PN-ABL-687

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Working Paper Series

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This paper was prepared under a cooperative agreement between the Institute for Policy Reform (IPR) and Agency for International Development (USAID), Cooperative Agreement No. PDC# 0095-A-00-9079-00. Views expressed in this paper are those of the author and not necessarily those of IPR or USAID.

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Financial Control in the Transition from Classical Socialism to a Market Economy

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March, 1991

Two problems in the transition from a socialist to market economy are the endemic loss of macroeconomic control and appropriate monetary and fiscal measures for controlling inflation during liberalization. Under classical socialism, all the means of production are state owned, and output targets are set by a Stalinist system of central planning while wages and prices are also centrally determined. If liberalization from classical socialism is to succeed, moves to dismantle the apparatus of central planning, decontrol prices, and to privatize property need to be supported by a proper sequence of fiscal, monetary and foreign exchange measures. On the fiscal side, at the outset of liberalization, an organized internal revenue service, a major government bureaucracy for collecting taxes from households and liberalized enterprises, should be in place. In privatizing the financial sector, reliance on self-finance is the simplest technique for imposing financial restraint on liberalized enterprises while simultaneously increasing the productivity of physical capital. When the price level has been stabilized and the sums the government must borrow from the banking system are much reduced, the financial system could enter a second stage where commercial banks begin limited and fully collateralized short-term lending to liberalized enterprises according to the "Real Bills Doctrine." Finally, financial arrangements governing the foreign exchanges should parallel and complement these domestic tax and monetary arrangements.

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March, 1991

FINANCIAL CONTROL IN THE TRANSITION FROM CLASSICAL SOCIALISM TO A MARKET ECONOMY

by

Ronald I. McKinnon

In either a mature capitalist or a centrally planned socialist economy, how to secure financial control and stabilize the price level is conceptually straightforward. In contrast, the transition from socialism to capitalism poses severe problems of financial management that have yet to be resolved--in principle, let alone in practice. One unfortunate consequence is continual financial turmoil in the reforming socialist economies of Asia and Eastern Europe. Inflation, either open or repressed, accompanies and then undermines attempts to decentralize decision-making. To prevent economic chaos and dampen inflation, even reform governments may be provoked to reintervene by seizing the financial assets of enterprises, reinstituting price controls, or commandeering outputs through state orders and similar devices.

But why should the transition from central planning to a market economy be inflationary? This paper first explains why this loss of macroeconomic control is almost endemic in liberalizing socialist economies. Then, in the second part of the paper, appropriate monetary and fiscal measures for containing inflation during liberalization are spelled out--and these may differ substantially from measures typically taken to control inflation in a mature capitalist economies.

Understanding the system of financial control in the preexisting regime of "classical" socialism is the key to understanding what might go wrong in the transition. Under classical socialism, all the means of production--industrial and agricultural--are state owned, and output targets are set by a Stalinist system of central planning while wages and prices are also centrally determined. Accordingly, I shall first identify:

(1) how domestic fiscal and monetary processes interact with, and complement, central planning in the classical socialist economy;

(2) why this mechanism for securing domestic financial control and avoiding inflation under classical socialism tends to break down naturally when decentralization begins and central planning through direct materials balancing is weakened; and

(3) how, in a more deliberate transition, domestic tax and monetary arrangements might be better managed to keep the average price level stable as the market prices of individual goods and services become free to fluctuate.

After sufficient domestic financial control is secured, and starting from the classical socialist regime of foreign exchange inconvertibility and state trading, I suggest

(4) how, in moving toward free foreign trade, explicit policies governing tariffs and foreign exchange convertibility could best parallel and complement the evolving restraints on money and credit in domestic commerce.

In effect, there is a natural or optimum order of economic liberalization. If liberalization from classical socialism is to succeed, moves to dismantle the apparatus of central planning, decontrol prices, privatize property, and so on need to be supported by a proper sequence of fiscal, monetary and foreign exchange measures. In this short essay, only the broad outlines of such a financial order can be sketched; a fuller treatment will soon be available.[1]

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

Fiscal and Monetary Policy Under Classical Socialism

In the classical socialist economy, the financial system has two essential features that differentiate it from its capitalist counterpart. First, the fiscal 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. No law establishing a personal income tax is necessary if enterprises essentially withhold household income at its source. Similarly, 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. (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.) Even levying a formal profits or turnover tax directly on enterprises may be a distinction without a difference as long as residual profits revert to the state, and the final prices of goods sold are controlled by the government.

Under classical socialism, having enterprise "profits", really residual cash surpluses, simply revert to the state is not an inefficient method of taxation. In the presence of centralized price controls, output targets, and input allocations, which enterprises generate surpluses and which generate deficits is largely arbitrary--and not the result of some profitability calculation undertaken at the firm level. Indeed, 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, 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 surpluses[2]. With wage controls already in place, maintaining a parallel system of personal income taxation is an unnecessary expense.

Even under centralized price and output controls, enterprise surpluses are somewhat unpredictable. Hence, enforcing revenue collection in the absence of formally codified tax law requires that these surpluses remain blocked when they are generated. Under classical socialism, therefore, enterprise deposits with the state bank cannot 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"[3] of enterprise money in socialist economies is much more restrictive than mere inconvertibility into foreign exchange, which of course is a more common phenomenon in nonsocialist economies as well.

Within a classical socialist economy like the Soviet Union's, 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, which is freely convertible domestically. Without getting

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[2]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].

[3]McKinnon [1979, Chapter 3]. John Williamson [1990] further clarifies various concepts of internal and external currency convertibility.

permission from the government, households can spend their cash freely for goods and services (if they can find them in the shops) or deposit it into personal savings accounts that can be later withdrawn without restraint[4]. To prevent an overhang (at fixed retail prices) of domestically convertible household money, 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 also complements the system of wage controls.

By itself, however, 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 Gosplan, whether or not the enterprise has "cash" on hand does not affect what it can or cannot do.

In summary, enterprises are not constrained by the financial system in bidding for scarce resources under classical socialism. But 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. Moreover, as long as the old method of implicit tax collection-

[4]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 withdrawls from personal savings accounts were restricted.

-based largely on the expropriation of enterprises' surpluses expost facto--generates enough revenue, 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, however, 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.

The result in China, the Soviet Union, and many of the smaller socialist economies of Asia and Eastern Europe is 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 the 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

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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," IMF Working Paper 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.

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 in order to increase infrastructure investments in their localities. Besides 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.

Although the period for observing the fiscal effects of liberalization is shorter, 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 this fall is attributable to falling remittances from state enterprises; special factors, such as diminshed sales sales of alcohol at home and petroleum abroad, account for the remainder. And the longer Chinese experience suggests that the fiscal decline in the Soviet Union might not be over. As the struggle between the central government and the provinces (republics) for control over revenue generating enterprises intensifies, enterprise surpluses may themselves continue to erode as prices are decontrolled and competition increases. Because the Soviet government responded less well than the Chinese to cutting back expenditures as revenue declined, by 1988-89 "formal" Soviet fiscal deficits had already reached 9 to 11 percent of GNP (Table 2).

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

	1985	1986	1987	1988	1989 (estimated)	1990 (plan)
State budget revenue	47.3	45.8	43.6	41.7	41.0	42.8
of which:						
From state enterprises	14.9	15.8	15.0	13.2	11.9	12.6
Turnover taxes	12.6	11.5	11.4	11.5	11.8	12.7
State budget expenditure	49.7	52.0	52.0	51.0	49.5	50.6
of which:						
Investment in the economy	8.2	8.3	8.7	8.7	7.2	4.4
Subsidies	8.9	9.4	9.3	10.1	10.6	11.8
Overall balance	-2.4	-6.2	-8.4	-9.2	-8.5	-7.9
Adjusted balance[1]	---	---	-8.8	-11.0	-9.5	-8.3

[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.

Because interest rates everywhere are pegged below market-clearing levels, fiscal deficits cannot be financed by the direct issue of government bonds to the nonbank public. Thus liberalizing socialist governments typically cover their revenue shortfalls by borrowing from the (state) banking system. The supplies of unrestricted cash owned by households, and the overhang of blocked deposit money owned by enterprises, are correspondingly increased. If incipient price increases are large, even reformist governments are reluctant to eliminate price controls over a wide range of goods and services. Normal market development is severely impeded.

Government deficits are not the only culprit in the inflation process, nor is inflation *per se* the only reason why markets fail to work when the apparatus of central planning is dismantled. The passive system of money and credit makes the budget constraints on enterprises unduly soft. First, loss making enterprises continue to borrow from the state bank, and this perverse flow of bank credit contributes to the loss of control over the money supply. Second, once planning controls are removed, profitable enterprises will be anxious to spend their existing overhang of previously blocked cash balances lest they be seized, and may well "overbid" for scarce producer goods or foreign exchange. Unsurprisingly, this increase in the money supply coupled with a fall in money demand--both arising from the liberalization itself--exacerbates inflationary pressure.

But this isn't the end of the inflation story for the transitional economy. The productivity of physical capital--both fixed assets and working capital in inventories of inputs and goods in process, could fall. Because of the absence of attractive monetary assets--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 substitute monetary stores of value. The abysmally low productivity of physical capital in socialist economies could worsen during liberalization--thus adding to the inflationary pressure [McKinnon 1991].

Finally, to come full circle, once central planning is dismantled and enterprises have more scope for making their own decisions, the uncodified tax system based on the seizure *ex post* of enterprise surpluses undermines managerial incentives. First, along with the passive credit system, the syndrome of the "soft budget constraint" [Kornai, 1986] is aggravated: firms making incipient losses get compensated by tax breaks, and "successful" firms have their surpluses removed. Second, central and local governments' desperate need for revenue leads to continual and unpredictable reinterventions to control enterprises and to extract surpluses; and these reinterventions are made easier when the deposits of enterprises with the state bank are easily (re)frozen or seized.

Such reinterventions make it virtually impossible for a socialist government like the Soviet to commit itself to lasting tax or monetary agreements with enterprises, or for enterprises to make long-term contracts with each other. Whatever tax, property, or credit arrangements are promulgated beforehand, 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 [Litwack 1991]. However, it is greatly aggravated if a government is fiscally straitened and must grab economic surpluses whenever they become visible. Knowing in advance that government reintervention is likely, "liberalized" enterprises will further reduce their demand for money (financial assets) in favor of excess commodity inventories (or even fixed capital) which are more easily hidden from the tax collector.

Creating an Internal Revenue Service: From Profits Taxation to a VAT and Personal Income Tax

As the government divests property while freeing wholesale and retail markets from price and output controls in the transition, how can financial control be better maintained? What domestic fiscal and monetary measures would be sufficient to constrain enterprises and households from overbidding for the economy's scarce resources?

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 government bureaucracy for collecting taxes from households and liberalized enterprises, should be in place. Operating under carefully crafted and stable tax laws, the IRS can collect revenue directly from households and rapidly growing liberalized enterprises. Then, as the relative size of the overall surpluses of the traditional (unreformed) state enterprises with low or negative growth decline, the government's fiscal position need not deteriorate.

Besides collecting revenue, however, the way the new IRS works vis-a-vis liberalized enterprises--as distinct from traditional unreformed enterprises under government ministerial control--must be carefully spelled out. The debilitating practice of seizing the cash surpluses of profitable enterprises while subsidizing loss makers must be ended. But the recent history of the reform socialist governments of the Soviet Union, China, Yugoslavia, and the smaller economies of Eastern Europe and Asia, however, 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 eliminate profits taxation as the main vehicle for extracting revenue from enterprises in the liberalized sector.

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 on liberalized enterprises. For example, imposing a flat 20 percent VAT rate on all liberalized enterprises whether profitable or not is straightforward; and, whether the liberalized enterprises were cooperative, private, or owned by the central or local governments, their tax liabilities would be unambiguous. Provided that the fledgling IRS also imposed a full-scale personal income tax, or a less comprehensive one supplemented by consumer excises, taxing the profits of liberalized enterprises would be unnecessary for securing sufficient revenue.[5]

Unlike the old-line industrial ministries sponsoring specific industries, the new IRS would deal with households and liberalized enterprises throughout the economy. The 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 separate accounting measure of enterprise profits is necessary for collecting the VAT. Thus the IRS would be relatively immune from pressure to seize enterprise profits as being "inordinate". (Operating

[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].

under a moderate-rate personal income tax, the IRS would still want to catch dividends 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 from paying the tax would be minimal.

Enterprise Financial Constraints in the Transition: A Tripartite Classification

Even with a fledgling IRS in place, 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[6]. Apart from the government's revenue needs, Hinds [1990] has stressed the importance of the state's maximizing the yield on the assets it owns--by limiting wage claims and other means--in order to increase industrial efficiency.

Breaking up large industrial concerns in the context of a "big bang" is a dubious proposition anyway [Murrell, 1990]--although one can move much more 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 a domestic

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[6]However, this does not preclude a one-time massive restructuring of 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. This position was vigorously argued by Jeffrey Sachs as keynote speaker at The President's Luncheon, American Economic Association Annual Meetings, Washington D.C., December 28, 1990.

entrepreneurial class--with proven managerial expertise--accumulates sufficient capital to buy state-owned industrial assets on a large scale.

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. In Table 3, I have tried to summarize what financial arrangements would be <u>consistent</u> with the degree of liberalization, i.e., mode of operation, of each class of enterprise. Three relatively gross classifications are distinguished:

(1) **Traditional** enterprises, which are state owned, subject to price controls on their outputs, and perhaps 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 be classified as "traditional".

This distinction between liberalized enterprises with hard budget constraints and traditional enterprises need not preclude substantial rationalization of relative prices in the latter. For example, in the energy sector, which one would expect to remain under state ownership and control much like a public utility, a sharp increase in the economy-wide price of energy to approximate world levels should be charged to the liberalized enterprises at the outset of the transition process. Otherwise, they will

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TABLE 3
ALTERNATIVE FINANCIAL ARRANGEMENTS FOR ENTERPRISES IN TRANSITION

	Traditional[1] Enterprises	Liberalized Enterprises: State Owned[2]	Liberalized Enterprises: Private
Taxation	Expropriation of surpluses	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.

continue to use energy wastefully. Higher energy prices would allow the government to better collect (tax) the economic rents (surplus) associated with the exploitation of this valuable natural resource.

Table 3 also distinguishes between

(2) **State-owned liberalized enterprises** where output and input decisions--on prices and quantities--are freely determined by the enterprise management in pursuit of higher profits after paying its value added tax. State-owned manufacturing concerns could fit into this liberalized category as long as the government strongly exerted its ownership claim over the return to capital--residual profits--as described above; and

(3) **Private liberalized enterprises** with no direct government restraints on their making output, price, and wage 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; the IRS would enlist their cooperation in withholding personal income tax on any wages, interest, dividends, or capital gains payouts to individuals.

For each of our 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; 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 generally highly circumscribed.

In contrast, columns 2 and 3 of Table 3 also show that liberalized enterprises--whether private or state-owned--are subject to a uniform VAT but not to a profits tax. But what system of money and credit, consistent with this different tax regime, is appropriate in the newly liberalized sector?

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

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. 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.[7] (The sorry history of bank lending in partially liberalized regimes--such as Yugoslavia, Poland, Hungary, and China in the 1980s--shows the severe moral hazard from overlending to enterprises that local or central governments wish to sustain or promote.) In the macroeconomic sense, the first assumption says hardly any room exists for noninflationary lending to the liberalized sector. 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.

Given these limiting, but uncomfortably realistic, initial conditions, how might domestic banking arrangements best evolve with respect to the

[7]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]. In the process, both enterprise deposits with, and loans from, the state banks may have to be scaled down.

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.

Then, after a lapse of some years when the (decontrolled) price level has been stabilized and the sums the government must borrow from the banking system are much reduced, the financial system could enter

Stage Two: Commercial banks begin limited and fully collateralized short-term lending to liberalized enterprises according to the "Real Bills Doctrine".

Consider first the economic rationale for Stage One. At the outset, all urban and rural liberalized enterprises--whether state-owned, cooperative, or private--become <u>ineligible</u> for credit from banks, i.e., from deposit-taking monetary intermediaries. (Borrowing from the nonbank capital market, which is likely quite small at the outset of the liberalization, could take place freely.) Instead, for investment finance, liberalized enterprises would depend mainly on their (untaxed) retained earnings which could now accumulate in currency and demand deposits, or in interest-bearing time deposits, that were now fully convertible for domestic spending (Table 3). 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.[8] When their old privileges of borrowing from the state bank were terminated, those state-owned enterprises which were declared to be "liberalized" would be compensated by being able to accumulate internally convertible domestic money and other financial assets.

[8]One approach would be to unify the monetary circuits of households and liberalized enterprises, while keeping the closely controlled accounts of the government and traditional enterprises carefully segregated. However, this technical problem can't be adequately treated within the confines of this essay.

In Stage One, the efficiency of the payments mechanism, the deposit side of the state bank's balance sheet, becomes critically important to all liberalized enterprises--whether private or state-owned. To facilitate free convertibility of enterprise deposits into domestic goods or coin and currency, rapid check clearing and money transfers are essential. To further increase the demand for monetary assets, the government would set interest rates on time deposits about 3 to 6 percentage points higher than the rate of inflation,[9] while credibly refraining from the old practice of seizing the deposits of profitable enterprises. Then, the perceived "real" deposit rate of interest on broad money, say M3, would increase enormously. As households and liberalized enterprises build up their liquid asset positions, discrete investment expenditures for productive capital with high real yields would increase. Similarly, excess inventories and other forms of low-yield capital would be voluntarily dishoarded and replaced with more attractive monetary assets--thus helping to disinflate the economy.

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 their internal cash flows became negative for any significant length of time. The effective wages paid to workers, as well as the (implicit) yield to all owners of the firm's equity, would vary directly with the firm's success in the open market with the goods and services it buys or sells. Besides

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[9]What the government can afford to pay on deposits 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. Developing countries that have successfully stabilized their price levels and experienced rapid real financial growth have typically set real deposit rates in this 3 to 6 percent range [McKinnon, 1991].

avoiding moral hazard in lending by government-owned or insured banks, self-finance has the great advantage of by-passing 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 only if profit margins are flexible: output prices have been fully decontrolled 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 do have access to cheap credit from the state bank, then all liberalized enterprises will be in the same competitive position: investments in fixed and working capital will have to be financed from their internal cash flows. In competitive equilibrium, therefore, profit margins should be sufficently wide for liberalized enterprises to finance their own ongoing investments.[10] For enterprises to build up sufficient cash, however, depends on the absence of any significant tax on current profits, and on having broad money bear a positive real deposit rate, i.e., not be significantly taxed by inflation.

As the nonbank private capital markets develop--say, rural credit cooperatives or urban markets in short-term commercial bills--the severe credit constraints on liberalized enterprises would be naturally relaxed. 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. Through the judicial system, however, the government would remain

[10]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 farm investments. This, and other examples, are discussed further in McKinnon [1991].

the ultimate enforcer of all debt contracts; and, by securing the price level, it would give the liberalized sector a stable unit of deferred payment.

Suppose such monetary control was established and fiscal deficits were reduced to the point that the government plus traditional enterprises no longer fully absorbed the lending resources of the state banking system. Moreover, enforcement of debt contracts in the liberalized sector was secured, and open markets in some debt instruments--such as commercial bills--had 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. 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--part of the general system of check clearing still run through the state bank--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 as their deposits.

Alternatively, appropriately recapitalized divisions of the State Bank could be designated as "commercial"; these would be authorized to begin authorization "for profit" lending to the liberalized sector by issuing higher yield time deposits to mobilize the additional saving. But tight regulations on collateral for securing their loans--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.[11]

Concluding Notes on the Foreign Exchanges

In this essay, 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. But foreign exchange and commercial policy is also critically important.

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 (Table 3). 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

[11]As occurred in Poland in 1988-89 with the partitioning of the State Bank aggravating the underlying inflationary pressure, and happened (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]. 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.

unified exchange rate.[12]

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 equilibrium interest rates, free foreign exchange convertibility on capital account would be inappropriate.

[12] At the beginning of the transition, implicit quotas protecting domestic industry might best be converted into explicit tariffs for some years before being phased out altogether. To understand the proper phasing of liberalization in foreign trade, however, the reader is referred to the lengthier treatment in McKinnon [1991].

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