. Liberalizing socialist governments typically cover their revenue shortfalls by borrowing from the (state) banking system which funds itself by issuing modest-yield saving deposits and liquid cash balances to households, and partly by allowing the blocked deposit money owned by enterprises to increase. Because of this monetary overhang, incipient price increases are large should price controls be removed. Thus even reformist governments become reluctant to eliminate price controls over a wide range of goods and services, and normal market development is severely impeded.

Monetized government deficits are not the only culprit in the inflation process, nor is inflation <u>per se</u> the only reason why markets fail to work as the apparatus of central planning is dismantled. The passive system of money and credit makes the budget constraints on enterprises unduly soft. Loss-making enterprises--those which are very inefficient or have their output prices pegged too low--continue to borrow from the state bank in order to prevent unemployment in their work forces; and this perverse flow of bank credit contributes to the loss of control over the money supply. In addition, once planning controls are removed, profitable enterprises will be anxious to spend their previously blocked cash balances lest they be seized or refrozen--thus exacerbating the inflationary pressure.

But this isn't the end of the inflation story for the economy in transition. The productivity of physical capital--both fixed assets and inventories of inputs and goods in process--could fall. Absent of attractive monetary assets, whether liquid cash, or time deposits bearing a positive real rate of interest, newly liberalized enterprises will overbid for storable material inputs, foreign exchange, capital goods and so forth. In effect, decentralized enterprises will carry "excess" inventories of all kinds as <u>substitute monetary stores of value</u> (McKinnon, 1991). The abysmally low productivity of physical capital in socialist economies could worsen during liberalization, thus adding to the net inflationary pressure as the supply of goods for sale falls relative to the aggregate demand for them.

Finally, once central planning is dismantled but the uncodified tax system based on the seizure of accumulated enterprise surpluses remains in place, it can hardly fail to undermine managerial incentives. The syndrome of the "soft budget constraint" (Kornai, 1986) is aggravated: firms making incipient losses get compensated by subsidies (including cheap credit), and "successful" firms have their surpluses removed. In addition, the desperate need for revenue induces the government to continually reintervene enterprises in order to extract surpluses; and these unpredictable reinterventions are made easier when the highly visible deposits of enterprises with the state bank are easily (re)frozen or seized.

Such reinterventions make it virtually impossible for a liberalizing socialist government to commit to lasting tax or monetary agreements, or for enterprises to make long-term contracts with each other. Whatever tax, property, or credit arrangements are promulgated, they are continually overturned as economic events unfold. This chronic instability in the "rules of the game" may well be characteristic of any socialist regime where political and economic power is monopolized by one party as in the Soviet Union [Litwack, 1991]. However, it is greatly aggravated if a government is fiscally straitened and must grab economic surpluses whenever they become visible.

Creating an Internal Revenue Service: Institution Building for Tax Reform

Suppose a socialist government begins liberalizing. It frees wholesale and retail markets from price and output controls so that agricultural procurement and other raw materials prices (including energy) increase to market-clearing levels. The operation of state-owned enterprises and collective farms is decentralized, and cooperative or private firms begin to operate more freely. How then can financial equilibrium be better maintained? What domestic fiscal and monetary reforms would be necessary and sufficient to balance the public finances on the one hand, and to constrain enterprises and households from overbidding for the economy's scarce resources on the other?

On the fiscal side, let us focus just on the central government by itself--although fiscal relationships among central, provincial, and local governments can be tangled (Wong, 1990). At the outset of the liberalization, an organized internal revenue service (IRS), a major central-government bureaucracy for collecting taxes from households and liberalized enterprises, should be in place. Operating under stable tax laws, the IRS can collect revenue directly from households and from enterprises in the rapidly growing liberalized sector. Then, as the relative size of surpluses in traditional state-owned enterprises inevitably decline, the government's fiscal position need not deteriorate.

Institutionally, the new IRS must break away from the socialist tradition of associating the power to tax with the actual formal ownership of property. In China since 1978, we know from Table 1 that profit remittances (or taxes) have declined sharply--although indirect taxes on goods and sevices from the industrial sector have been rather better maintained. In 1990, over two thirds of tax revenues was still being (narrowly) collected as taxes or other remittances from industrial enterprises--reflecting the relative failure to collect much revenue from the personal income tax, from agriculture per se, or from international trade [Wong, 1991]. In the absence of a generalized IRS, this unduly narrow focus of revenue sources in Chinese industry reflects the fact that the central and local governments continue to own most significant-scale industrial enterprises--and these are convenient administrative vehicles for collecting both commodity taxes and profit remittances.

The revenue position of the Chinese central government has been particularly weakened. Because of the huge expansion of township and other locally owned and controlled industries, the traditional tax base of the central government, i.e., the enterprises it owns, has declined relatively. Of the the 83,000 or so industrial enterprises in China in 1990, less than 2000 (albeit some of the bigger ones) are now owned by the central government. This has resulted in various forms of contracting by which the central government designates local governments to be its tax collecting agents for sharing revenues from local industry--a form of "fiscal federalism" which has worked badly. In inflationary circumstances, revenue buoyancy to the central government has decreased because intergovernment transfers have been specified in nominal terms. In addition, by diverting local-industry revenues from budgetary to extrabudgetary channels, local governments can understate the volume of tax revenues actually being collected [Wong 1991]. Contracting has proven so unsatisfactory that old rules are continually being scrapped, and the whole system is in a state of flux as governments try to (re)negotiate new contracts.

Fforde and de Vylder [ADB Report, August 1991] report the same impasses in negotiations between the central and local government authorites in Vietnam when the former attempts to force the latter to remit "surplus" revenues. They quote (pps 91-92) a Vietnamese official Tran Vinh who accuses local officials of

"...hiding of revenues, expenditures outside the system, fraudulent over-reporting, for example of the number of pupils in schools, nurseries, kindergartens, primary schools and training establishments. When accompanied with extra staff recruitment, this confused situation leads to highly contradictory reports and to fierce arguments".

The effect has been a sharp fall in central government revenue in Vietnam from about two thirds of total revenue in the early 1980s to about a planned 25% in 1991 (p. 87).

Associating tax revenues with the ownership of industry also encourages an unhealthy form of intergovernmental mercantilistic rivalry. In China (as in Vietnam), local governments vie with each other for new (taxable) industries, and strive to protect old ones from "foreign" competition--imports from enterprises in adjacent local jurisdictions.

"Most problematic was the apportionment of revenues between the central and provincial governments on the basis of enterprise ownership, which linked local revenues with income of local enterprises... Faced with intense budgetary pressures, local governments had little choice but to engage in industrial expansion. Not only has vigorous local expansion been a major source of overheating and macroeconomic imbalance through the 1980s, the distorted price and tax signals ensured that much of the investment was wasted in duplicative and irrational projects. Moreover, the dependence of local budgets on the financial health of local industry in turn induced officials to intervene to protect the welfare of their enterprises whenever possible, perpetuating bureaucratic management and exacerbating the tendency toward regional protectionism. [Wong ADB Study, August 1991 p. 49]

Clearly, institutional change to divorce tax collecting by different levels of government from their ownership of industrial property is of first order importance for the liberalizing socialist economy. For the central government, this can be accomplished be the formation of a broadly based internal revenue service for collecting taxes directly from all enterprises in industry and agriculture--whether they be owned privately, by cooperatives, by local governments or by the central government itself. Presuming that such an institutional change can be effected, what forms of taxation would be particularly appropriate?

Procurement Prices and the Taxation of Agricultural Land

Consider agriculture first. Compared to their European counterparts, our five liberalizing Asian socialist economies are much more agrarian with between 60 and 70% of the population still in agriculture--despite ongoing population shifts toward urban areas. However, with collectivization of agricultural land under "classical" socialism, and with the reduction of agricultural procurement prices as method of extracting an economic surplus from agriculture that were captured by generating "monopoly" profits within industrial enterprises, direct tax revenues from agricultural land have fallen dramatically. In China, Christine Wong [1991, p. 39] estimates that the share of agricultural revenues from 40% in 1950 to less than 5% of total government revenue by 1960. In part because of ongoing price inflation for which land assessment could not be updated, the formal taxation of agriculture accounts for less than 2% of total government revenue in 1990.

Although Myanmar's economy remains overwhelmingly agrarian today with about two thirds of the population directly in agriculture, the fall in government revenue--both direct taxes and indirect extractions--from agriculture has been going on for a long time.

"Before World War II, the main method of taxing agriculture was the land revenue system based on periodic settlements for the assessment of the land tax. ... In the early days of British rule, the land tax yielded as much as half of total revenues. But with the expansion of other sources, especially customs duties, excise duties, and taxes on income, the contribution of land revenues declined in importance; in 1939/40 they yielded 22.6% of total revenues.

In the early postwar years, a government owned State Agricultural Marketing board was established which was given the monopoly of exporting rice and rice products. Domestic purchase prices were fixed below international prices in order to give huge profits to the government..... In 1961/62, implicit taxes on the marketing of rice amounted to 15% of total revenues... while land revenues amounted to another 3.4% of total revenues. ....

The liberalization of agricultural prices and abolition of government monopoly of the rice trade in 1987-88 have eliminated implicit taxes on agriculture;...As a result, taxation of the agricultural sector is now essentially about 1% of tax revenues and 0.5% of total revenues.
[U Tun Wai, ADB Report, August 1991, pps. 66-68]

This remarkable fall in the government's "take" from agriculture in China and Myanmar (as well as in Laos and Vietnam) is, in part, a (welcome) consequence of liberalization where procurement prices seen by domestic farmers have risen to market-clearing levels. In an optimum order of liberalization, however, as the position of farmers improved through price reforms, agricultural land taxes should have been phased in to replace some of the lost revenue. In none of our five Asian economies has their been sufficient effort to systematically tax agricultural property once the commodity prices received by farmers increased.

True, in developing countries more generally, relatively few countries have followed the almost universal advice of economists to raise money by suitably constructed land taxes in agriculture

"Very few countries collect as much as 10 percent of total government tax receipts from direct taxes on agricultural land. There are no countries in which land taxes account for more than 20 percent of revenues. In most, all kinds of taxes on property bring less than 5 percent of central government revenues." [John Strasma et. al., 1990, p. 439]

Even by this weak standard, the effort to collect land taxes in our five liberalizing socialist Asian economies has been inadequate--given their strongly agrarian status and market oriented commitment to improve agriculture's terms of trade. To mobilize popular support for land taxation, such revenues could be earmarked as the primary source of funding for (badly needed) infrastructure improvements in agriculture--to be mainly undertaken by local governments under the threat that bank credit for such investments is to be phased out and "monopoly" profits in locally owned industry will continue to dissipate.

However, assessing the value of real property--particularly agricultural land--can only be carefully and fairly done with substantial lags. This year's tax liability in cash typically typically depends on the assessment of the land's potential productivity made a year or more ago. Thus the real proceeds from a cash based property tax can be greatly diminished by ongoing inflation. Given the failure of all five of our Asian economies to bring inflation under control, governments may have to consider doing the assessments and imposing land taxes in kind by using some common regional crop as the numeraire--although actual payments would still be made in money terms on the day the tax becomes due.

Personal Income Taxation and the VAT

In a liberalizing socialist economy, the traditional tax base--the huge "protected" flow of monopoly profits in state-owned indistrial enterprises--will largely disappear as the economy becomes more competitive. In addition to land taxation by local governments, what new revenue sources can be tapped?

In the longer run, a "global" personal income tax, i.e., one that consolidates all forms of household income into the same taxable schedule, should eventually become the principal tax base in the economy. In the United States, consolidated government revenue from the personal income tax was almost 13% of American GNP in 1990--and was 41% of the revenue collected by all levels of the American government. However, personal income taxes are more difficult to collect when per capita incomes are still low. Although the most advanced of our five countries in developing a personal income tax, China still collects less than 1% of GNP in this format. In a largely agrarian developing country, institutions for tracking and collecting personal income taxes in a nondistortionary fashion will take some years to put in place. But it is important to start immediately in levying a moderate rate personal income tax--say 25 to 30 percent after a basic exemption for the poor--as soon as possible.

But what about the immediate fiscal crisis and fall in government revenues in each of our five countries? Our hypothetical fledgling IRS will still need enterprises as administrative vehicles for collecting taxes. However, the old format based on "profits" appropriation needs to be dramatically changed toward uniform taxation of commodities and services. Once prices are decontrolled, shifting to a uniform value-added tax on industrial enterprises is both feasible and necessary. With a determined effort over one or two years, large amounts of revenue can be raised rather quickly in a nondistortionary fashion--as shown by the experience of Chile in the late 1970s [Edwards and Edwards, 1987].

"No public finance development of the last half century can rival the emergence and spread of the value-added tax. It is difficult for contemporary economists to believe that, barely fifty years ago, there was no such thing as a value-added tax. The French were the first to institute such a tax, in the 1950s. What is astounding is the degree to which the idea thus planted has in subsequent decades proliferated around the world--in both developed and developing countries." [A. C. Harberger, 1990, p. 27]

In the industrial sector, the way the new IRS works vis-a-vis liberalized enterprises--as distinct from enterprises remaining under government ministerial control--must be spelled out. The debilitating practice of seizing the cash surpluses of profitable enterprises while subsidizing loss makers must end. But the recent history of the reform socialist governments of the Soviet Union after 1985, China in 1989-90, and the smaller economies of eastern Europe and Asia, is one continual reintervention to seize high profits and to subsidize losses. This moral hazard in public policy is now so pronounced that major institutional changes in both the fiscal and monetary systems are necessary if government reintervention is to be credibly foreclosed. On the fiscal side, I suggest that reforming socialist governments replace the taxation of profits generated within domestically owned enterprises in the liberalized sector with a broadly based and uniform value-added tax[4]. (Profits paid out to individuals--whether in the form of interest, dividends or capital gains--would be subject to withholding against the personal income tax.)

Once output prices are decontrolled and production decisions are made freely--but not until then--a full-scale value-added tax (VAT) can be effectively imposed. Thus, new enterprises, or existing enterprises just entering the liberalized sector, would immediately register to pay their VAT as a condition for getting an operating license and legal protection from the State. For example, imposing a flat 20 percent VAT rate on all liberalized enterprises whether profitable or not is straightforward. Whatever their corporate form--

[4]There remains a strong case for moderate domestic taxation of domestic profits that are repatriated in some form to foreigners. Not only would the socialist government need the revenue, but the foreign-owned firm can typically claim equivalent tax credits against its own corporate income tax liability in its home country.

cooperative, private, or owned by the central or local governments--their VAT liabilities would be unambiguous. Provided that the fledgling IRS also imposed a full-scale personal income tax, supplemented by consumer excises, taxing the profits of liberalized enterprises should be unnecessary for securing sufficient revenue.[5]

Traditional enterprises whose output and input prices remain under direct state control, as described below, would remain subject to the old-style full taxation of residual profits. For accounting purposes, however, a "shadow" VAT might also be imposed on them. Although this shadow VAT reduced residual profits one-for-one much like the old socialist turnover tax used to do, the government would then have a better accounting measure of "true" profits and losses in traditional enterprises.

Unlike the old-line industrial ministries, or local governemnts sponsoring specific industries, the new IRS would deal with households and liberalized enterprises throughout the economy. A VAT is levied at a flat rate on enterprises' gross sales less the tax embedded in purchased supplies. If profit taxation is officially abandoned, no accounting measure of enterprise profits is necessary for collecting the VAT, which would help shelter the IRS from pressure to seize "inordinate" enterprise profits. (Operating under our moderate-rate personal income tax, the IRS would still want to catch dividends and capital gains paid out to individuals.) Moreover, because the incidence of the VAT is eventually passed forward to retail buyers, pressure to exempt liberalized loss-making enterprises, those which the state is no longer sponsoring, from paying this well-defined tax would be minimal.

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[5]The pros and cons of different forms of taxation under classical socialism in comparison to a more liberalized economy are reviewed in McKinnon (1991).

Although China has a VAT as one of several commodity taxes, it is neither uniform nor widespread. Instead, the government tries to hit liberalized enterprises with highly progressive profits taxes

"Since 1950, the industrial and commercial tax has been levied on the profits of collective enterprises on an 8-grade progressive scale that begins at 10% with annual profits of 1000 yuan or less, reaching 55% with profits over 200,000 yuan. In practice many enterprises are exempted.

In response to their growing numbers during the process of reform, the government introduced a new tax in 1986 to cover all privately owned businesses in industry, commerce, construction, and service trades. This tax has a 10-grade progressive scale, with rates that rise from 7 to 60%. In addition, a surtax of 10-40% is levied on annual profits over 50,000 yuan."

[Wong, ADB Report, August 1991, pps. 37-38.]

This Chinese approach of taxing collective or private enterprises "progressively" confuses the role of a uniform business tax necessary for raising revenue efficiently with the desire of the authorities to have a progressive ta on personal incomes. It comes uncomfortably close to the old discredited idea of the government seizing "excess" profits. Personal income taxation and business taxation should be separated. The most natural approach is to impose a uniform VAT of say 20% on <u>all</u> private, collective, or otherwise liberalized enterprises. Besides being well-defined <u>exante</u>, the VAT format provides institutional protection against the government seizing "inordinate" profits of collective or private enterprises <u>expost facto</u>. Then, income actually paid out to individuals could be subject to a progressive personal income tax--against which all enterprises would be liable for withholding at the source to help the government collect the tax.

<u>Gradualism or a Big Bang?</u>

Even with a fledgling IRS in place for dealing with households anf liberalized enterprises, the fiscal position of the reforming socialist government is likely too precarious, and its ability to collect tax revenue from the private sector too weak, to afford any massive giveaway of claims on earning assets. For fiscal reasons alone, an early attempt at a "big bang" privatization by giving common shares in large state-owned enterprises or in natural resource industries to households on a widespread basis could be seriously misplaced. However, this argument does not preclude a one-time restructuring of formal ownership rights in state enterprises to better recognize the implicit claims of existing stake-holders -- workers, banks, pension funds, and the public treasury -- by the distribution of explicit equity shares that validate these claims [Lipton and Sachs, 1990]. Nor does it preclude rapid effective privatization in agriculture--as the Chinese demonstrated with the break up of the communes and the advent of their "family responsibility system" after 1978.

However, breaking up large industrial concerns in the context of a "big bang" is a more dubious proposition (Murrell, 1990)--although one can move quickly to liberalize small-scale industry and agriculture. Indeed, capitalism is best grown from modest beginnings in small-scale enterprises that provide a sorting mechanism for successful and unsuccessful entrepreneurs (Kornai, 1990). Many years might have to pass before domestic entrepreneurs with proven managerial expertise accumulate sufficient capital to buy state-owned industrial assets on a large scale. Corrrespondingly, massive sales of domestic assets to foreigners at the outset of the liberalization could even delay the development of domestic entrepreneurship--although joint ventures, in which domestic partners retain the principal ownership claims, can sometimes be useful vehicles for absorbing foreign technologies.

All five of our Asian economies moved sharply towards the effective privatization and marketization of agricultural activities. However, China, Vietnam, and Myanmar have moved rather slowly in changing the ownership and control structure of the traditional state owned industrial enterprises (SOEs). In China, in particular, small-scale private and collective enterprises have simply grown in and around "the commanding heights' of the socialist economy--which remain state owned and controlled. Only in special economic zones such a Guangdong, have fully liberalized--largely private--enterprises become the dominant mode of economic activity.

In contrast, Laos has opted more for a "mini bang" in allowing highly autonomous and decentralized operations of its SOEs since 1988, but without first putting proper financial controls--including wage controls--in place. The result has been a wage explosion and significant decapitalization in traditional industries

"The freeing up of wages and the ability of managers and workers to vote themselves bonuses, led to a pay explosion. From a situation of rough parity with the levels of pay in the civil service in late 1987 and early 1988, pay levels within state enterprises are now reported to be as much as five times those in the government....

Given the diversion of a major part of after-tax profits to bonus payments, the ability of SOEs to fund investment from their own resources is severely limited. At the same time, enterprise managers have a strong incentive to invest. By borrowing funds to raise the capital intensity of the production process, the consequent increase in labor productivity will be available for higher real compensations, in the form of wages and bonuses, while government held equity goes unremunerated."

[Vokes and Farbella, ADB Report on Laos, August, 1991, pps 35-36.]

Going much further than the Laotians, Mongolia is opting for a "big bang". Starting from a situation where its government owned and controlled virtually all property in an extreme version of the old Stalinist model, the legal and institutional structures in Mongolian sosciety are to be changed in 1991-92 so as to radically transform the economy into a market system based on private property.

"A radical form of privatization is to begin in July 1991. Privatizaton of (formerly) state-owned property is to take place in two stages over a 14-month period. Between July and October 1991, all small units and assets (shops, livestock, farm equipment, trucks etc.) are to be auctioned off; and in the subsequent 12-month period, ownership in the remaining large enterprises is to be transfered (through) vouchers, which are to be distributed to every citizen on an egalitarian basis." [Y.C Kim, ADB Report on Mongolia, August 1991, p. 35.]

But it appears as if the financial controls necessary to allow such an economic program to succeed are not yet in place. Neither the fiscal system nor the banking system have been reconstructed to compensate for this massive loss of resources by the State

"A new law on customs duties has gone into effect in March 1991, and the new Tax Law in January 1991. The Tax Law introduced income taxes for individuals, enterprises and cooperatives--replacing then-existing profit transfers. Yet, it is said that little income taxes are being collected because (a) no system of tax collection has yet been set up; and (b) because of very bad economic conditions, enterprises have no "taxable" income....

Timing in implementing the privatization program is said to have been moved up in order to minimize the hemorrage in the fiscal budget resulting from ever-increasing government subsidies to enterprises. At the same time, it is universally acknowledged that virtually no newly privatized enterprises would become financially viable under the country's present and near future economic conditions. Simply to pass the bankuptcy law (June 1991) will not address the wholesale insolvency of the country's enterprises even after privatization".
[Y.C.Kim, ADB Report on Mongolia, August 1991, pp. 36-38.]

Instead of a big-bang, I will simply presume for the remainder of the paper that our model economy adopts a more gradualist approach in which approprate financial controls are put in place as liberalization proceeds from "the bottom up", i.e., starting with small-scale farming, manuafacturing and services. Although in agriculture, the transformation to small-scale "virtually" private farming best takes place very quickly--as in China in 1979-81--presuming that a suitable system of land taxation can be put in place as agricultural procurement prices increase.

Enterprise Financial Constraints in the Transition: A Tripartite Classification

Before the transition to a full-fledged market economy is effected, therefore, both traditional enterprises with soft budget constraints and liberalized enterprises with hard budget constraints would likely coexist for some years--but under somewhat different monetary and tax regimes in order to better maintain financial control. Focussing on industrial sector, I have tried in Table 3 to summarize what financial arrangements would be consistent with the degree of liberalization or mode of operation of each class of enterprise. Three relatively gross classifications are distinguished.

First, traditional enterprises remaining under state ownership would remain subject to some price controls on their outputs, and perhaps to state materials allocations for some inputs (including credits from the state banking system). They could include both natural public goods such as utilities, energy-producing resource-intensive industries, and infrastructure activities like roads and irrigation facilities. In addition, industrial basket cases--those running with negative cash flows even when prices are fully liberalized, but which the government could not immediately close down for social reasons--would also fall into this "traditional" category.

This distinction between liberalized enterprises with hard budget constraints and traditional enterprises need not preclude substantial rationalization of relative prices in the latter. Indeed, although I am eshewing a "big bang" in the sense of a massive transfer of ownership claims to industrial property at the outset of liberalization, widespread marketization of economic transacting where government controlled prices are set closer to market-clearing levels is both feasible and highly desirable. For example, in the energy sector, which one would expect to remain under state ownership and control much like a

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TABLE 3
ALTERNATIVE FINANCIAL ARRANGEMENTS FOR ENTERPRISES IN TRANSITION

	Traditional[1] Enterprises	Liberalized Enterprises	
		State Owned[2]	Private
Taxation	Expropriation of surpluses[5]	Uniform value-added tax	Uniform value-added tax
Deposit Money: Domestic Commodity Convertibly[3]	Restricted	Unrestricted interest-bearing	Unrestricted interest-bearing
Credit Eligibility	State Bank	Nonbank capital market	Nonbank capital market
Wages	Government determined	Government determined	Market determined
Residual Profits	Accrue to government	Dividends to government -retained earnings for reinvestment	Dividends to owners[4] -retained earning for reinvestment or lending to other private enterprises
Foreign Exchange	Restricted	Current account only	Current account only

Notes: [1]Traditional enterprises are those whose output and pricing decisions are still determined by a central government authority or planning bureau with centrally allocated inputs and credits from the state bank to cover (possible) negative cash flows.

[2]"State owned" can refer to any level of government. Nevertheless, the VAT and restrictions on bank credit would apply equally to liberalized enterprises owned or controlled in different jurisdictions.

[3]"Commodity convertibility" here means the freedom to spend for domestic goods and services or to buy and hold domestic coin and currency--but need not imply convertibility into foreign exchange.

[4]Dividends would be subject to the personal income tax when paid out to private owners, but retained earnings would not be taxed.

[5]Although residual profits revert to the state, they could include a "shadow" VAT levy in order to better understand the "true" profitability of traditional enterprises.

public utility, a sharp increase in the economy-wide price of energy to approximate world levels should be charged to all enterprises at the outset of the transition process. Otherwise, liberalized enterprises will begin using, or continue to use, energy wastefully. Even though traditional enterprises may not economize on energy use very rapidly, the reduction in their accounting profits as the price of energy is increased would be a better signal to the government of their true profitability. Higher energy prices would allow the government to better tax the economic rents (surplus) associated with the exploitation of this natural resource.

Second, in <u>state-owned liberalized enterprises</u>, output and input decisions would be freely determined by the enterprise management--who could also bargain freely over commodity prices in pursuit of higher profits after paying the value-added tax. State-owned manufacturing concerns could fit into this liberalized category as long as the government exerted its ownership claim over capital to maximize profits. Although managers of liberalized state-owned enterprises would operate freely in commodity markets, the government would continue to set wages and salaries for managers by direct participation in wage bargaining. The government would also determine the division of profits between dividends reverting to the state and earnings retained by these enterprises themselves.

Third, <u>private liberalized enterprises</u> would have no direct government restraints on their making output, price, wage and dividend decisions in the pursuit of higher profits. Along with their liberalized state-owned counterparts, these private or cooperative enterprises would be liable for the value-added tax but not for any separate profits tax. However, the IRS would also enlist their cooperation in withholding personal income taxes on any wages, interest, dividends, or capital gains paid out to individuals

For each of these three enterprise classifications, the columns in Table 3 list consistent tax, monetary, credit, wage, and profit arrangements. Down column 1, for example, traditional enterprises continue to be taxed by the expropriation of their surpluses (although this would include a "shadow" VAT calculation); their deposits in the state bank remain blocked, and could be considered simply an extension of the government's treasury accounts. Being thus incapacitated in terms of their own financial resources, traditional enterprises would still be eligible for loans from the state bank at positive real interest rates to finance new investments or to cover ongoing losses. As under classical socialism, their freedom of financial action remains highly circumscribed. In contrast, columns 2 and 3 of Table 3 show that liberalized enterprises--whether private or state-owned--are subject to a uniform VAT but not to a profits tax.

Hardening the System of Money and Credit: Banks and Liberalized Enterprises

What system of money and credit for the newly liberalized sector would be consistent with this different tax regime? The answer depends partly on the initial conditions that the transitional economy faces. Suppose it faces a near "worst-case" scenario in two important respects.

First, a fiscal deficit forces the government (and traditional enterprises) to continue borrowing heavily from the banking system despite the best efforts of the newly created IRS. As of 1991, all five of Asian economies had this problem of falling tax revenues and inflationary pressure from excess government direct or indirect borrowing.

Second, the state banking system itself, with an enormous bad loan portfolio from past lending to loss-making enterprises at the government's behest, has yet to be restructured to avoid similar moral hazard in future lending. The need for a complete recapitalization of existing divisions or branches of the state banking system, before normal lending on commercial terms can begin, has been stressed by Brainard (1990). The current state of bank lending in China is also indicative of bank portfolios in Vietnam, Laos, Myammar and Mongolia.

"Bad" loans is a concept that has no specific definition in Chinese banks. ...One reason for distinguishing between irrecoverable "bad" loans and overdue loans is the lack of clear guidelines for identifying and treating defaults on loan payments... At present, many bankers report that loans are automatically rolled over if a request is made 7 days prior to maturity. At the same time there is little follow up on the rolled over loans to distinguish between those caused by the unealistically short repayment terms, and those encountering real financial problems. Another reason for the low percentage of "bad" loans is that a high percentage of industrial loans are guaranteed by the supervisory bureaus or corporations, so that outright defaults are rare.

In the views of many economists in China, the issue of bad loans in the banks is currently impossible to solve, since many of the bad loans were either inherited (such as when the Industrial Commercial Bank inherited the portfolio of the People's Bank of China when the latter devolved its commercial operations) or they had been under administrative orders in the first place. ...The situation deteriorated in 1989-90, when the government ordered banks to make loans that were clearly problematic--to allow enterprises to meet payroll and build inventories of unsold goods."

[Christine Wong, ADB Report on China, August 1991, pps. 58-59]

At the macroeconomic level, the first assumption says that no room exists for noninflationary bank lending to the liberalized sector. At the microeconomic level, the second assumption says that monetary intermediaries, whose deposits must be insured to protect the payments system, can't be trusted to lend safely on commercial terms anyway.

Nor could traditional enterprises with "soft" budget constraints be trusted to lend to, or borrow from, other enterprises--particularly those in the liberalized sector -- on any substantial scale. The recent financial history of partial "liberalizations" in the 1970s and 1980s in many Eastern Eurpoean countries is that loss-making traditional enterprises overborrow from their suppliers by simply not making payments on their trade credits--thus throwing suppliers into financial difficulty. To prevent general industrial collapse, the State Bank is often forced to reintervene to provide (inflationary) credit to all concerned.

In our model, free trade on commodity account would prevail between the traditional and liberalized sectors, but they would be insulated financially. In order to maintain control over the aggregate supply of internally convertible ("household") money, the government would have to carefully monitor and limit the cash deficits of the traditional (and general government) sector with households and liberalized enterprises--as shown in Table 3. But this insulation and monitoring become more difficult as marketization proceeds.

"As in other Soviet-type economies, there are separate circuits for enterprise and household money. In the prereform period, all enterprises were required to have an account with PBC, and all transactions of value greater than Y50 were required to go through bank transfers. Cash holdings of enterprises were restricted to three days currency requirments in locations with a bank branch, and to two weeks elsewhere. Payments to households and to rural collectives were made in cash supervised by the PBC. Control over currency outstanding was relatively simple, through manipulating wage policies and the supply of consume goods.

With monetization of the economy in the reform period, the control of the currency has been complicated by the much greater transactions demands for currency among farm households and among non-state and private traders. The development of extra-plan trade and the growth of nonstate enterprises have increased the the use of cash in enterprise transactions, weakening the separation between the two monetary circuits. After 1985, when enterprises were allowed to open accounts with more than one bank, the accounting and monitoring functions of the banking system were further eroded. While enterprise transactions are still required to take the form of checks, monitoring has become more difficult. The unpopularity of checks in the service trade in Beijing indicates that cash payments are still preferred (perhaps to facilitate tax avoidance).. In an effort to control spending by state organizations, some accounts were frozen by the banks, and transactions were blocked."

[Wong op.cit. pps. 56-57]

Traditional state-owned enterprises in China are inevitably now more bound up with the cash economy because of the general liberalization. However, the government can still maintain a tight line on extensions of new credits beyond those needed to refinance old debts, on giving or receiving more than "normal" trade credit, and on new funding for investment. Other than investment in important infrastructure activities, a deliberate decision could be made to scale back (bank-financed) investments in traditional manufacturing (including township industries) while continuing to restrict the ability of traditional enterprises to spend from their own accumulated deposit money or cash--as indicated in Table 3 above. The relative size of this traditional sector would then shrink as the economy grew.

However, new or financially reorganized state-owned enterprises with clean balance sheets could be put wholly onto the "cash" economy. Old debts and deposits would be cancelled on the presumption that these now-liberalized enterprises could be financially autonomous in the future. Other than auditing against fraud, what they did with their owned cash balances--including deposit money--for new investments or the purchase of supplies would be unrestricted. Checking accounts would still be held with the state bank to ensure the integrity of the payments mechanism. Along with households, liberalized enterprises could still hold interest-bearing savings accounts that were unrestricted for deposit or withdrawl. The important caveat, however, is that these <u>financially liberalized state-owned industries could no longer borrow from the state banking system</u>--or from any monetary intermediary. Like private or independent cooperative enterprises, they would have to seek funding from the nonbank capital market, and from building up their own cash positions, i.e. from self finance.

Given the macroeconomic need to restrain inflation and the current incapacity of the banks to be "responsible" lenders, how might domestic banking arrangements best evolve with respect to the liberalized sector? Imagine two successive stages in the transition.

Stage One: Liberalized enterprises are confined to self-finance and to borrowing from the nonbank capital market not involving traditional enterprises. Bank lending to liberalized enterprises is prohibited.

Stage Two: Commercial banks begin limited and fully collateralized short-term lending to liberalized enterprises according to the "Real Bills Doctrine." That is, they lend only to finance the build up of "productive" short-term assets, such as inventories or accounts receivable, that can be easily realized if assumed.

At the outset of Stage One which is portrayed in Table 3, all urban and rural liberalized enterprises, whether state-owned, cooperative, or private, become ineligible for credit from banks (that is, from deposit-taking monetary intermediaries). Nor can they borrow from traditional enterprises who continued to have access to bank credit. But borrowing and lending in the nonbank capital market among liberalized firms and individuals could take place freely. Apart from "normal" trade credit, however, nonbank sources of finance are likely to be quite small for some years. Instead, liberalized enterprises would depend mainly on their on their owners' equity and subsequent untaxed retained earnings for investment finance. These earnings could now accumulate in currency and demand deposits, or in interest-bearing time deposits, that were now fully convertible for domestic spending. Banking institutions would be rearranged so that the government could no longer conveniently monitor, appropriate, or freeze the financial asset positions of the liberalized enterprises. When a state-owned enterprises was declared to be "liberalized," it would lose the privilege of borrowing from the state bank, but be compensated with the right to accumulate internally convertible domestic money and other financial assets.

A primary goal of Stage One is to encourage firms to use monetary assets as a store of value, rather than physical assets. As households and liberalized enterprises build up their liquid asset positions, excess inventories and other forms of low-yield capital would be voluntarily disgorged and replaced with more attractive monetary assets. Thus could the average productivity of physical capital increase from the outset of the liberalization--despite industrial restructuring.

Decreasing the demand for physical assets as a store of value will also help disinflate the economy. If monetary assets are to be attractive, however, the efficiency of the payments mechanism becomes critically important to all liberalized enterprises, whether private or state-owned. To facilitate free convertibility of enterprise deposits into domestic goods or currency, rapid check clearing and money transfers are essential. In effect, the monetary circuit of liberalized enterprises would be unified with that of households as both could hold coin and currency as well as domestically convertible deposits. (However, the monetary deposits of traditional enterprises would remain blocked--their funds could not be spent or converted into cash without permission).

In addition, the government would set substantially positive real interest rates on time deposits in the mode of successfully disinflating developing economies--such as Taiwan in the late 1950s and Korea in the mid-1960s. What the socialist government can afford to pay on deposits, however, is limited by its own fiscal position and its success in increasing the yields on the government-owned assets that dominate the loan side of the state bank's balance sheet. In order to achieve high real financial growth in households and liberalized enterprises, setting real deposit rates in this 3 to 6 percent range is consistent with the experience of other countries (McKinnon, 1991)--provided that these deposits are not subject to being blocked.

Such reliance on self-finance is the simplest technique for imposing financial restraint on liberalized enterprises while simultaneously increasing the productivity of physical capital. Bankruptcy would be virtually automatic if the internal cash flow of a liberalized enterprise became negative for any significant length of time. The effective wages paid to workers and the (implicit) yield to all owners of the firm's equity would vary directly with the firm's success in the open market. Self-finance avoids the issue of moral hazard in lending by government-owned or insured banks. It also has the great advantage of bypassing the difficult problem of how to establish a more elaborate corporate structure, with different forms of accountability to outside lenders.

However, self-finance works for liberalized enterprises if and only if output prices have been decontrolled fully and firms can negotiate freely over input prices and wages. As long as no liberalized enterprise can borrow from the state bank, nor from traditional enterprises which still have access to credit from the state bank, then all liberalized enterprises will be in the same competitive position. In competitive equilibrium, therefore, profit margins should be sufficently wide for liberalized enterprises, on average, to finance their own ongoing investments.

Are there historical examples of this widening of profit margins in a regime of self finance? The successful liberalization of Chinese agriculture from 1979 to about 1985 relied almost exclusively on Chinese farm households building up their own cash positions in order to finance on-farm investments[6]. For enterprises to build up sufficient cash, however, depends on the absence of any significant tax on current profits, and on having broad money bring a positive real deposit rate--that is, not be significantly taxed by inflation. In the early years (1979-84) of China's agricultural liberalization, the price level was quite

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[6]This and other examples are discussed further in McKinnon (1991).

stable--although inflation later became a serious problem--and Chinese farmers built up their cash positions remarkably rapidly [Wong 1991].

True, self finance has its limitations. Large scale infrastructure investments for roads, pipelines, major irrigation facilities and so forth would have to remain in the government (traditional) sector, although with a better set of commodity prices and positive real interest rates to guide decision making. Unless they could attract additional equity finance, even successful liberalized enterprises with excellent investment opportunities would have to wait a bit longer (compared to borrowing externally) to generate internal funds sufficient to overcome indivisibilities in purchasing capital goods. Nevertheless, by building up or drawing down bank deposits at positive real interest rates, liberalized enterprises and households would be engaging in a limited form of intertemporal arbitrage. Without access to external credits liberalized enterprises would aim for rather larger average stocks of liquid assets (including deposits) to cover unexpected contingencies--like shifts in their terms of trade--that might suddenly reduce current cash flows.

As the nonbank private capital markets develop--say, unsubsidized rural credit cooperatives or urban markets in short-term commercial bills--the severe credit constraints on liberalized enterprises would relax naturally. But these private lenders would also face bankruptcy if they made bad loans or charged interest rates below market levels. Compared to lending by the state-owned or state-insured banks, moral hazard in lending would be dramatically reduced. The government role would be to serve as ultimate enforcer of all debt contracts through the judicial system; and to give the liberalized sector a stable unit of deferred payment by securing the price level.

Suppose such monetary control is established and fiscal deficits are reduced to the point that the government plus traditional enterprises no longer fully absorbed the lending resources of the state banking system. The price level has stabilized. Moreover, enforcement of debt contracts in the liberalized sector is secured, and open markets in some debt instruments, like commercial bills, have begun to develop in the nonbank capital markets. Then, and only then, is Stage Two feasible: to begin fully collateralized bank lending to the liberalized sector on strictly commercial terms. The prior existence of a commercial bill market could provide a natural vehicle for providing that collateral; in fact, established bill brokers might be the most technically qualified applicants with sufficient capital to be granted private commercial bank licenses. Checkable and interest-bearing deposits could be offered to the general public provided that these authorized banks invested in a diversified portfolio of commercial bills with well-defined secondary markets, and with more or less the same term to maturity as their deposits.

Alternatively, appropriately recapitalized divisions of the state bank could be designated as "commercial"; these would mobilize additional saving by offering higher yield time deposits, and then use the fund to begin "for profit" lending to the liberalized sector. However, tight regulations on collateral for securing their loans--perhaps inventory bills of lading or accounts receivable--would have to be in place to prevent moral hazard through the nonrepayment of loans from developing all over again.

In the optimum order of liberalization, therefore, the development of ordinary commercial banking may well have to be deferred for some years after liberalization begins, and to wait until overall monetary and fiscal control is secured. Putting the matter more negatively, premature efforts to break up the monolithic state bank (associated with classical socialism) into a central bank and more loosely regulated commercial banks (associated with mature capitalist economies) could lead to a disastrous loss of overall monetary control and a worsening of moral hazard in bank lending in transitional economies. This pattern occurred in Poland in 1988-89 with the partitioning of the state bank aggravating the underlying inflationary pressure,[7] and is happening in the Soviet Union in 1990-91 with the formation of hundreds of wildcat "commercial" banks controlled by the old state enterprises (McKinnon, 1991).

In Vietnam, the experience with new "private" unregulated banking intitutions--which the Vietnamese prefer to call credit cooperatives--has not been successful.

"Today in Vietnam, there are some 7,500 rural credit cooperatives with total assets of about 90 billion dong. However, the portion of uncollectable loans is very large, estimated at some 50 percent.

Urban credit cooperatives are a more recent phenomenon. The cooperatives have been providing funding for private enterprises that have not been able to get funding from the state banks, but some state enterprises have been involved both as depositors and borrowers. In the beginning of 1990, around 300 urban credit cooperatives of various sizes were reportedly in operation, controlling deposits of around 400 billion dong, or almost $US100 million.

Until the credit crashes of 1990, most urban credit cooperatives operated like pyramid schemes, attracting deposits by offering interest rates of up tp 15 percent per month. But beginning in Ho Chi Minh City in March 1990, a number of credit cooperatives--largely unregulated and poorly supervised, and with no system of reserve assets or deposit insurance--started to go bankrupt. Some of the worst cases of pyramid schemes--involving grossly fraudulent behavior on the part of owners--were closed down by the authorities, and several well-known managers were arrested. The scandals panicked depositors, who rushed to withdraw their money, forcing many cooperatives out of business. The bankruptcies also caused the collapse of more than 2,000 small private enterprises." [Fforde and Vylder, ADB Report on Vietnam, August 1991, pp. 51-52.]

Vietnam's problems with the premature sanctioning of private bank-like insitutions has both obvious and not-so-obvious dimensions.

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[7] I am indebted to Professor Arnold Harberger for pointing out this ill-advised feature of financial reform in Poland prior to the more successful price-level stabilization of 1990.

As in any more mature market economy, regulating against fraud--usually in the form of some kind of ponzi game or pyramid scheme--is a problem but an obvious one. Small savers are particularly vulnerable if deposits in the past had been government guaranteed--and they feel an implicit guarantee still exists.

In socialist economies, however, it can be particularly inappropriate for state-owned enterprises to begin sponsoring their own commercial bank--or to make deposits in, and to receive loans from, "private" commercial banks (credit cooperatives) which they indirectly own or control. The classical socialist method for the government to collect (implicit) taxes from traditional state-owned enterprises is simply to impound their cash surpluses in the state bank. However, the SOE may well avoid paying this implicit tax if it can deposit funds in its own commercial bank--or one that it indirectly controls. Then the SOE can convert otherwise blocked balances into expendable funds--possibly by directing loans from this "commercial bank" to whom it designates.

The result is a further fall in government revenue in the transitional socialist economy. Before the final collapse of the Soviet Union itself in late summer of 1991, the revenue position of the central government had been completely undermined by a number of factors--one of which was the rapid spread of "cooperative" commercial banks which were mainly fronts for SOEs. From virtually none in 1989, about 1700 of these new banking institutions had sprung into existence by May of 1991--leading the authorities to lose control over the rate at which "inconvertible" enterprise deposit money was transformed into cash. The result was a wild inflation.

Clearly, keeping liberalized enterprises confined to self finance and to the nonbank capital market (Stage One above), while also keeping tight control over (state) bank credit to traditional enterprises, is a straightforward--albeit very draconian method--of securing financial control. If at the same time the public finances are also improved through expenditure reduction and the broadening of the tax base, price inflation could be rather quickly eliminated. Then, the economy would be ready for Stage Two: a deliberate, but very careful, broadening of the base of bank lending to include the liberalized enterprises. With the price level firmly under control with positive real interest rates on time and savings accounts, the stage would be set to allow liberalized enterprises to grow very rapidly compared to the shrinking relative size of the still-credit-constrained traditional sector.

Foreign Trade and Foreign Exchange

The optimum order for liberalizing quotas, tariffs, and exchange controls in foreign trade in parallel with the freeing of domestic trade is as complex as it is important. To this point, I have focused on domestic financial policy: how to reconstruct the public finances and the system of money and credit in a step-by-step transition from classical socialism toward a market economy.

In the order of liberalization, financial arrangements governing the foreign exchanges should parallel and complement these domestic tax and monetary arrangements. For example, traditional enterprises whose deposits remain blocked for domestic transacting could hardly be allowed to exercise convertibility of this money into foreign exchange. In contrast, the money of liberalized enterprises could be freely convertible for current-account transacting, for importing or exporting, provided that the country's foreign commercial (tariff) policy was simultaneously well-defined under a unified exchange rate. These distinctions appear in the last row of Table 3.

However, the severe domestic credit constraints imposed on the liberalized enterprises as a matter of policy would be undermined if such enterprises could freely borrow (or deposit) abroad. Until the domestic capital market matured with borrowing and lending at market interest rates, foreign exchange convertibility on capital account would be inappropriate, even for liberalized firms.

What about tariffs, quotas, and commercial policy in foreign trade? Again the pace of liberalization would depend heavily on the socialist economy's initial conditions: the preexisting system of protection and the degree to which it influenced resource use.

In a traditional centrally planned Stalinist economy, protection for domestic manufacturing is almost entirely implicit. From exchange controls and the apparatus of state trading, disguised subsidies to users of energy and other material inputs are coupled with virtually absolute protection from competing foreign manufactures. Although no formal tariffs appear in any legal codes, the implicit structure of tariff equivalents "cascades" downward from very high levels for domestic production of finished consumer goods through manufactured intermediate products through industrial raw materials and energy, which are negatively protected because of implicit export taxes (or import subsidies).

This highly cascaded structure of implicit tariffs in socialist economies raises effective protection in finished goods to the point where most manufacturing well exhibit negative (or very low) value added at world market prices. In such circumstances, a precipitate move to free trade could provoke the collapse of most domestic manufacturing industries--no matter how the exchange rate is set, and no matter that some of this industry might eventually be viable at world market prices.

Thus, reforms to make commercial policy more explicit should accompany efforts to make the currency convertible on current account. In McKinnon (1991), I suggest the simultaneous "tarification" of quantitative restrictions on competing imports and the elimination of implicit export taxes on energy and material inputs as the economy moves quickly to a market-based system. Once made explicit, the highest tariffs in the cascade can then be phased down step-by-step to zero (or a low uniform level) over a preannounced five to ten year time horizon. The newly marketized economy would then converge to free foreign trade at a more deliberate pace--one that better recognized the problem of overcoming distortions from the preexisting system of protection.

Is the Eastern European "J-Curve" Necessary in Asian Economies? A Concluding Note

Before moving quickly to decentralize domestic economic activity, or to privatize state property, a comprehensive explicit system of personal and business income taxation should be in place. In addition, the system of money and credit should be transformed into one that actively constrains the ability of enterprises to bid for scarce resources--while at the same time providing them with attractive monetary assets which they can freely accumulate. Otherwise, the liberalizing socialist economy faces the possibility of an immediate inflationary explosion.

Similarly, a precipitate move to free foreign trade without taking adequate account of the pre-existing implicit system of industrial protection--and the severe distortions in resource use arising therefrom--risks the possibility of a rapid collapse in industrial output much like that experienced in East Germany and Poland in 1990-91.

Instead, one can conceive of a more deliberate pace of liberalization conditioned by the ability of the government to reform its monetary, fiscal, and foreign trade policies to properly support market liberalization (McKinnon 1991).

Not only would the initial sharp downturn in economic activity characteristic of all the Eastern European economies at the present time be mitigated, but liberalizing reforms themselves would stand a better chance of being sustained into the indefinite future. Without experiencing inflation, the spectacular early success with China's liberalization of agriculture in 1979-84 suggests that a newly liberalized socialist economy can indeed begin to grow more rapidly if the financial conditions are right.

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