



# Lessons of the Russian Crisis for Transition Economies

Soft budget constraints and weak administrative controls brought Russia to the brink of hyperinflation. The lesson is to disinflate rapidly and to impose hard budget constraints quickly.

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**W**HAT LESSONS does the Russian financial crisis hold for other economies in transition? I could approach the topic by providing an avalanche of details about exchange rate, interest rate, and budgetary policies, or, perhaps more interesting, details about errors committed by the Russian government, the Russian central bank, and, yes, even the IMF. I will not do so, however, but will instead focus on the problem of soft and hard budget constraints.

## **Soft budget constraint**

The concept of the soft budget constraint—essentially a lack of financial accountability by enterprise managers—was first elaborated by nonsocialist economists for enterprises under the socialist system. The application of the term to enterprises in transition economies and in postsocialist economies is, in my view, entirely appropriate. Under the socialist system, the authority of the enterprise manager had nothing to do with whether or not the enterprise was profitable. The soft budget constraint was normally the result of a state budget process far removed from considerations of efficiency or profit. Under market conditions, because profits are the very essence of a manager's authority, the soft budget constraint is rare and always

temporary. The market economy, as you well know, is founded on very tough budgetary discipline. A manager whose indifference to budgetary considerations allows an enterprise to fall into bankruptcy suffers a swift and unpleasant fate.

## **Hard administrative constraint**

On the other hand, under the socialist system, soft budget constraints coexisted with hard administrative constraints. Since each enterprise was part of a comprehensive hierarchy, the state exercised rigid control over the appointment of managers and made sure that they fulfilled the tasks assigned to them, including the achievement of wide-ranging social aims. When, however, the totalitarian socialist regimes began to disintegrate, administrative control over the enterprise managers also fell apart. In some stage of development in all postsocialist economies, this phenomenon led to a fatal combination of soft budget controls and soft or nonexistent administrative controls.

To understand the attitude of managers in the socialist system, try to imagine an economy in which an enterprise owner has no need to be concerned when the enterprise fails to turn a profit. He knows that a weak bottom line will be compensated by various budgetary understandings, such as subsidies,

loans on easy terms, and the possibility of allowing tax arrears to build up without untoward consequences. Imagine what this would mean for the general efficiency of the market mechanism!

First, it would mean that the usual market instruments for redistributing resources from poorly functioning, inefficient enterprises to better-functioning, efficient ones would not work. The discipline of the market would be rendered ineffectual.

Second, because soft budget constraints are incompatible with an equitable and efficient tax system, the enterprise's tax obligation would be determined in practice not by tax law but by the terms of a contract negotiated between the enterprise and the state authorities. Such negotiations invariably lead to corruption.

### Worst of both worlds

As I just mentioned, practically all postcommunist countries have experienced problems with this combination of soft budget constraints and soft administrative constraints. What is the difference between "market socialist" economies before the start of serious reform and in the postcommunist reality? Before the reforms, enterprise managers were firmly under a system of totalitarian political control. They had to behave. They had to show that they were loyal members of the party. It is also unfortunately true that many managers skimmed off funds from the enterprises, enriching themselves and their families. There were limits to such transgressions, however. The enterprise still had to meet the requirements of the central plan and still had to provide for the welfare of its workers. Failure to carry out fundamental managerial duties would be regarded as breaking the manager's contract with the political establishment. This was simply not done and could result in serious repercussions for the offending manager.

After the crash of communism, the totalitarian regime, with all its social and administrative restraints, ceased to exist. Then, the combination of easy budget constraints and easy administrative constraints produced most undesirable consequences for the enterprises, for society, and for the economy as a whole. These developments were entirely to be expected, given the social environment that emerged after the breakup of the totalitarian regime. Why? First, because of a mind-set deeply ingrained over 70 years of socialism. Far from being distinct entities, enterprises were regarded as part of the state, a result of socialist industrialization. How could an enterprise be disciplined on the trivial grounds that for a time it was unable to fulfill its tax obligations? It would be absurd: the duty of the state was to provide for the enterprise, not the other way around.

Second, because enterprise managers were part of the social infrastructure of the totalitarian society, they were in no way different from other officials in the state administration. They had gone to university together, they worked together, they socialized with one another. They could also collude together. Unless there were countervailing political and legal safe-

guards—and over the past decade there have been few—this combination of feeble budgetary controls, weak administrative controls, and "old boy" cronyism engendered an inefficient, stagnant, and extremely corrupt environment.

### Remedies

What could change this situation? What forces could nudge the economy in the direction of tighter restraints on the enterprises? The first prerequisite is to deal with the huge budget imbalances and monetary overhang that remain as the macroeconomic legacy of the socialist era. Aspirations on the part of the political elite to conform to Western norms of macroeconomic stabilization require a slowdown in the rate of money creation, a reduction in the budget deficit, and the elimination of soft budget constraints (including a very hard stand against tax arrears). In Central European countries, such as Hungary and Poland, that found themselves in a similar situation, and where these aspirations were reinforced by the elite's commitment to join the European Union, governments acted resolutely and quickly to impose serious, not to say harsh, financial discipline on enterprises during the early stages of the transition. Their resolution was such that they were able to eradicate the institutionalized culture of the soft budget constraint soon after the transition began.

The Czech Republic provides an interesting example because, of all the socialist countries, it found itself in the best financial condition at the moment of the crash of the socialist economy, and its financial condition remained strong during the first years of transition. Lulled into complacency as a result of its financial advantages, the government failed to push seriously to harden budget constraints on enterprises. Despite the Czech Republic's vaunted macroeconomic efficiency, the government delayed restructuring, allowing the large state enterprises to continue to enjoy soft budget constraints during the first three years of transition and implementing a bankruptcy law only in 1993. The result of the delay was the loss of three precious years of development.

In the majority of cases, macroeconomic stabilization in the postsocialist countries is inseparable from the microeconomy. Stabilization cannot go forward without budgetary restraint at the enterprise level and a wholesale restructuring of inefficient operations. In Russia, of course, macroeconomic policy during the first years of transition was extremely weak, mainly because of a lack of political consensus and a division of political power (as evidenced by rampant inflation during those years). Inadequate budgetary and monetary constraints at the macroeconomic level combined with inadequate budgetary constraints at the enterprise level.

### Financing the budget

By the time monetary stabilization was attempted in Russia, inflation had eroded cash balances and made the financing of budget deficits all but impossible. People were sick of the prolonged inflation. The situation was quite different from what it had been at the moment of the collapse of the

socialist economy and demonstrated the folly of delaying reform.

The erosion of monetary balances by inflation made the ratio of money to GDP much lower than it would have been if disinflation had been attempted at an earlier stage. Moreover, the freedom of enterprises to accumulate tax arrears also contributed to an erosion of budgetary receipts. It was very difficult to challenge, let alone change, this firmly established habit.

The government's ability to borrow in the domestic Russian market to finance the deficit was severely limited by the lack of cash balances in the economy. Its budgetary revenues were low, both absolutely and relative to revenues in those transition economies that had begun the reform process earlier. And it seemed unable to legislate the drastic cuts in expenditures necessary for monetary stabilization. Between 1995 and the first half of 1998, the government struggled against easy budgetary restraints at the enterprise level, huge budgetary imbalances at the macroeconomic level, and weak monetary policy. It succeeded in tightening monetary policy, but it continued to struggle with its micro-economic and macroeconomic budgetary problems.

During 1995–98, the problem of tax collection was not a problem of tax administration in the usual sense. It was more a political struggle about what constituted the essence of the emerging economic system, whether it was to be a system in which the relationship between the state and the enterprises was to be regulated by law or whether it would be business as usual, based on political influence and personal contacts. The result of the struggle was what I would call a semi-equilibrium in which the budget deficit was stabilized at around 6 or 7 percent of GDP, but there was not enough political support to reduce this figure. Obviously, deficits of this magnitude are unsustainable in the long run. They can continue perhaps for a year or two, but then the government must either cut expenditures and restructure the interface between the state and the enterprises or forget about monetary stabilization. The choice is clear.

### Present dangers

Radical changes in the international financial climate since 1997 have posed a considerable threat to the Russian economy with its weak financial policies. Unable to reduce the budget deficit, the Russian government is finding it extremely difficult to finance the gap entirely by borrowing from the IMF and the World Bank. Needless to say, it is experiencing even more difficulty in finding commercial credits to finance the deficit. Its ability to borrow commercially depends on swings in the mood of the international financial markets. If these markets are optimistic and expansive, there is some breathing space, but if the mood changes, the borrower is

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caught in a very serious trap. Foreign investors are extremely wary of taking chances with an unpredictable exchange rate policy: to attract capital, you must have a transparent and stable exchange rate. Capital inflows will not occur if currency risks are not hedged.

Between the autumn of 1997 and August 1998, the Russian government faced a choice between two possible strategies. The first was to demonstrate that it had the political will to tighten the budget by reforming its relationship with large enterprises, such as those in the oil and gas sectors, through the imposition of hard budget constraints. The second was to give up, abandoning the attempt to promote anti-inflation policies. Unfortunately, the

attempt to tighten budgetary policy received insufficient political support. The result was inevitable: the continuation of soft budget constraints, soft budget policy, and soft monetary policy.

The first steps of the new government formed in September 1998 showed that it, too, very much preferred the soft budget alternative. What were these first steps? First, it negotiated tax agreements with the largest Russian taxpayers, thus institutionalizing the practice of defining tax obligations not by law but by agreement. Second, it also institutionalized a system of monetary offsets by allowing enterprises to pay taxes in kind and by forgiving the debts of enterprises in the agricultural sector.

These are not isolated initiatives. They are part of a comprehensive policy (even if the government does not recognize it) whose essence is to enable an elite to retain control over valuable properties and to continue to manage enterprises, regardless of their level of efficiency, while the state picks up the tab. This is what has been happening in Russia during the past five months.

### A word of advice

In conclusion, I would draw a number of lessons from the Russian experience:

- If the socialist economy no longer functions, the government should try to disinflate as rapidly as possible. A delayed disinflation will be much more painful.
- If the government is confronted with delayed disinflation, it should cut budget deficits radically.
- The illusion of being able to finance the deficit out of a short-term portfolio should be abandoned.
- Consideration should be given to the vulnerability of the exchange rate regime to changes in commodity prices.
- It should be understood that hardening the budget constraint is important not only for raising budget revenues but also for allowing market mechanisms to work and thus for increasing the efficiency of the economy. **F&D**