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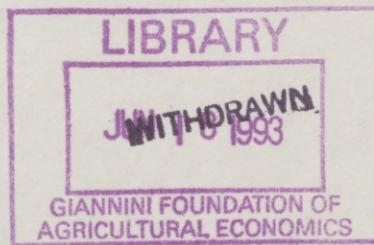
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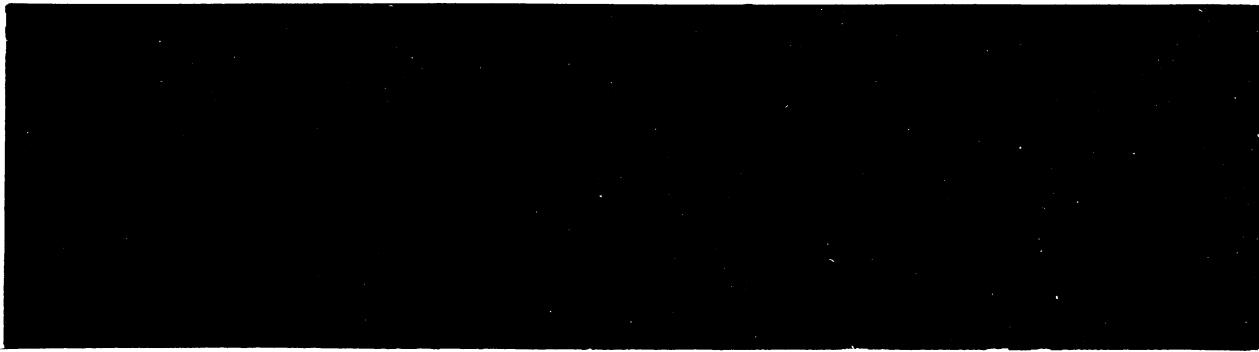
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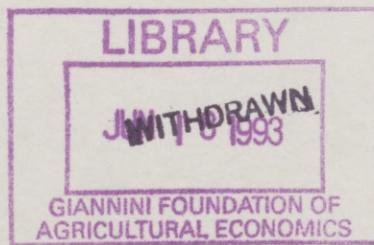


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*The Role of the State, Ownership and Taxation
In Transitional Economies*

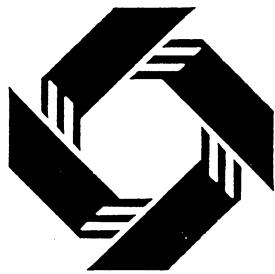
Athar Hussain[#] and Nicholas Stern*



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*The Role of the State, Ownership and Taxation
In Transitional Economies*

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The transition is discussed from the perspectives of the Chinese reforms of the 1980s and the theory and experience of taxation and tax reform in developed and developing countries. The Chinese example is not a model for other countries, but has many lessons, positive and negative. For example: (i) the payoff to providing market incentives, households and small farms can be rapid and large, without immediate privatization; (ii) "limited private ownership" may be desirable and feasible in the transition; (iii) the building of the new institutions can be a lengthy process, as opposed to macro stabilization which can be done quickly.

The transition requires a new social security system to replace that previously provided by rationed and subsidized "necessities" and by firms with their life-long employment. It also requires a new tax system to replace the reliance on enterprise profits. The "Western European" model has some rationale as a long-term goal in basic economic principles and experience at delivering the revenue. The tax system in transition may have to be rather different, however, from the long run. For example, it may be advisable to have: (i) wage or employment taxes as a precursor to the personal income tax; (ii) measures to correct errors generated elsewhere in the transition, such as gratuitous gains or losses; and (iii) measures to alleviate distortions in the nascent markets.

1. Introduction

Central to the transition from a command to a market economy is a radical transformation in the role of the state. Crucial to this transformation of the state is the re-casting of enterprises into institutions akin to firms in market economies and a restructuring of their relations with the state. The disengagement of the state and enterprise requires more than a redistribution of economic decision-making, or privatization. It involves institution-building on a large scale. It requires a complete overhaul of the public finances and, particularly, the tax system, to replace the previous reliance on enterprise profits with other sources of revenue which will not only deliver the funds in a way which is administratively feasible, but which will also keep distortions of nascent markets to a minimum. It requires the creation of a social security system with a different basis from the old regime with its extensive range of price subsidies and its reliance on firms to provide permanent and secure employment.

The purpose of this paper is not to propose a scheme of transition but to raise and discuss questions which we think have been inadequately considered in the design of packages which have been pressed on transitional economies. Their neglect is likely to expose the process to dangers and mistaken decisions which may seriously damage its prospects for success. This paper is structured around the following issues:

- the role of the state and the pace of transition (§2)
- the relation between the state and enterprises (§3)
- tax design (§4)
- taxation in transition (§5)

Conclusions are provided in §6.

The perspectives from which we discuss the transition are the study of the Chinese experience and the theory of public economics. We believe that they provide real insights into problems and opportunities which have been

ignored or underemphasised in the literature. We must make clear at the outset that we are not proposing the Chinese example, which is *sui generis*, as a model for Eastern Europe and the Soviet Union. We are simply drawing some positive and negative lessons from the experience of the reforms since 1978. More extensive discussion of those reforms are available in other papers (Hussain and Stern, 1991a and b) and we shall not dwell on the detail here. On the other hand we would argue that the theory of public economics and the long experience of taxation and tax reform in developed and developing countries do together provide a useful framework for structuring analysis of taxation in transition and the long run.

2. The role of the state and the pace of transition

The transformation of the state involves changes in its functions, particularly the levels and patterns of expenditure, the policy instruments at its disposal and its sources of revenue. These changes raise two related but distinct sets of issues: first, the eventual aim, and, second, the transition. One may take the eventual aim to be the emulation of developed market economies although, since these vary widely, such an aim begs the question of which particular pattern. However, the configuration of the state's functions, policy instruments and the public finances during the transition is likely differ substantially from the eventual pattern. Many economies beginning the transition process from a command to a market economy are handicapped by severe actual and potential disruption. Further, for a considerable time the economy will consist of a mix of institutions inherited from the command economy, and new institutions, and such an economy may require tax, expenditure and policy measures which bear only a partial resemblance to what is required in the long run.

The state in command economies differs from the state in developed market economies in two important respects: it has a much wider role in economic decision-making, especially those decisions relating to production, investment and consumption, but carries smaller responsibilities for income-maintenance, many of which are vested in the enterprises. The primary aim of

the transition is to promote economic well-being by leaving decisions on production and consumption to individual agents by allowing them to take their own decisions in markets with a minimum of government interference. From this perspective the long-run role of the state should be to provide a stable, reliable and competitive environment, basic infrastructure, elements of health and education, some social protection from the extremes of hardship, environmental protection, defence, law and order. This view of the role of the state in market economies is well-founded in economic theory and in experience (see, for example, Stern, 1991).

Command economies had neither an unemployment insurance scheme nor a comprehensive income-transfer scheme for poor households. Not that income-maintenance was not an important state objective but it was, for the most part, built into employment practices and the pricing policy for consumer goods, obviating the need for an elaborate governmental social security system. The transition will involve not merely the withdrawal of the state from certain areas of economic decision-making but also an extension of its responsibilities for social welfare.

From the point of view of public finance, transition to a market economy is essentially a complex redistribution of claims to income and responsibilities for expenditure between the state, the enterprises and households. The importance of enterprises as a tax handle is bound to diminish and the state will have to rely on a wider range of taxes so as to secure its revenue and reduce the disincentive effect of taxation. The considerations of efficiency and equity played a negligible or no role in the raising of government revenue in command economies, since it was assumed that such issues could be handled by other means, but will become central both in the transition and the long run. Some of these issues are taken up in §4 and §5 below.

The perspectives on transition to a market economy now differ widely. Following the downfall of the one-party state, most of the East European economies and the (ex or still remaining) Soviet Republics seem to have

decided to go for a rapid transition. In contrast, the Chinese are persisting with their 'long march' to a market economy, with its approach of piecemeal, though sometimes radical, reforms, whilst still maintaining features of the old command economy such as, in some sectors, output planning and the state-ownership of medium- and large-size enterprises. There appears to be widespread agreement in discussions of Eastern Europe that the two-track approach of grafting elements of a market economy to the command economy, which characterized earlier attempts at economic reform in Eastern Europe and the Soviet Union failed and, in some cases, left behind a legacy of a large foreign debt and money stock and a high inflation rate (Brus and Laski, 1988, Kornai, 1986). It is sometimes argued that such failure must logically follow from any attempt at 'mixing systems' or from any route other than the rapid one (Lipton and Sachs, 1991a and b).

Yet the Chinese economic reforms, in contrast, have been an outstanding success in terms of economic growth. Whilst, as we have pointed out elsewhere (Hussain and Stern, 1991a and b), the Chinese economy still faces serious problems which require major reforms, the economy looks set to continue on a high growth path on the East Asian pattern. In China, the combination of the command and a market economy has prevented neither the expansion of foreign trade nor the rapid growth of foreign investment. On the contrary, the Chinese performance in these fields compares very favourably with those of other developing economies in the 1980s. The purpose of our drawing attention to this contrast is not to commend the Chinese approach to the East European economies and the Soviet Republics. The initial economic and conditions are very different. Comparatively speaking, the Chinese economy was stable, when it embarked on the reform process in 1978. Moreover, political conditions are very different also: in China the economic reforms have preceded democratization which has yet to happen. The reforms have been introduced from the top and the Communist party retains its monopoly of political power. In contrast, in the Soviet Union and Eastern Europe the breakup of the traditional political order has preceded, or been contemporaneous with, the transition process. In some of these economies, the main problem is no longer pervasive government interference in economic activities and the lives of

citizens, but a breakdown of law and order and the inability of the government to take and implement decisions.

In the remainder of this section we shall both develop lessons, positive and negative, from the Chinese experience for other transitional economies, and consider other examples from historical experience relevant to the question of rapidity on the road to transition. One negative lesson from the Chinese experience is that combining elements of the command and the market economy leads to problems of coordination which become more serious with the passage of time, for example, as evidenced by the growth of black markets with the 'two-track' system of prices. Another negative lesson is that the reform of the public finances and social security should not be left, as has been done in China, for later. Rather it should be planned together with other reforms, in particular those concerning enterprise.

The Chinese example also offers important positive lessons. Prominent amongst these is that it is possible to provide, fairly quickly, economic incentives to households and small enterprises without major sell-offs and give-aways, and whilst maintaining the state industrial sector. Leaving decisions to individuals and groups and giving them a reward in the outcome can have speedy and impressive effects, without immediate and complete privatisation. A large state industrial sector does not necessarily crowd-out an incipient non-state sector. The relative importance of the state sector in the Chinese economy has decreased steadily since 1978, due not to privatization but to the fast growth rate of the non-state sector. In the short-run it is possible to use leasing and various types of contracts as a possible alternative to more radical privatization where that might be chaotic or inequitable (a point we take up in the next section). The Chinese experience also indicates that in a large economy there may be benefits in going for a geographical or sectoral decentralized approach to reforms: letting particular regions and sectors race ahead.

One cannot do controlled experiments of transitions, but the history of transitions may provide some lessons. There can be few historical analogies

to it in magnitude of the task and ambition. Yet there is one, the transformation of 'market economies' into command economies in those countries in which transition is currently underway. The current controversies concerning the speed and the sequencing of transition are mirror images of controversies about the building of a socialist economy in the Soviet Union in the 1920s and in China in the 1950s (Carr, 1979, Cohen, 1973, Fairbank, 1986). For example, the idea of making the transition in one leap is not new, on the contrary it was the favoured option of newly-established communist regimes in the past (Lewin, 1975). Some of the major economic disasters in these economies arose from the attempts to make rapid transitions either from a market to a command economy, or within a command economy. Notable examples are the wholesale confiscation of firms and productive assets in the Soviet Union between 1918-1919 (the period of War Communism), the collectivisation of land in the Soviet Union 1930s and the Great Leap Forward in China between 1958-1960 (Nove, 1969, Fairbank, 1986). It is important to note that all these disastrous attempts involved building of new institutions from scratch and radical changes in the forms of ownership.

It has also to be said that some fairly swift transitions have met with successes. But the examples of rapid transitions involving building of new institutions are few. Commonly cited are monetary reforms such as those in Germany during the 1920s and after the Second World War. The 1980s provide some notable examples of stabilization within a short period such as those in Israel (Fischer, 1986) and Mexico (Cordoba, 1991). To this list one might also add the Chilean stabilization after the fall of Allende (Edwards and Cox Edwards, 1991). It does seem that history tells us that action on rapid inflation must be sharp and dramatic if it is to be effective. Difficult as this may sometimes be, it is far easier than restructuring an economy and we cannot automatically assume that the fast route is appropriate there too.

The Mexican example, which saw substantial restructuring following stabilisation, has been singled out by Jacques Attali (1991), the President of the European Bank for Reconstruction and Development, as being of special relevance for the East European and the Soviet economy. The transformation of

the Mexican economy began following the debt crisis of 1982 and initially took the form of an orthodox fiscal policy to reduce budget deficits drastically. This was followed by trade liberalization, deregulation and, later, privatization. The success of fiscal reforms was premised upon strict government control over expenditure of public companies and on lending by state-owned development banks. In the second stage, the government eliminated price subsidies and also abolished wage-indexation so as to keep the wage-price spiral under control. The privatization process in Mexico, which followed fiscal stabilization and price liberalization, has been fairly gradual and its scope is far more limited than what is being proposed for East European economies and the Soviet Republics. Chile also saw restructuring following liberalisation and again is an example much used in discussion of Eastern Europe and the Soviet Union. But the scale of transformation is much smaller than was seen in the transitional economies in their earlier move from market to command economies and in their moves being contemplated now.

The decollectivization of agriculture in China between 1979-82 is a telling example of a successful transition from one system of economic organization to another. Within a few years, almost all collectively-owned agricultural land was parcelled out to households, and farm production grew at an unprecedented pace whilst this massive transition was under way (Lin, 1991). A central reason for the rapid success of the decollectivization of agriculture in China is that it was not premised on the building of entirely new institutions. Households as they existed provided a ready-made alternative to collective structures.

We would argue, therefore, that history would seem to suggest caution when the building of new institutions is involved, though, given the right conditions and policies, the promotion of household-based economic activities and macroeconomic stabilization can succeed within a relatively short time period.

Transition is bound to be something of a tightrope between the desire for rapid change and the protection of individuals from extreme hardship. The

possible scenarios one may want to avoid are: reversion back to some form of command economy; the concentration of economic and political power in a few hands leading to the rise of a coercive oligarchy; or a populist backlash bringing to power a government with no long-term goal (Blanchard et al., 1991, Lipton and Sachs, 1990b). We would argue that given the popular rejection of the command economy and the one party state, the likelihood of reversion to the old command economy would seem to be remote. In this respect also the Chinese example would seem to be particularly instructive. In June 1989, the Chinese leadership crushed political demonstrations by students and citizens in general by force and went on to tighten party control. Although further economic reforms were frozen and voices in favour of radical transformation of state-ownership were silenced, there was no significant attempt to reverse economic reforms. Aside from the division within the ranks of leadership about the market-oriented reforms, what stopped the leadership from reverting back to the command economy was the expectation of an adverse reaction from ordinary citizens. The market-oriented reforms brought in their wake a massive improvement in living standards for a large majority and the number of losers was small. Although particular reforms had hurt certain sections of the population and there was a widespread dissatisfaction with corruption, the economic reforms commanded general support.

3. The state and enterprises

An attempt at changing the relationship between the state and enterprises and transforming them into independent economic organizations responsible for their own profits and losses has to take into account the multifarious role of enterprises in a command economy. Amongst these, we stress in this paper the roles of the enterprise as the main tax handle for the government and as the mainstay of income-maintenance. We may think of the structure as follows. Enterprises organized their operations so as to meet plan targets, sold their output at government-set prices (which usually included a turn-over tax), handed their profits to the government and pursued recruitment and employment policies which guaranteed full-employment. Although many enterprises made a loss, the enterprise sector as a whole returned a

sizeable profit, enabling the government to keep loss-making enterprises afloat and to finance other government activities. The situation of general shortages and insurance against insolvency, provided by government subsidies to loss-makers, enabled enterprises not only to live with gross inefficiencies, but also to provide their labour forces with life-time employment. This by itself was sufficient in most command economies to rule out significant visible unemployment, a principal contingency which the social security systems in market economies have to cater for. In China the absence of visible unemployment has also depended on restrictions on migration from rural to urban areas (although leakages have produced a floating population, much of it in casual employment).

The extension of the government's responsibility for income-maintenance may go beyond the provision of an unemployment insurance scheme. Price liberalization, which is and will be a crucial component of transition, involves the abolition of price subsidies on necessities. Such subsidies have already been abolished in Poland and are being phased out in other East European economies and the Soviet Republics. Notwithstanding the high cost and waste such subsidies and rations involved, they performed an important function in income maintenance. Their abolition may call for the institution of some form of income-transfer scheme for poor households. Unemployment compensation alone would not be sufficient because, as in market economies, there will be many not entitled to it.

Changing the relationship of enterprise and state must go beyond simply taxation and social security, important as they are to the viability of the whole process. The central point of the exercise is to make the economy more efficient, dynamic and responsive to real demands and scarcities through the process of private decision-making in competitive markets. Essential conditions for the effective functioning of firms in the new structure, as emphasised in the preceding section are an infrastructure (communications, transport, power supply and the like), limitations on market power - preferably through competition but, if not, by regulation or taxation, and an incentive structure based on clear and enforced ownership rights and, again,

a tax structure. It is clear, as we shall emphasise below, that regulation, taxation and ownership should be analysed and decided together. In the remainder of this section we concentrate on the restructuring of ownership.

Much recent discussion of enterprise reforms in Eastern Europe has revolved around privatization.¹ In keeping with a broad view of ownership outlined below, privatization may be regarded as part of a wider economic transformation with two elements. The first is the shifting of responsibility of and rewards (positive or negative) from economic decision-making from the government to non-governmental agencies, including individuals and households, and the second is the disposing of state-owned enterprises through sales or give-aways. The first is essential for the emergence of a decentralized economy, and the second raises the issues of the eventual pattern of ownership of industrial enterprises, and of how that pattern is to be achieved. Given the aim of building an economy modelled on developed market economies, the aim is to transfer the substantial majority of state-owned enterprises to non-government agencies, including persons. Exceptions may be some 'natural monopolies' associated with the infrastructure.

Many have called for rapid privatization. The argument is, in part, that an immediate change of property rights is necessary if incentives are to work effectively and factor rewards are to be controlled by market processes. A more cautious view would stress possible conflicts with other considerations, including the public finances, furthering competition and controlling monopoly, and macroeconomic stability (Kornai, 1990, Newbery, 1991, Vickers, 1991). We would also argue that many discussions of privatization are based on a narrow conception of property and thus rule out a wide range of potentially useful possibilities by assumption. We attempt to broaden the discussion of ownership in what follows.

The binary opposition between 'private and public property' does not capture the full complexity of the issues involved in ownership. The term can

¹ Blanchard *et al.*, 1991, Grosfeld and Hare, 1991; Lipton and Sachs, 1990a and b, Milanovic, 1990, Vickers and Yarrow, 1991).

cover a wide range of rights and claims, including: custody or physical control; the right to manage; the right to income; and the claim to capital, including its transfer and use as a collateral. The list of rights and claims constituent of property is open-ended and depends on the social and economic context and the object of ownership (see, Honoré, 1961). Commonly in economic theory, ownership is equated exclusively with the right to the residual income and other rights relating to ownership are assumed to follow from it (Hart, 1988). It is, however, important to recognize that many rights and claims constituting ownership are separable and may be vested in different agencies and persons, as in the case of business corporations. They may also be limited in various ways. The instances of limited ownership include franchises, leases and mortgaged property, which are common in market economies but have been rare or absent in command economies. 'Limited ownership' is of special relevance in the context of transition, as it not only enlarges the policy options but also may provide a way of proceeding with 'privatization', whilst accommodating other objectives. Moreover, ownership rights may not all be *de jure*, some may be founded on social custom and trust.

Thus market behaviour could be learned and firms restructured under a temporary system. Capital markets could at the same time be established. Full transfer of ownership may then both yield more revenue, be more equitable and less likely to establish monopoly positions.

The Chinese example may be instructive here. In agriculture, the reforms have taken the form of transferring ownership rights to households for a period of 15 to 20 years rather than in perpetuity. This leaves open the possibility of revising the division of land in future whilst providing farming households with an economic stake in land. In addition to that the government has leased out small state-owned enterprises to individuals and has instituted various forms of contracts covering performance, payment of dividends and taxes in medium- and large-size state-owned enterprises. As interim measures these have worked in the sense that the economy has continued to grow. They suffer from many problems and are far from the last step in the transformation of state-ownership and they do not necessarily provide models

for adoption elsewhere. But they indicate that the possibilities for limited ownership in the transition are real.

There is, however, one aspect of state-ownership in command economies which is incompatible with the emergence of a decentralized economy founded on contracts between economic agents: the lack of a clear delineation of various ownership rights. This was not necessary in an economy built around authority and commands, but is essential for contractual relations. The problem of ambiguous property rights has been compounded in some economies by the breakdown of governmental authority and the law and order which has given rise to illegal appropriation or outright plunder. The protection of property rights by the state is essential for a well-functioning economy regardless of whether those rights are vested in the government or non-governmental agencies, *de facto* or *de jure*. Although the plunder of state property is regarded as a justification for immediate and complete privatization, the connection is far from clear (Blanchard et al., 1991). Property rights, even if vested in non-governmental agencies or individuals, will have to be protected. Plunder does not respect the division between public and private, however defined, and it is difficult to see how it could be stopped by giving away state property. What is needed is the institution of the rule of law and mechanisms for the protection and enforcement of property rights whatever form they might take.

Real benefits in terms of flexibility with stability could flow from a diversified approach to privatization, broadly interpreted to mean the transfer to non-governmental agencies of the rights to manage, part rights to income and to capital. In some cases, a complete privatization involving a transfer of all ownership rights may be immediately desirable and also feasible. This may apply to agricultural land where family farming remains, small shops and firms. The privatization of large enterprises poses serious problems, as the growing literature rightly acknowledges. Since furthering competition and the regulation of monopolies is also important for a well-functioning decentralized economy, there may be arguments for retaining some form of public ownership of medium and large-size enterprises, whilst they are

being reorganized (on industrial structure in Eastern Europe, see Ehrlich, 1985).

4. Tax design

A number of countries in Eastern Europe have declared their intention to, or have been advised to, follow a Western European economic structure as a long-term model. One description of their goal, therefore, in tax policy, is to achieve a tax system of a similar kind to those operating in Western Europe. This goal may also be implied by a desire eventually to join an enlarged economic community in Europe. Our main purpose in this section of the paper is to contrast such a tax structure with the position in other countries, including those of Eastern Europe prior to the reform, and to ask about the desirability of, and the options within, the Western European model. In so doing we shall ask also whether that model embodies difficulties, errors or omissions which the countries of Eastern Europe would be well advised to avoid. In the next section we will raise transitional questions, including whether it is sensible to attempt to move the tax system very quickly to the long-term structure envisioned.

The major sources of tax revenue in Western Europe are: the value-added tax (VAT); excises on cigarettes, tobacco and oil; the personal income tax; the corporate income tax; and social security contributions (see Table 1 for examples). On average the total tax revenue might constitute 30-35% of GDP, although there is a very substantial range. A typical breakdown might be 5-6% (of GDP) from VAT, 4-5% from excises, 8-10% from the personal income tax, 3-4% from the corporate income tax, and 8-10% from social security contributions. Thus taking social security contributions with the direct taxes, tax revenue would be divided approximately 2:1, direct versus indirect.

Interestingly, viewed at this level of aggregation (direct versus indirect), the breakdown of tax revenue is not dissimilar from the pre-transition economies where the bulk of tax revenue came from taxes on profits of enterprises and turnover taxes on those enterprises. This similarity is,

however, somewhat misleading since the source of direct tax revenue was from companies rather than households, and the sense in which turnover taxes were indirect taxes is unclear. If the output of the factory is subject to government direction, the turnover tax is unrelated to any sales or output decision that the company might make and is therefore, in one sense, like a direct tax on company profits.

The figures for Western European countries are presented in Table 1 and those for Eastern European countries in the 1980s in Table 2. Although comparisons must be rather imprecise, given the unreliability of data for Eastern Europe, the different definitions, and that the figures for Western Europe exclude some local taxes, (the figures illustrate the points we have just made). It is interesting to contrast these positions with the state of affairs in developing countries. The levels of tax revenue, as a fraction of GDP, and the makeup of that tax revenue for developing countries, varies enormously. Generally speaking, however, the position looks very different from industrial countries. On average, in developing countries the breakdown of tax revenue is 2:1 indirect and direct. Indirect taxes are split roughly 50:50 between domestic and trade taxes, whereas direct taxes are predominantly from the corporate sector. This different tax structure may be largely traced to the availability, or lack of tax handles in developing countries where, in many cases, weakness of administration is the major obstacle to raising revenue. Accordingly, the taxation of trade and the taxation of companies, both of which are administratively easier than domestic indirect taxation and taxation of individual incomes, are more important (see Burgess and Stern, 1992, for a discussion).

The different makeup of taxes in the three groups of economies may usefully be illustrated using the triangle diagram of Figure 1. The points A, B, and C in the triangle represent 100% of tax revenue from income and social security taxes, 100% from trade and other taxes, and 100% from domestic indirect taxes, respectively. A point on the line BC corresponds to a zero level of income and social security taxes, and similarly the lines AC and AB represent the other axes. It can be seen that the industrialised countries

cluster very close to the AC axis, whereas the developing countries are spread out with an average close to the centre of gravity of the triangle (i.e. where one-third of revenue comes from each category).

There are also clear differences in the levels of taxation, expressed as a fraction of GDP, both across and within different types of economy. As Tables 1 and 2 show (using figures for mid-late 1980s), there is a ranking which can be expressed as EESU > INDUSTRIAL > CHINA > DEVELOPING. The share of government revenue in GDP in China fell from roughly 40% to 20% during the 1980s as revenues from enterprises were lost in the process of the reforms and government responsibilities for investment were shed.

An interesting example of how transition affects the pattern of taxation is provided by the Chinese economy. China, at the start of her economic reforms in 1978, was like other communist countries focussed on enterprise taxation and therefore fairly close to the AC axis and the A corner. As foreign trade has increased, and along with it trade taxes, and as companies have been allowed to retain more of their profits, the tax structure in China has moved closer to that associated with developing countries and to its position near the circumcentre of the triangle but closer to the BC axis than the AC. Over time it is likely to move back towards the AC axis, but it may well be that it is the growth of personal income taxes will be driving the move rather than the restoration of profits taxes. This, of course, remains to be seen.

We may now ask how the Western European tax model squares with the economic principles of taxation. In doing so we draw on the basic lessons from the modern theory of normative taxation, as expressed through the models of optimal direct and indirect taxation. For a summary of those lessons see Atkinson and Stiglitz (1980) or Ahmad and Stern (1989, 1991), or Burgess and Stern (1992). A first lesson from that theory is that intermediate goods should not be taxed, save where output cannot be taxed or where there is some special motivation pertaining to income distribution which cannot effectively be achieved in ways other than influencing sectoral profit by taxation of

intermediate goods. Broadly speaking, a VAT-based indirect tax system is consistent with this principle. It should be noted that the same argument, when applied to public-sector pricing says that intermediate goods should be priced at social marginal cost, and final goods at this price plus an element for indirect taxation.

A second principle is that consumers and producers should pay tax on those aspects of their behaviour which have negative externalities. This can be seen as partial justification for the heavy taxation of cigarettes, alcohol and oil products. With increasing concern in relation to pollution, environmental taxation, such as that proposed for carbon dioxide in connection with global warming, may increase. Such taxes may be of great importance in Eastern Europe with its environmental problems. Such taxes enable efficiency to be promoted and revenue generated at the same time.

Thirdly on indirect taxes, we have the question of differentiation of rates. The Ramsey-type results point to higher taxes for those goods which have the greatest complementarity with leisure (the untaxed source of income). It is unlikely, however, that we can identify the relative strength of these complementarities with any confidence and the stronger arguments for differentiation are based on income distribution. If the mechanisms for redistributing income through the direct tax and transfer systems are powerful, then the arguments for differentiation on income distribution grounds through the indirect tax system are weaker. It would seem unlikely, however, that these mechanisms are sufficiently finely tuned in concept and in practice to allow the ignoring of income distribution considerations in setting the indirect tax structure. In many countries such distribution-based differentiation is provided through exempting certain important items such as food and having higher rates of VAT, or special excises,² on certain goods seen as luxuries. For administrative reasons differentiation should be avoided unless the distributional arguments are very strong.

² A higher rate of VAT would bring redistribution concerns within the VAT system (e.g. 20% VAT on yachts as opposed to 10% VAT on televisions) at the cost of complicating VAT arrangements. Special excises, parallel those on alcohol and tobacco, would require special arrangements.

The fourth principle is that domestically produced and imported commodities should be treated alike. This rules out tariffs and quotas on imported commodities, except in cases of an infant industry or where the industry is subject to static or dynamic increasing returns to scale. Even in such cases, measures which act directly on the perceived problem are likely to be preferable to tariffs and quotas. Whilst there may be an argument in favour of some tariffs in developing economies on the grounds that such taxes are easier to collect than alternatives, even here one should take care not to dismiss other sources of revenue too readily. The relative absence of trade taxes in West European economies, however, does not mean that imports are not taxed. VAT, of course, is not just on domestically-produced goods, but applies also to foreign goods. The fact that it applies equally to the two, means that there is no discrimination between domestic production and foreign imports.

One of the virtues of the VAT is that it eliminates hidden protection, so that any protectionist taxation policies need to be made explicit. However, substantial trade distortions can still be introduced through regulation, administration and quotas. One can, for example, insist on documentation so complicated that it is difficult or costly to comply. Similar tactics can be pursued using production standards or administrative procedures for imports. Restrictive practices are embodied in a very strong way in the agricultural policies of the EC and, although food is not taxed explicitly, it is heavily taxed implicitly through the high prices that European consumers pay. What we have is essentially a subsidy to producers financed by a tax on consumers.

We may conclude then from our comparison of indirect tax structures and the theory of indirect taxation that, broadly speaking, tax structures of the kind imposed in Western Europe are not inconsistent with the economic theories of normative taxation. And to this extent, the Western European model constitutes a reasonable long-term goal. Of course, consistency with economic principles would be of little value if the taxes in question could not be collected, but the excises and the VAT have shown themselves to be good

performers on this score. They do, however, involve a certain amount of sophistication and record-keeping on behalf of the tax-paying population, and this has been seen as an obstacle by some developing countries, notwithstanding the, more-or-less, successful implementation of a VAT in more than 20 developing countries (see, for example, Tait, 1988). With the high levels of education in Eastern Europe this problem may be less serious, but the more widespread and understood are coherent accounting practices, the better this type of indirect tax system is likely to operate.

On personal income taxes, theory tells us that, from the point of view of both efficiency and equity, the tax system should be global in the sense that all sources of income should be aggregated together to form the basis of personal income taxation. We leave on one side here the question of the appropriate unit (individual, family or household) and assume also that the structure of elasticities of supply for the types of work within a household do not themselves provide arguments for taxing different sources differently, although in some circumstances this may be a rather implausible assumption (there may well be an efficiency case for taxing more heavily less elastic types of labour supply). A problem with using a global measure of income for individual households is that it requires a very well developed system of checking on behalf of the authorities who must have access to information on different sources of income in a form that can be linked to the tax unit. Alternatively, it requires from income tax payers both honesty and an understanding of the system. These, of course, might be enforced by random audit and heavy penalties, but even with random audit the authorities are going to have to be in a position to trace incomes. The gathering of such information poses challenges for any economy. Information and enforcement difficulties constitute the principal reasons why so little personal income tax is collected in developing countries.

In many circumstances the theory of personal income taxation tells us that marginal rates should first rise and then fall (see, for example, Mirrlees, 1971, or Stern, 1984). This feature of falling marginal rates at higher levels of income does not seem to be observed in Western tax systems.

Indeed, many social security systems are such that marginal rates of tax are at their highest at the lowest levels of income.

Economic theory does not provide strong arguments for taxing corporate income, except as a component of personal income which should be included along with all the other elements of personal income. In this sense the emphasis in Western tax systems on the integration of the personal and corporate income taxes is consistent with theory. The reasons theory does offer for taxing corporate income, *per se*, are as follows:

1. as a means for taxing monopoly rents (although these are very difficult to identify);
2. as a means of taxing foreign income
3. to prevent the emergence of capital gains which would be associated with the removal of such a tax, gains which might have undesirable redistributive consequences.

This last argument does not, of course, apply when there is no income tax present and is not an argument in favour of introducing it. Withholding the personal income tax at the corporate stage is a convenient method of collecting part of the personal income tax, but does not constitute a theoretical reason for taxing corporate income separately.

Broadly speaking, the income taxes of the Western European system are consistent with theory in parts, although we can be less strong in this assertion than we can for indirect taxes.

Before leaving the Western European tax systems with this apparently (fairly) good theoretical bill of health one must also ask whether they have any major holes or defects, that is whether there are goods, activities or incomes which could usefully be taxed, but which are not, or which are treated in particularly problematic ways. This concern applies particularly to the taxation of property (land and buildings). Most Western European countries make a mess of property taxation for various historical reasons. Most notably in the UK we have seen the confusion over the local tax system which moved, at the end of the 1980s, from property taxes (land and buildings) to head

taxes, the so-called poll tax, and which looks as if it will be moving back to property taxation in some form again. Property taxation provides opportunities which may be very valuable to the Eastern European countries and which should not be missed. Revenue from property taxation could be, and probably should be, very important. Property (including land) taxes have the virtue of being attractive both from efficiency and distributional perspectives since elasticities of supply are low and the value of property owned is strongly related to wealth. Further the tax base is fairly easy to measure, at least relative to other taxes.

The revenue potential of a property tax is also, in principle, substantial. One may gain a quantitative feel for its potential from the following calculation. The ratio of the value of private houses to average household gross incomes in the UK has generally moved in the range of 3 to 4 over the last few decades (Hills, 1991). Let us take it as 3.5 for the purposes of the calculation. If the asset yields a real rate of return of 5-6% (imputed or realised income plus capital gain) then the imputed income from owner-occupation would be of the order of 20% of personal incomes. Taxation of that income at a rate of 20-25% would yield 4-5% of personal incomes in property taxation, or 1% or so of property values. In fact in the UK in the late 1980s domestic rates were around 3.8% of gross household incomes (UK Government Economic Trends, 1987, 1988). To domestic property should be added commercial property, also of considerable revenue potential. The ratio of house prices to incomes in the UK does not seem to be an outlier compared to other European countries (it seems a little lower in France and a little higher in Germany, see, for example, Nationwide Anglia Bulletin of House Prices in Europe, 1987). Property provides a substantial tax base which transitional economies would be unwise to ignore.

Even if the Western European model of taxation is adopted, there are a plethora of other decisions that have to be taken. The level of taxation varies greatly across countries. It may be anything between 20-40% depending on how ambitious the country is with social security systems (including pensions), investments in infrastructure, public health provision, and so on.

Within that system there are many rates and bases which have to be decided. A tax and transfer system can be more or less progressive over a very substantial range. The tax unit has to be defined. Is it going to be individual, family, household, or what? These are very basic and important decisions even within a standard overall model, and one cannot regard the Western European blueprint as in any way settling the greater part of the important issues.

The questions of taxation and ownership cannot be separated, either in the transition or in the long-run. And both are intertwined, as regards revenue, incentives and distribution, with regulation. The important example of profits taxation illustrates the point. A 50% profits tax, with full loss offset, has the effect of splitting profits and losses between the state and private owners of the firm in the proportion 50-50. In the sense of rights to residual income it is like 50% ownership. Such a tax also, of course, shares risk in the same way. This illustrates that it makes little sense to see the question of ownership in isolation from taxation. Changes in one dimension can, in large part, be negated by changes on another. Fortunately this also means that mistaken policies in one area can also be corrected, in part, in the other.

Similar issues arise with regulation. If industries are privatised into monopoly positions then regulation may have to be used as a substitute for market discipline. Whilst the discipline of market competition, be it domestic or foreign, may be desirable, there are many situations in which it would be unlikely to work unaided. The obvious need for regulation has been recognised for the privatised telecommunications, gas, water and electricity industries in the UK. Some forms of regulation again act like taxation in their effect on which costs may be passed on, what rates of return are permitted and so on. These limitations on rights of privately-owned firms to take decisions on their own affairs again indicates the narrowness of the discussion of property rights if confined to residual income.

5. Taxation in transition

We shall approach the analysis of taxation in transition by asking whether there are transitional issues in taxation which might mitigate in favour of a different kind of tax system from that associated with the long-term model. It is clear that to go straight for the long-term model provides economy in decision-making and, possibly, a secure tax system in which private agents can take decisions. Further it provides a structure which may be well understood by potential foreign investors and collaborators. On the other hand, there are important problems which arise in the transition which could, in principle, be alleviated at least in part by certain interim tax measures. These involve: special incentives during the transition; distortions; uncertainty; risk bearing; political capabilities; and administrative capacity. We shall raise and discuss several here. It will be a matter of judgement whether they, separately or together, constitute an argument which would justify different kinds of tax measures in the transition from those anticipated in the long run. We would be of the view that some simple interim measures are necessary.

We begin with arguments associated with incentives and distortions. It may be claimed that lack of experience with market mechanisms and profit-seeking may imply that stronger incentives are necessary in transition than would be associated with a price mechanism in a mature market economy. Thus it may be suggested that special interim incentives are needed. These special incentives could, for example, take the form of protective tariffs, following standard infant industry arguments. One would be arguing that entrepreneurs and other participants in the profit-oriented processes who are learning that part of their trade need some protection whilst doing so. Similar considerations might apply to those learning new technologies and work practices. The 'infant industry' argument has been commonly advanced in favour of protection in developing countries. Whilst it has some validity, there is no doubt that it has been much abused and that, once established, protection is difficult to remove because of the strong vested interest it creates. Further, restricting international trade may reduce transfers of technology and management ability from abroad reduces pressure to reform inefficient practices. It should also be remembered that there are other ways

of getting over learning problems (for example, by identifying the lack of, and supporting the creation of, certain skills) and any risk aversion which may be associated with them. One could, for example, go for joint ventures with foreign companies - a technique which seems to have had some success in China. One can import particular skills that are missing, for example through consultancy and technical assistance operations.

There may be grounds in the transition for introducing tax measures to compensate for distortions elsewhere. Certainly this is what the theory of optimal taxation in the presence of distorted markets would suggest (see, for example, Drèze and Stern, 1987). There is a basic theoretical principle that it is better to try to remove distortions at source than try to compensate for them elsewhere but, notwithstanding the importance and validity of this canon, there is no doubt that in the transition, many of the distortions will remain. How far the 'tuning' of other taxes which might compensate for these distortions should go, relative to, or along with, attempts to remove the distortions themselves is a difficult question. In the transition the price system will work inefficiently. Whilst some firms will gain short-run monopoly positions, others will be at risk of going bankrupt when, in the long run, they are socially and financially profitable. Special short-run tax measures or price control, on monopolies might be justified, or price control. There may also be arguments for special loans to companies which may have short-run difficulties but a long-term future where such short-run difficulties arise from an inadequacy of markets. The problem here, of course, is in achieving a reliable administrative structure which would honestly make and administer such decisions. The potential for special pleading, undue preference and corruption is clearly substantial.

The next pair of transitional considerations concerns errors and uncertainty. There is no doubt that there will be many public policy errors made during the transition processes. There are so many decisions to be taken and so little experience in taking them. One should, therefore, look for a tax system which has sufficient flexibility to correct for mistakes which might emerge. One conclusion might be to seek privatisation through 'limited'

ownership such as leases to run activities or control resources for short periods, for example in housing. Housing, in particular, may be privatised in ways which create large windfall gains. One may consider capital gains taxation which could in part correct for these. Another form of error-correcting mechanism could be price regulations where monopoly positions are privatised and the monopoly is not controlled by competition as rapidly as might have been hoped.

Risks in economic activity may be considerably higher during the transition and risk-bearing institutions very weak. In these circumstances there may well be a role for government in trying to distribute risk. One way of doing this, as we have remarked, would be to introduce 'loss-offset' in the corporate tax system, thus providing the government with a share in the downside as well as the profits tax which provides the government with a share on the upside. Loss offset may work through companies offsetting one loss making activity against another more profitable one, but this may not function so well in transition economies where profits from other areas may not be sufficient to produce tax benefits from loss elsewhere. It might be possible, for example, for the government to compensate directly or for tax losses to be sold.

There is a further group of arguments concerning political capabilities and instabilities. It might be suggested that the fundamental constraint on policy-making is the ability to take political decisions. If this is the case, then it could be claimed that the long-run solution should be imposed immediately because the system will be incapable of a stepwise approach. Against this must be set problems of political instability where a very radical change may involve individuals in losses and shocks which lead them to strong political opposition.

Administrative capabilities place constraints on tax systems throughout the world and may be particularly severe in transitional economies. These economies have advantages over many developing countries in that education is much more widespread so that some degree of accounting proficiency could be

learned quite quickly. This is not yet present, however, and it may be a mistake to force through tax systems which require that kind of accounting facility before it is available. It is for this good reason that McLure (1991) has suggested a simple form of interim taxation of incomes where no attempt is made initially to link company and personal income tax. He calls it the Simplified Alternative Tax (or SAT). The personal income tax would be largely withheld at source with some simple personalisation for household circumstances. No attempt to 'globalise' income would be made, so that, for example, there would be no taxation of interest or divided income. The enterprise tax would be as simple as possible with complicated depreciation allowances replaced by immediate deduction of all business purchases and no deductibility for interest payments. It is argued that, as well as having the virtues of simplicity, the SAT would promote savings (by households since interest income would be untaxed) and investment (by firms since there would be full deductibility of investment spending).

Erstwhile command economies may be at an advantage relative to other poor countries as regards personal income taxation in that the earlier systems of social control presumably left rather good information on individuals' identities and whereabouts of a kind that would not be available in countries with similar incomes per capita but different histories. They also have higher levels of literacy. On the other hand it will take a considerable time to build income tax administrative capabilities of the kind found in Western Europe.

Major problems with administrative capability are likely to arise from the skills enterprise managers have developed in the past of avoiding and getting round central controls and edicts. Many managers, it seems, became highly developed manipulators and evaders of the enforcement system, and such habits may die hard. This will raise a major challenge for taxation and may mitigate in favour of the simpler, more directly observable bases - perhaps connected with outputs and employment which are more easy to measure than profits. Where different forms of income are taxed at different rates, for example, or there are major loopholes (through untaxed payment in kind, for

example) there may be great opportunities for managers and workforce to collude in avoidance. These could arise even within the simple system proposed by McLure. These difficulties would be in addition to those associated with dishonesty or corruption. An employment or wage tax to be paid by employers might have very similar economic properties to a simple personal income tax. At the level of economic analysis it makes little difference whether the difference between the cost of employment perceived by the employer and the take home income of the employee are called employment tax (paid by the employer), social security contributions (paid by both) or personal income tax (paid by the employee). Political perceptions may, however, differ and for this reason, together with administrative feasibility, an employment tax deserves serious consideration as an interim measure. Similarly simple output or turnover taxes might be retained until the system is 'ready for a VAT'.

Finally, we turn to more aggregative questions of the bases for taxation and the magnitude of revenue and expenditure. There is no doubt that the strains on the budgetary position for countries in transition will be severe. An attempt to move very rapidly to a long-run tax system may lead to major problems of collection in the short run which will be superimposed on low tax revenues, associated with a depression, and high expenditures associated with unemployment. In these circumstances revenue from privatisation should not be discarded lightly through giveaways (explained by 'problems of valuation' or otherwise) or excessive haste. Shorter-run contracts which allow some continuing capital in state hands might allow, for example, a country to borrow abroad on the strength of this capital stock, which is to be privatised in the future when markets improve. The housing stock might well provide an important example in this context.

At the same time one must take care not to exaggerate the revenue potential from privatisation and attempts to realise it quickly may make it even smaller. The following considerations suggest the limitations. Let us suppose we value a firm at twice its turnover (or, say, 6 to 8 times profits). If the whole of GNP came from saleable enterprises, the maximum revenue

available would be twice GNP. However of the order of half or more of income may be generated in ways which are not directly or easily saleable as firms because of the nature of the activities (including large parts of the service sector, parts of agriculture and so on). In addition (i) the condition of much of the capital is likely to be poor, (ii) the capital may be associated with activities that could not profitably survive in the new regime, i.e. the capital may be worthless and the firms may be essentially bankrupt, (iii) the very large uncertainties in the new order will make values considerably less than discounted future profits given that insurance markets are poorly developed, (iv) the weaknesses of capital markets will hamper the ability to finance purchases even if some companies look profitable, and (v) expectations of profits taxes will lower capital values. These considerations together suggest that $\frac{1}{4}$ of GNP would be a rather optimistic level of total receipts from privatisation even if all possible sales took place. Note that revenues from the privatisations in Chile after Allende reached a maximum level of 3.5% of GNP in one year (Vickers and Yarrow, 1991) and much of that was later lost in bad loans. It looks unlikely, therefore, that revenues in any one year would exceed those from excises on tobacco or alcohol, and these latter would, of course, be gained annually whereas those from privatisation would last for only a brief period.

On the basis of the calculations on housing presented in the previous section, rents of the order of 20% of income might be charged for houses retained in the public sector. This is likely to exceed substantially the annuitised value of revenue from houses privatised in a hurry at low prices, even if property taxes are successfully imposed.

There will also be important issues in adjusting to changes in bases of taxation. It may well be that, in the short run, transition sees a swing in favour of wages and against profit, as was experienced in China. In these circumstances one wants to have a tax system of sufficient breadth so that it is not subject to the kind of volatility and uncertainty likely to be associated with changing bases. This would put some form of wage taxation high on the agenda so that movements from profits to wages (or vice versa)

would not destabilise revenues.

Finally we should draw attention to the policy question of the appropriate size of the deficit. If the structural transition is fast then lags from a new tax system combined with low tax receipts and high expenditures associated with economic dislocation may cause a severe problem. At the same time there should be a high priority given to establishing the health of the public finances quickly, since experience has shown the perils of high deficits and debt (and this may call for interim measures). There is a fundamental question, then, which is closely connected with the pace and nature of adjustment of the tax/expenditure system, of how much a country should borrow.

There will also be special needs for investment in infrastructure. It is now common for the IMF, for example, to adjust permitted borrowing limits for developing countries to allow for investment in infrastructure which is held to be productive to either the private or the public production sectors in the future. In other words there may be international acceptability to borrowing on projects which make a high long-run rate of return. There is, as ever, the bankers' problem in judging whether the environment for economic activity and project management will be of the kind which will lead to such productivity gains actually occurring. In any case a careful conceptual analysis of the appropriate level of borrowing would seem to be a high priority.

The arguments above bring out the important lesson (as we saw for tax design) that questions of taxation, ownership and regulation must be seen together. We may decide, for example, to proceed more quickly on ownership change if we have more flexible tax and regulation tools. These could be used to realise revenues and mitigate those mistakes concerning windfall profits and monopoly positions which are bound to arise in the process of ownership change.

6. Conclusions

We have approached the analysis of transition by asking what role is perceived for the state both during the process of transition and as a long-term goal. In doing this we have drawn on the experience of the Chinese reforms and on the theory and practice of public economics. Both the Chinese experience and the reform of the public finances have received insufficient attention in discussions of East European countries and erstwhile Soviet Republics. These perspectives provide real lessons and warnings.

Transition from a command to a market economy is a process of the withdrawal of the state from economic decision-making, but also one which is charted and steered by the state. This somewhat paradoxical role confronts economists and policy makers with the problem of coping with economic dislocation, whilst building the new institutions needed for a decentralized economy. As far as the East European countries and Soviet Republics are concerned, an influential view seems to be that piecemeal reforms soon peter out and attempts at combining a market economy with the ownership structures and the forms of government control inherited from the past even temporarily is doomed to failure.

Yet, the Chinese reforms would seem to cast doubt on these assumptions as being incontrovertible. The Chinese experience suggests the following:

- piecemeal reforms can, cumulatively, produce some successes;
- the pay-off to providing market incentives can be rapid and large even without immediate privatisation;
- it is possible for the household and the private sector to prosper, in the presence of a large state industrial sector;
- the combination of old-style planning and markets creates problems of coordination which worsen over time, but it can help to reduce uncertainty and maintain stability in the initial stages of transition;

- if economic reforms bring tangible benefits to a majority of the population, whilst protection is offered to the losers, a constituency in favour of continued reforms can emerge;
- the reform of the public finances and the institution of a new social security system should be contemporaneous with enterprise reforms rather than left for later.

The arguments in favour of comprehensive reforms with a 'big bang' are regarded by many as compelling. Yet the historical experience of attempts at a rapid transition from one economic system to another seem to indicate they take much longer than envisaged and can inflict a heavy cost arising from severe economic and social dislocation. It is important to draw lessons from the historical experience of the building of command economies in the same economies where transition is now taking place - an experience which parallels the magnitude of 'social engineering' involved in the transition to a market economy. Some of the major policy-induced economic disasters of this century are associated with the attempts to institute public ownership or redirect the economy with a big bang.

Central to the transition is a radical transformation of relations between enterprises and the state and the recasting of enterprises into market firms. This transformation has to take account of the multifarious role of enterprises in a command economy and requires more than a devolution of economic decision-making from the government to enterprises, as in the earlier economic reforms in Eastern Europe and the Soviet Union, or privatization (with the attendant risk of bankruptcies), as envisaged in the current policy packages for transitional economies. It also requires the institution of a social security system to cater for contingencies arising from the replacement of permanent with terminable employment and the ending of price subsidies on consumer goods. Moreover, a radical overhaul of the tax system, which is heavily dependent on enterprises, is also needed.

Discussions of privatization in transitional economies have often been

based on a rather restrictive opposition between 'private and public property', foreclosing, by default, many possibilities open to transitional economies. Instead we have adopted a broader view of ownership as a combination of diverse rights and claims, which may be vested in different agencies and persons and may be limited in certain ways. 'Limited ownership' such as leasing and franchising, which are widely used in market economies, suggest that policy options for a transformation of ownership are very wide. 'Give aways' of permanent rights may squander public assets and court the risks of chaos and macroeconomic destabilization.

The broader view of ownership brings out the relation between it, taxation and regulation. For example profits taxation at 50% with loss-offset is equivalent to 50% ownership, in the limited sense of right to income and liability for losses. Similarly, a capital gains tax of, say, 25% is equivalent to the government retaining a quarter claim to (or 25% equity in) the capital value on realization in excess of the initial sale price. These equivalences suggest that the retention of part claim on income or capital by the state can be substitutes for income and capital gains taxes and may in certain cases be easier to institute than corresponding taxes. Moreover, such ownership claims may be combined together with government liabilities for a part of losses so as to distribute risks between the state and economic agents.

Similarly, there are also important connections between regulation and taxation. For example, some forms of regulation are close to profits taxation. For example, price regulation with a view to controlling monopoly profits is akin to an excess profits tax. A tax-based incomes policy, which is used in a number of transitional economies in the form of an excess wage tax, provide a another instance of close similarities between regulation and taxation.

The aim of Eastern European countries and many former Soviet Republics is to fashion their economies on the 'Western' pattern. Western market economies, however, exhibit an enormous range in the level and scope of government activities and their finance and to elect for the tax systems

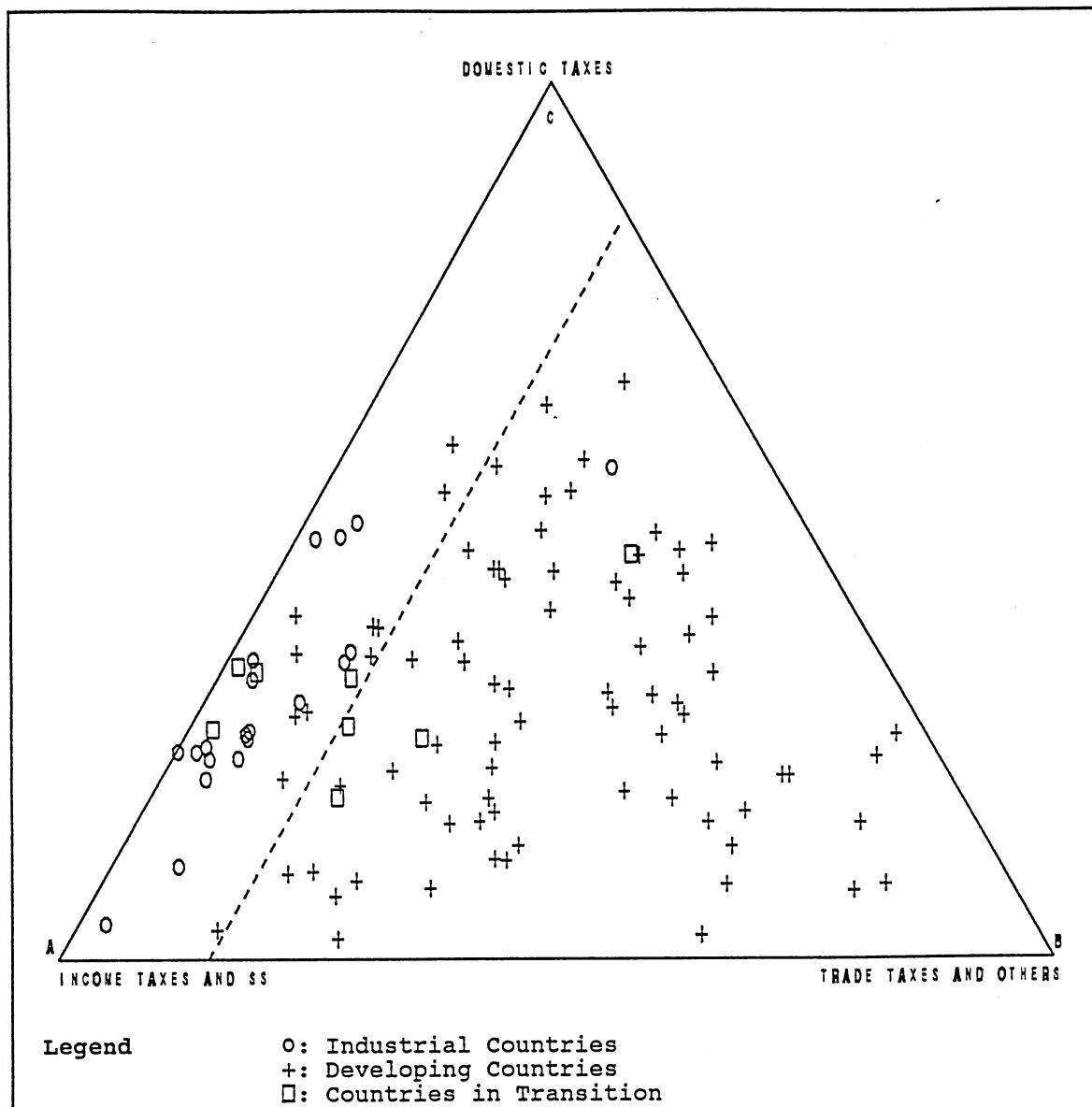
associated with these economies leaves a wide range of vital issues unsettled. As we have shown, there are good arguments for emulating Western European tax systems especially in the field of indirect taxes and with some qualification in the case of income taxes. But these tax systems suffer from major defects when it comes to property (land and buildings) taxes. There is ample room for innovations in property taxes open to transitional economies. Such taxes commend themselves on the grounds of efficiency and equity and are easier to collect than a range of other taxes.

Public finance measures in the medium term should be related to the guiding of the transition as well as to the usual criteria of revenue, equity, efficiency, and administrative convenience which guide the long-term design. The trade-off between revenue and distortion which is central to tax issues in most economies will have important dynamic aspects here. In the initial phases of transition, some of the considerations important in market economies such as the interface between personal and corporate taxes will not be of great importance strong relevance. Instead raising enough revenue in the face of an erosion of the traditional tax base such as enterprise profits and reducing particular types of inequities such as large personal gains through exploitation of gaps in the system may be paramount. Some of the new taxes such as the personal income tax may have to be initially introduced in a piecemeal fashion such as via an employment tax, social security contributions or a levy on benefits in kind such as heavily subsidized housing. They could later be consolidated as part of a personal income tax. Moreover, there may be justification for holding some of the rules of good taxation, such as no taxes on intermediate inputs, in abeyance so as to correct for price distortions and to get an indirect handle on incomes which may otherwise escape taxation.

Central issues for taxation in transition include: the relationships between tax policies and the market distortions which will no doubt persist into the medium term; measures to deal with medium-term hardship of both enterprises and individuals in restructuring; the new distribution of income and wealth which will emerge, much of which may be gratuitous and chaotic; and

deficiencies of record-keeping, accounting and administration where new methods have to be learned and implemented. The arguments for transitional tax measures must be examined very carefully and one should not assume that the only sensible route is to go straight for the desired long-term structure, even if one was clear as to what that was. The instantaneous route for taxation, as with other aspects of the transition, appears to carry with it many perils and pitfalls.

Figure 1: Breakdown of tax revenue by type:
industrial and developing countries



Notes: 1. This is adapted from a figure in Burgess and Stern (1992). We are grateful to Tony Atkinson, Robin Burgess and Stephen Howes for advice and help with the diagram.

2. The dotted line represents 15% of tax revenue from trade and other taxes. The only industrial country to the southeast of the 15% line is Iceland. The transitional country close to the Icelandic position is China.

3. Sources: Industrial and developing countries - Burgess and Stern (1992), China - World Bank (1990), East Europe and USSR - Tanzi (1991).

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TABLE 1 TAX REVENUE BY TYPE OF TAX (PERCENT OF GDP)

Industrial Countries	GNP per Capita (1987 \$a)	Years		Income Taxes				Domestic Taxes on Goods and Services				Foreign Trade				Other Taxes			
				Total Taxes	Individ- ual	Corpo- rate	Other	Total	Gen. Sales, turn- over, VAT	Excis- es	Other	Total	Import Duties	Export Duties	Other	Social Securi- ty	Wealth & Propre- ty	Other	
Switzerland	21310	1985	1987	19.62	3.00	2.45	0.55	0.00	4.02	3.03	0.65	0.34	1.51	1.51	0.00	0.00	10.20	0.88	0.00
United States	18580	1986	1988	18.45	10.39	8.58	1.81	0.00	0.75	0.00	0.61	0.14	0.34	0.34	0.00	0.01	6.81	0.17	0.00
Luxembourg	17780	1984	1986	38.84	16.24	11.07	4.83	0.33	9.94	5.35	4.14	0.45	0.03	0.03	0.00	0.00	10.33	2.25	0.05
Norway	17450	1985	1987	38.41	9.31	3.96	5.35	0.00	18.34	9.51	6.92	1.92	0.25	0.23	0.02	0.00	10.00	0.43	0.08
Iceland	16890	1983	1985	22.57	2.40	1.81	0.58	0.00	12.62	8.36	2.36	1.90	4.07	3.84	0.01	0.22	1.24	2.19	0.06
Japan	15840	1985	1987	20.69	8.57	4.77	3.79	0.00	2.19	0.00	1.91	1.28	0.19	0.48	0.00	0.00	8.54	0.74	0.47
Sweden	15613	1986	1988	37.59	7.55	5.38	2.11	0.10	12.68	7.39	4.54	1.74	0.23	0.23	0.00	0.00	12.89	4.22	0.03
Canada	15070	1986	1988	17.32	10.13	7.96	1.93	0.24	3.56	2.40	1.04	0.11	0.78	0.78	0.00	0.00	2.85	0.00	0.00
Denmark	14910	1986	1988	36.34	15.76	12.10	2.29	1.37	17.45	10.16	4.85	2.44	0.03	0.02	0.00	0.00	1.54	1.58	0.00
Finland	14670	1985	1987	27.03	9.21	8.61	0.59	0.00	13.40	8.28	4.62	0.50	0.25	0.25	0.00	0.00	2.99	1.11	0.08
Germany	14440	1986	1988	27.44	5.12	4.06	1.06	0.00	6.49	3.80	2.34	0.36	0.00	0.00	0.00	0.00	15.77	0.05	0.00
France	12910	1986	1988	38.25	7.32	4.98	2.31	0.03	12.17	8.63	2.61	0.94	0.01	0.01	0.00	0.00	17.41	1.27	0.07
Austria	11970	1985	1987	31.74	6.62	5.44	0.99	0.19	9.29	6.19	2.39	0.71	0.49	0.48	0.01	0.00	12.80	2.14	0.39
Netherlands	11790	1986	1988	45.75	13.11	9.57	3.54	1.00	11.06	7.82	2.56	0.68	0.00	0.00	0.00	0.00	20.32	1.06	0.20
Belgium	11470	1985	1987	43.09	16.66	13.92	2.73	0.00	10.17	7.20	2.14	0.83	0.01	0.01	0.00	0.00	15.37	0.88	0.00
Australia	11180	1985	1987	24.87	16.88	14.05	2.54	0.30	6.46	2.39	4.02	0.05	1.39	1.33	0.03	0.02	0.00	0.14	0.00
United Kingdom	10540	1985	1987	33.64	14.49	10.23	4.26	0.00	11.45	6.03	4.56	0.86	0.02	0.02	0.00	0.00	6.85	0.81	0.01
Italy	10430	1986	1988	37.75	13.69	11.08	2.57	0.03	8.60	4.83	2.47	1.30	0.01	0.01	0.00	0.00	14.05	0.78	0.63
New Zealand	7870	1985	1987	33.63	22.95	19.64	3.05	0.25	8.53	4.87	3.23	0.43	1.33	1.28	0.03	0.02	0.00	0.79	0.04
Ireland	6290	1985	1987	37.29	14.24	12.81	1.43	0.00	13.03	3.01	4.02	1.00	3.08	3.38	0.00	0.00	5.58	1.36	0.00
Spain	6010	1984	1986	25.20	6.43	4.94	1.45	0.05	5.85	2.89	1.48	1.48	1.06	1.05	0.00	0.00	11.39	0.45	0.03
INDUSTRIAL	13477	--	--	31.21	10.96	8.45	2.37	0.14	9.43	5.58	3.02	0.83	0.72	0.70	0.00	0.01	5.90	1.11	0.10
DEVELOPING	1241	--	--	18.05	5.51	2.08	3.29	0.40	5.21	2.46	2.07	0.68	5.13	4.32	0.62	0.20	1.30	0.45	0.54

Source: Burgess and Stern (1992).

TABLE 2 GENERAL GOVERNMENT TAX REVENUE OF TRANSITIONAL ECONOMIES, 1986 (PERCENT OF GDP)

	Bulgaria	Czecho-slovakia	Hungary	Poland	Romania ³	Yugo-slavia	USSR	China	OECD
Profit taxes	18.7	25.1	11.1	11.0	13.5	6.4	16.0	7.1	3.0
Income taxes	4.0		0.8	3.8	6.0	8.6	3.9	⁴ 0.0	12.1
Social Security contributions	9.7	5.9	16.6	10.3	7.2	8.1	3.3	0.0	9.3
Turnover taxes	16.5	15.9	16.7	11.6	9.8	6.8	11.5	10.7	11.5
Customs duties	0.5	0.7	3.5	2.8	0.9	1.8	7.2	7.0	--
Other	0.2	1.0	3.5	4.1	--	5.0	3.8		2.2
<u>Total</u>	<u>49.6</u>	<u>48.6</u>	<u>52.2</u>	<u>43.6</u>	<u>37.4</u>	<u>36.7</u>	<u>45.7</u>	<u>24.8</u>	<u>38.1</u>

Sources:

Tanzi (1991) and World Bank (1990) for China.

³ 1988.⁴ These exist but are negligible.

