

# **Fiscal Policy and Capital Formation in Transition Economies**

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**Abstract**

The paper discusses the relations between fiscal policy, savings, capital formation and growth in transition economies. In the 1990s they have suffered significant recession and persistent imbalances. Fiscal policies were aiming mainly at the structural adjustment, liberalization and stabilization. The issue of capital formation has been somewhat overlooked. Lately, in the countries advanced in transition, capital formation is gaining momentum. It is based on growing domestic savings, yet the nondebt flow of foreign capital is important, too. Policies facilitating sustainable growth ought to target a shift from direct to indirect taxation, thereby gradually reducing the corporate tax burden and narrowing the personal tax brackets and widening the tax base.

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## SUMMARY

In the 1990s the transition economies of Eastern Europe and the former Soviet Union have suffered significant recession and persistent imbalances. Over ten years of vast changes GDP has contracted significantly and income inequality increased, too. In several countries post-socialist depression still continues. Whereas in the best example, that is Poland, GDP in 1999 is at about 120 percent of pre-transition level of 1989, in the countries involved in ten years lasting depression, for example, Russia or Ukraine, it is around meager 30-40 percent.

During transition the fiscal reforms and policies have been aimed mainly at the structural adjustment, liberalization and stabilization. Hence the issue of raising the propensity to save and enhancing capital formation has been somewhat overlooked. The main concern of fiscal policy was overhauling the public finance system and tax regime in a way facilitating the needs of emerging market economies. A number of new taxes has been introduced, including personal income tax and VAT. Owing to the shrinking output and despite the attempts to widen the tax base, the revenue were not sufficient to cover even downward adjusted expenditure. The government budget deficits do remain.

Yet lately, especially in the countries which are well along in transition and already on the path of growth, capital formation is gaining momentum. It is based on growing domestic savings. Their increase is a function of growing real income, however fiscal measures, that is, the structure of taxes and accompanying system of deductions and other intensive, are helping to raise the marginal propensity to save and therefore the investment in fixed capital.

The nondebt flow of foreign capital plays an important role, too. Whereas in emerging post-socialist markets the strategy for sustainable development must rely essentially on domestic savings, the foreign savings—especially long-term capital flowing as direct foreign investments—are also of significant importance. Thus the fiscal policy should encourage such a flow of capital.

Policies facilitating sustainable growth ought to target a shift from direct to indirect taxation, thereby gradually reducing the corporate tax burden and narrowing the personal tax brackets and widening the tax base. In the countries that are following such direction and sequence of fiscal reforms, the recovery had come earlier and the growth is stronger. This process calls for sound institutional building, since for transition to succeed the new institutional arrangements are as important as liberalization and privatization.

During the ongoing process of catching-up in the areas of development and growth, fiscal policy must play a more active than so far role in capital formation. After initial period of transition and the first ten years of creating new economic framework, there is henceforth a time to use more actively fiscal measures as the means for capital formation and the factor imperative for sustainable development, including higher investments in human capital.

## I. OUTCOMES OF THE FIRST DECADE OF TRANSITION TO A MARKET ECONOMY

1. The first decade of post-socialist transition to a market economy has been rather disappointing endeavor. **The expectations of durable growth and improvement of the standard of living have not been met.** Only a few countries were able to overcome the pre-transition level of output. If measured in terms of GDP, after ten years of transition process, that is, in 1999, one may expect that the level of national income from 1989 will be exceeded only in 3 out of 27 countries (Table 1). Yet it must be noticed that the composition of the output has changed significantly and in the meantime the quality of the products, together with the removal of the shortage phenomenon, has improved remarkably. In some leading in transition countries, for example, the Czech Republic or Slovenia, as much as about two third of foreign trade is now with the European Union and up to 80 percent with the OECD countries (IMF 1998, OECD 1998).

**Table 1: Growth in Real GDP in Transition Economies, 1990-98**

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1997 (1989=100)	1998 (1989=100)
Albania	-10.0	-27.7	-7.2	9.6	9.4	8.9	9.1	-8.0	10.2	79.1	87.2
Armenia	-7.4	-10.8	-52.6	-14.8	5.4	6.9	5.8	3.3	5.7	41.1	43.0
Azerbaijan	-11.7	-0.7	-22.6	-23.1	-18.1	-11.0	1.3	5.0	7.9	40.5	43.6
Belarus	-3.0	-1.2	-9.6	-7.6	-12.6	-10.4	2.6	10.0	4.2	70.8	71.2
Bulgaria	-9.1	-11.7	-7.3	-1.5	1.8	2.1	-10.9	-7.4	3.5	62.8	65.0
Croatia	-6.9	-20.0	-11.7	-0.9	0.6	1.6	4.3	5.5	5.5	73.3	77.3
Czech Republic	-0.4	-14.2	-3.3	0.6	3.2	6.4	3.9	1.0	1.4	95.8	97.1
Estonia	-8.1	-7.9	-14.2	-8.5	-1.8	4.3	4.0	10.0	6.4	77.9	82.8
Georgia	-12.4	-13.8	-44.8	-25.4	-11.4	2.4	10.5	10.0	7.2	34.3	36.3
Hungary	-3.5	-11.9	-3.1	-0.6	2.9	1.5	1.3	4.3	5.4	90.4	95.2
Kazakhstan	-0.4	-13.0	-2.9	-10.4	-17.8	-8.9	1.1	1.8	1.4	58.1	59.0
Kyrgyzstan	3.0	-5.0	-19.0	-16.0	-20.0	-5.4	5.6	10.4	3.0	58.7	60.2
Latvia	2.9	-8.3	-34.9	-14.9	0.6	-0.8	2.8	6.0	6.0	56.8	60.3
Lithuania	-5.0	-13.4	-37.7	-17.1	-11.3	2.3	5.1	5.7	5.0	42.8	45.0
FYR Macedonia	-9.9	-12.1	-21.1	-8.4	-4.0	-1.4	1.1	1.0	2.8	55.3	56.9
Moldova	-2.4	-17.5	-29.1	-1.2	-31.2	-3.0	-8.0	1.3	-2.2	35.1	34.3
Poland	-11.6	-7.0	2.6	3.8	5.2	7.0	6.1	6.9	4.8	111.8	117.2
Romania	-5.6	-12.9	-8.7	1.5	3.9	7.1	4.1	-6.6	-2.1	82.4	80.7
Russia	-4.0	-13.0	-14.5	-8.7	-12.6	-4.0	-4.9	0.4	-4.8	52.2	49.7
Slovakia	-2.5	-14.6	-6.5	-3.7	4.9	6.8	6.9	6.5	4.0	95.6	99.5
Slovenia	-4.7	-8.1	-5.5	2.8	5.3	4.1	3.1	3.3	4.1	99.3	103.4
Tajikistan	-1.6	-7.1	-29.0	-11.0	-18.9	-12.5	-4.4	2.2	4.3	40.0	41.8
Turkmenistan	2.0	-4.7	-5.3	-10.0	-18.8	-8.2	-8.0	-15.0	4.7	48.3	50.6
Ukraine	-3.4	-9.0	-13.7	-14.2	-23.0	-12.2	-10.0	-3.2	-2.3	38.3	37.4
Uzbekistan	1.6	-0.5	-11.1	-2.3	-4.2	-0.9	1.6	2.4	4.5	86.7	90.6
GDP-weighted avg.*											
25 countries of EBRD	-5.0	-11.5	-10.5	-5.5	-7.1	-1.1	-1.3	1.6	2.0	71	72
Eastern/Central Europe	-6.8	-11.0	-4.1	0.7	3.5	5.3	4.2	3.5	3.2	95	98
CIS	-3.7	-12.0	-14.3	-9.3	-13.5	-4.9	-4.6	0.5	-0.8	56	55

Sources: EBRD 1998a. Estimations for 1998 from PlanEcon 1998a and 1998b, and author's own primary evaluation.

\* The weights used are EBRD estimates of nominal dollar-GDP for 1996.

2. Transition is a complex, historical process of changes from centrally planned economy, based upon the state property, to the market economy, based upon private property. This endeavor consists of three simultaneously going processes:

- Liberalization and stabilization;
- Institutional building;
- Microeconomic restructuring of the industrial capacities.

Considering the point of departure, that is, the great range of administered prices and large price distortions, on the one hand, and severe financial imbalances, on the other hand, initial liberalization had caused an acceleration of price and wage inflation. Thus a main target of following policies was financial stabilization. **The fiscal policy, therefore, was firstly subordinated to this end, without taking much concern about other aims of economic and social policy, especially the needs to shift the economy toward the path of sustainable growth and contain growing income inequity.**

Yet despite the sound commitment to fight inflation for the sake of stabilization and improvement of efficiency, the inflation has remained rampant and in each case was higher and more stubborn to be conquered than envisaged earlier (Table 2).

**Table 2: Inflation, 1991-98**  
(In percent)\*

	1991	1992	1993	1994	1995	1996	1997	1998
Albania	104.0	236.6	30.9	15.8	6.0	17.4	42.0	14.0
Armenia	25.0	1,341.0	10,896.0	1,885.0	32.0	5.8	21.9	13.0
Azerbaijan	126.0	1,395.0	1,293.8	1,788.0	84.5	6.7	0.5	4.5
Belarus	93.0	1,159.0	1,996.0	1,960.0	244.0	39.2	63.1	84.0
Bulgaria	339.0	79.4	63.8	121.9	32.8	310.8	578.6	17.0
Croatia	250.0	938.2	1,149.0	-3.0	3.8	3.4	3.8	5.0
Czech Republic	52.0	12.7	18.2	9.7	7.9	8.6	10.0	6.8
Estonia	304.0	953.5	35.6	42.0	29.0	15.0	12.0	11.0
Georgia	131.0	1,177.0	7,488.0	6,474.4	57.4	13.8	8.1	8.0
Hungary	32.0	21.6	21.1	21.2	28.3	19.8	18.4	10.4
Kazakhstan	137.0	2,984.1	2,169.0	1,160.0	60.4	28.6	11.3	8.5
Kyrgyzstan	170.0	1,259.0	1,363.0	95.7	31.9	35.0	14.8	12.1
Latvia	262.0	959.0	35.0	26.0	23.0	13.1	7.0	5.0
Lithuania	345.0	1,161.1	188.8	45.0	35.5	13.1	8.5	6.8
FYR Macedonia	230.0	1,925.2	229.6	55.4	9.3	0.2	4.6	5.0
Moldova	151.0	2,198.0	837.0	116.0	23.8	15.1	11.2	10.0
Poland	60.0	44.3	37.6	29.4	21.6	18.5	13.2	8.6
Romania	223.0	199.2	295.5	61.7	27.8	56.9	151.6	47.0
Russia	144.0	2,508.8	840.1	204.7	131.3	21.8	11.1	84.5
Slovakia	58.0	9.1	25.1	11.7	7.2	5.4	6.4	7.0
Slovenia	247.0	92.9	22.9	18.3	8.6	8.8	9.4	8.0
Tajikistan	204.0	1,364.0	7,344.0	1.1	2,133.0	40.5	165.0	19.3
Turkmenistan	155.0	644.0	9,750.0	1,328.0	1,262.0	446.0	21.5	50.0
Ukraine	161.0	2,730.0	10,155.0	401.0	182.0	39.7	10.1	19.0
Uzbekistan	169.0	910.0	885.0	1,281.0	117.0	64.0	28.0	35.0

Sources: EBRD 1998a. Data for 1998 are EBRD early projections and for Poland, Russia Hungary and Czech Republic PlanEcon 1999.

\*Change in the year-end retail and consumer price level.

**3. In all transition economies in the course of the 1990s income inequity has been on the rise.** The emerging pattern of income distribution and equity issues were not at the top of the agenda of policy at the time – neither of the national governments, nor even the more of the international financial organizations. The fiscal policy, at large, does not prevent the natural tendency accompanying liberalization and privatization toward increasing inequity. In several countries the pattern of distribution has changed significantly, causing growing poverty and mounting social tensions. The latter in some countries with sluggish progress in the real sphere of the economy, that is, where the recovery is still to be accomplished, will be growing even further in the foreseeable future.

It is still a bigger problem to be tackled, since growing inequality has occurred during transitional contraction, thus a great number of people have been driven into poverty, especially in two biggest post-socialist countries with the population of about 200 million people, that is, Russia and Ukraine, where between 1988/99 and 1995/96 the income disparity, if measured by the Gini coefficient, has at least doubled (Table 3).

**Table 3: Changes in Inequality During Transition**

<b>Gini Coefficient (income per capita)</b>		
	1987-88	1993-95
Krygyzstan	26	55†
Russia	24	48†
Ukraine	23	47‡
Lithuania	23	37
Moldova	24	36
Turkmenistan	26	36
Estonia	23	35†
Bulgaria	23#	34
Kazakhstan	26	33
Uzbekistan	28#	33
Latvia	23	31
Romania	23#	29‡
Poland	26	28§
Belarus	23	28†
Czech Republic	19	27‡
Slovenia	22	25
Hungary	21	23

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Slovakia

20

19

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Sources: UNDP 1996; Milanovic 1998.

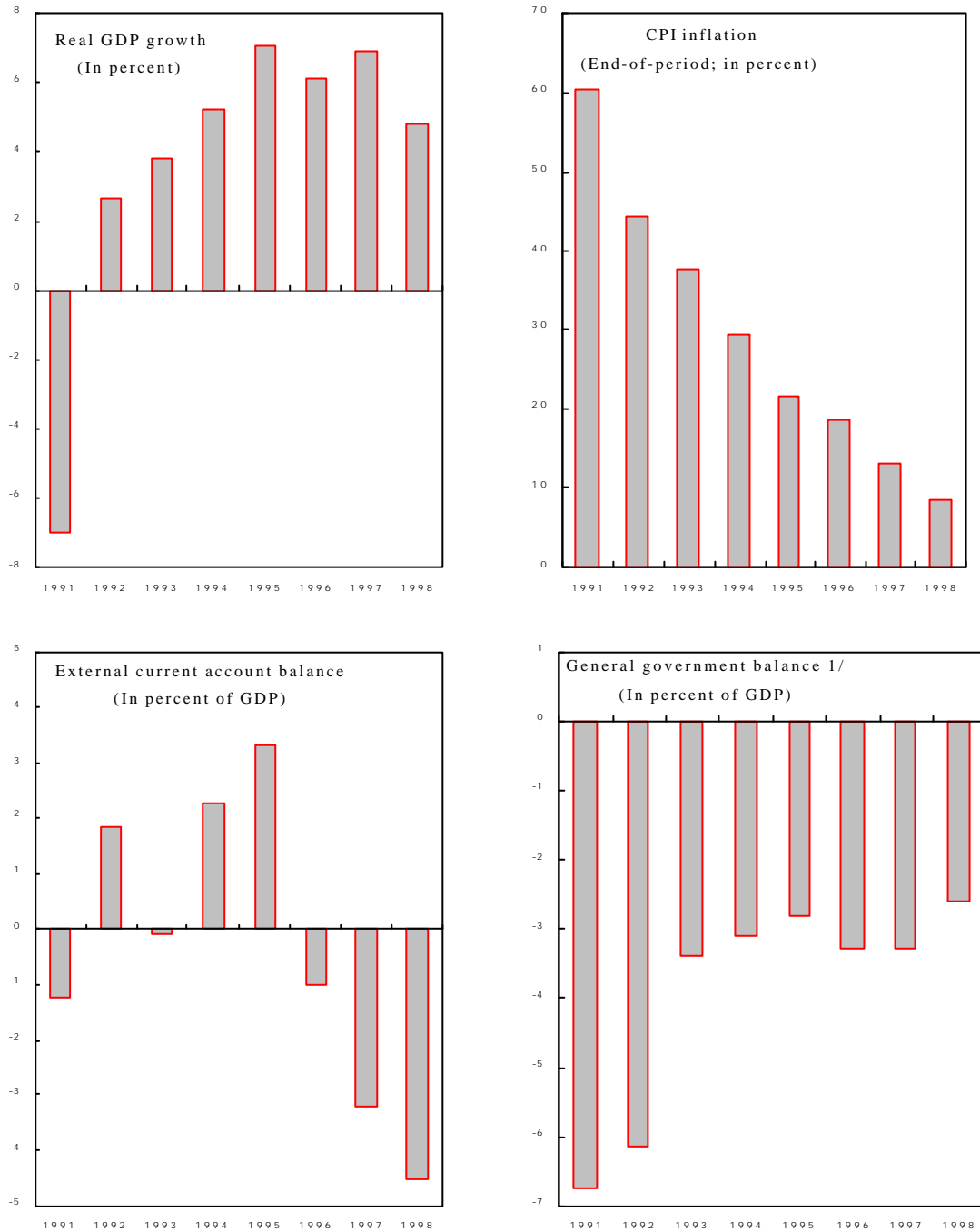
\*For most countries the income concept in 1993-95 is disposable income. In 1987-88 it is gross income, since at that time personal income taxes were small, and so was the difference between net income and gross income. Income includes consumption in kind, except for Hungary and Lithuania in 1993-95.

†Quarterly. ‡Monthly. #1989. §Semi-annually.

There is not yet available comprehensive data illustrating the developments *vis-à-vis* the income dispersion pattern in the recent couple of years, but the anecdotal evidence clearly suggests that the inequity is continuously on the rise in 1996-99, too. Moreover, there are not neither on the side of the implemented policies, nor on the ongoing tendencies the prerequisites strong enough to assume, that such a trend will be put on the reverse in the early 2000s.

**4.** In so far **the most successful case of transition, Poland**, which was able to raise its GDP in 1998 to over 117 percent of pre-transition level from 1989, the overall situation is by far better than on the average in transition economies (EBOR 1998, PlanEcon 1998b and 1999). Due, *inter alia*, to the fiscal and income policy, the inequity ceased to rise in 1994-96, and on the path of high rate of growth the savings started to grow again. Yet the economy recently seems to be losing momentum, owing to unfavorable external shocks, but mainly because of wrong set of policies implemented since recently. The attempt to cool the economy, following the mistaken assertion that it had been overheated, has brought the rate of growth from 6-7 per cent, on average, in 1994-97 down to about 2-3 percent in last quarters (Figure 1).

Figure 1. Poland: Selected Economic Indicators, 1991-98



Sources: Polish authorities; and staff estimates.

1/ General government balance on a cash basis.

Consequently, industrial output and employment after several years of growth have started to decline again. As a result, the rate of unemployment increased from about 9.5 percent in summer of 1998 to as much as about 12 percent in the Spring of 1999 (Figure 2).

Figure 2. Poland: Industrial Output and Unemployment, 1993-99



Source: National statistics.

**5. Thus, after ten years of transition, the output of the overwhelming majority of post-socialist countries is well below where it was a decade ago.** Several of them are still on the decline and some others are affected by the recession only after for a while they were able to bottom up. As for 1998-99, some 6-7 countries in Eastern Europe (EE) and the Commonwealth of the Independent States (CIS) are involved in contraction. Yet until recently there were quite optimistic expectations that since 2000 on, with only a few exceptions, the whole region supposed to be on the rise (Table 4).

**Table 4. Forecast of Economic Growth in Transition Economies, 1998-2002**

	GDP index, 1989 = 100		Rate of Growth				Average	Ranking*	GDP index, 2002	
	1997	1998	1999	2000	2001	2002	1998-2002		1997 = 100	1989 = 100
Poland	111.8	6.5	5.9	5.8	5.8	6.1	6.0	7	133.9	149.8
Slovenia	99.3	4.1	4.1	4.8	4.2	4.9	4.4	20	124.1	123.3
Albania	79.1	10.2	9.7	10.6	8.6	3.7	8.6	4	150.6	119.1
Slovakia	95.6	4.0	2.3	2.5	5.0	5.0	3.8	22	120.2	114.9
Czech Republic	95.8	1.4	3.3	4.3	4.5	4.7	3.6	24	119.5	114.5
Hungary	90.4	5.4	4.6	4.5	4.8	4.5	4.8	19	126.2	114.1
Uzbekistan	86.7	5.8	4.3	4.9	4.5	4.5	4.8	16	126.4	109.6
Estonia	77.9	6.4	5.5	5.9	5.6	5.9	5.9	8	132.9	103.6
Romania	82.4	-2.1	3.3	5.8	5.5	4.9	4.9	21	118.4	97.6
Croatia	73.3	5.5	3.4	5.4	5.4	4.9	4.9	15	127.1	93.2
Kyrgyzstan	58.7	6.5	6.8	6.0	5.5	5.6	6.1	6	134.3	78.8
Bulgaria	62.8	3.5	5.4	5.7	4.4	4.0	4.6	18	125.2	78.6
Yugoslavia	62.7	3.7	2.3	3.9	5.0	6.0	4.2	9	122.7	76.9
Kazakhstan	58.1	4.4	3.8	4.9	7.0	7.0	5.4	11	130.1	75.6
Latvia	56.8	6.0	3.9	4.6	5.8	5.7	5.2	12	128.8	73.2
Belarus	70.8	-7.1	-1.5	2.7	3.7	5.5	0.7	26	102.8	72.8
Turkmenistan	48.3	4.7	12.1	16.0	3.5	4.2	8.1	3	146.8	70.9
Macedonia	55.3	2.8	3.4	3.4	4.9	5.0	3.9	17	121.1	66.9
Azerbaijan	40.5	7.1	9.0	10.7	11.2	10.7	9.7	1	159.1	64.4
Armenia	41.1	6.6	6.5	6.7	7.8	6.9	6.9	5	139.6	57.4
Lithuania	42.8	5.0	5.0	5.7	5.1	4.9	5.1	13	128.5	55.0
Georgia	34.3	10.2	10.1	9.3	9.1	7.6	9.3	2	155.7	53.4
Tajikistan	40.0	4.5	5.1	5.7	6.0	6.1	5.5	10	130.6	52.2
Russia	52.2	-3.8	-4.7	-1.8	1.4	3.1	-1.2	25	94.1	49.1
Ukraine	38.3	1.2	3.0	4.8	5.2	6.0	4.0	23	121.8	46.7
Moldova	35.1	1.2	6.6	5.0	6.3	5.8	5.0	14	127.4	44.7

Sources: PlanEcon 1998a and 1998b.

\* Ranking is according to the 2002 GDP index (1997 = 100) and 1998-2002 average rate of growth.

However, in the aftermath of the global financial crisis and especially owing to the Russian contagion, with its negative impact especially on CIS economies, these predictions are recently corrected downward, and in some cases, like Russia or Poland, quite significantly. For example in Poland, owing mainly to unnecessary overcooling of the economy, the expected rate of growth of 6.9 and 5.8 in 1998 and 1999, respectively, was adjusted down to 4.8 percent in 1998 (*ex post* data) and to still unrealistic 5.1 percent in 1999. The latter index, being also a foundation for the 1999 budget and agreed with the IMF as late as in March 1999, is recently predicted by JP Morgan for a mere 1.5 percent (JP Morgan 1999). Most probably, it will be slightly over 3 percent.

## II. FISCAL POLICY DURING TRANSITION

6. The main purpose of fiscal policy is the redistribution of income. Part of it must be moved from the places where the income is created and then taxed to the places where the financial resources are needed, though they can not be created there. The same is in the transition economies, yet—due to long lasting depression—the redistributive policy becomes much more difficult. **Whereas the needs for financial resources are growing, the ability to satisfy them is weakening, because of the shrinking income.** Resulting fiscal policy, therefore, is even more exposed for bringing social tensions and political conflicts than usually in the market economy.

7. It was assumed that liberalization-cum-stabilization, supported by fast privatization, that is, the shift of assets from the state sector (presumed to be inefficient and thus a burden for the budget) to the private sector (seen as efficient, thus contributing to the improvement of the fiscal stance), should soon improve the overall fiscal position of an economy. Yet for a number of reasons it didn't happened to be the case. Owing to the systemic vacuum—created in an aftermath of the negligence of institutional building, indispensable for the success of the early stage of transition—one type of inefficiency has been replaced by another.

**Inefficiency typical for the outgoing system of central planning and bureaucratic interference has been changed for specific inefficiency of the post-socialist emerging markets with weak institutions.** In another words, the pace of liberalization and privatization turned to be too fast from the viewpoint of ability of the transition economies to establish the new, sound institutional arrangements. The latter must underlie the former. Hence, the fiscal problems remain serious.

In several cases, due to so-called perverse effect of fiscal adjustment (Kolodko, 1992), the fiscal deficit is even larger than it used to be under the previous systemic arrangements, prior to transition. After initial improvement of the fiscal stance, mainly due to cut of unproductive transfers, the later fall of revenue turned to be even larger, thus the deficits reappeared (if they were contained in the

first place, as for instance in Poland in 1990) after some short period of time. To close such deficit is much more difficult, since the policy of the removal of subsidies could be executed just one time.

There have been **three main concerns of fiscal policy at the early stages of transition.**

First, it was a desire to contribute to quick improvement of budget situation, that is balancing it by the means of downward adjustment of expenditure and, later – when the recovery had occurred already and the taxation base has started to widen – through growing revenue. The aim of these policies was to provide the resources to finance indispensable expenditure that must be covered by the government, either central or the local ones.

Second, it was inflation stabilization, mainly through the means of containing fiscal deficit and financing it, if only possible, in noninflationary way.

Third, it was the necessity to overhaul the tax system and administration in the way facilitating the need of emerging market economy.

In the short-run there were contradictions and trade-off between those aims defined in such ways, yet in the long run all these concerns are supposed to be compatible and positively supporting each other.

**8.** The outcomes of fiscal policies exercised during transition are mixed. **In several countries there are all the time large budget deficits** and in many cases it can hardly be financed without at least a partial monetization of the occurring deficits (Table 5). As a consequence, the inflationary pressure lingers. Many countries struggle to contain the existing deficits by further cuts of the expenditure, since their policies to raise the revenue are not working properly, owing to continuing contraction, or narrow taxation base, or both – as, for instance, is the most spectacular instance of Russia.

**Table 5: General government balance, 1990-98**  
(In percent of GDP)\*

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Albania	-15.0	-31.0	-20.3	-14.4	-12.4	-10.4	-11.4	-17.0	-14.8
Armenia	--	-1.8	-8.1	-56.1	-10.1	-12.0	-9.3	-6.7	-5.6
Azerbaijan	--	--	2.8	-12.7	-11.4	-4.2	-2.6	-2.8	-3.0
Belarus	--	--	0.0	-1.9	-2.5	-1.9	-1.6	-2.7	-3.3
Bulgaria	--	--	-5.2	-10.9	-5.8	-6.4	-13.4	-2.7	-1.6
Croatia	--	--	-4.0	-0.8	1.7	-0.9	-0.5	1.4	2.1
Czech Republic	--	--	-3.1	0.5	-1.2	-1.8	-1.2	-2.1	-0.9
Estonia	--	5.2	-0.3	-0.7	1.3	-1.2	-1.5	2.3	1.7
Georgia	--	-3.0	-25.4	-26.2	-7.4	-4.5	-4.4	-3.8	-3.0
Hungary	0.4	-2.2	-6.8	-5.5	-8.4	-6.7	-3.5	-4.6	-4.9
Kazakhstan	1.4	-7.9	-7.3	-1.3	-7.2	-2.0	-2.5	-3.4	-4.5
Kyrgyzstan	0.3	4.6	-17.4	-14.2	-11.6	-17.2	-9.6	-9.2	9.0
Moldova	--	0.0	-26.2	-7.4	-8.7	-5.7	-6.7	-7.5	-7.5
Latvia	--	--	-0.8	0.6	-4.1	-3.5	-1.4	1.3	-0.4
Lithuania	5.4	2.7	0.5	-4.3	-5.4	-4.5	-4.0	-2.4	-3.0
FYR Macedonia	--	--	-9.6	-13.6	-3.2	-1.3	-0.4	-0.6	-0.8
Poland	3.1	-6.7	-6.6	-3.4	-2.8	-3.6	-3.1	-3.0	-3.0
Romania	1.0	3.3	-4.6	-0.4	-1.9	-2.6	-3.9	-4.5	-5.0
Russia	--	--	-21.6	-7.4	-10.4	-5.7	-8.2	-7.5	-6.0
Slovakia	--	--	--	-7.0	-1.3	0.2	-1.9	-3.4	-2.1
Slovenia	-0.3	2.6	0.2	0.3	-0.2	0.0	0.3	-1.5	-1.0
Tajikistan	--	-16.4	-28.4	-23.6	-10.2	-11.2	-5.8	-3.5	3.0
Turkmenistan	1.2	2.5	13.2	-0.5	-1.4	-1.6	-0.2	-0.5	-5.0
Ukraine	--	--	-25.4	-16.2	-7.8	-4.8	-3.2	-5.8	-4.0
Uzbekistan	-1.1	-3.6	-18.4	-10.4	-6.1	-4.1	-7.3	-2.3	3.0

Sources: EBRD 1998a.

\*General government includes the state, municipalities, and extrabudgetary funds. Balances are reported on a cash basis except for Albania and Poland. Data for Armenia refer to the consolidated state government, for Croatia to the consolidated central government, and for Uzbekistan to state and extrabudgetary funds.

9. Against such a background of tough budget situation and relatively small flow of transfers through the budget, the **financing of social sphere and human capital has deteriorated**. Those budget transfers are relatively further falling, owing to the conviction of the mainstream neo-liberal economic thought (and also an insistence of the IMF), that the so-called 'small government' is always the 'better government'. The absolute level of government investment into the human capital has declined in all transition economies—including the leaders that were able to return to the path of growth already several years ago. These unfavorable events will affect negatively the ability to grow in the long run, too. Thus it may be claimed that over the 1990s the ways the fiscal policies have been managed did contribute to worsening of the situation *vis-à-vis* human capital formation, with all the negative implications for sustainable development.

10. As for the systemic changes, the aims of the fiscal policies have been accomplished to quite an extent. **The fiscal system**, if not yet overhauled entirely, has been changed substantially (Tanzi (1991), Ebrill, Escolano and Stotsky (1998)) and **is well advanced to serve the purpose of the emerging post-socialist market economies**. The new system of public finance has been created, what was especially difficult in the countries that didn't reform their centrally planned economies before transition, especially in the FSU. Yet not only the legal foundations for the new fiscal system are necessary, but the changes of behavior and new fiscal culture are needed, too. To create such, it is a long lasting process. It is requiring permanent attention of the governments and the legislatures as well as an involvement of the nongovernmental organizations (NGOs) supporting transition to a market economy and civic society, on the one hand, and continuing technical assistance and monitoring by the international organizations, mainly the IMF, on the other hand.

11. There is another important aspect of fiscal policy, which somehow has been overseen during the initial stages of post-socialist transition. That is the capital formation. While being engaged mostly in dealing with those above mentioned three major concerns, the **fiscal policies were not enough involved into the process of capital formation**, necessary for durable growth financing. Fiscal policies were rather focussing on short-term stabilization measures and the systemic changes, without giving enough respect toward the impact of these changes and policy decisions upon savings, investment and long-term capital accumulation. It was rather assumed, that capital formation should be automatically boosted, if only stabilization and critical structural reforms are accomplished. Yet so far, it has not been the case accomplished on the sustainable basis.

12. Moreover, the accumulated capital sometime was wasted, because of the lack of government policy assisting its allocation at the infant stage of market economy. In the extreme cases, for example, in Albania or Russia, there was vast **capital flight**. Weak institutional arrangements and inconsistent policies allowed for development and later collapse of a disastrous financial pyramids. Among the results of such ill-advised endeavor was a meaningful capital outflow, which was not neither vigorously enough, nor for time counteracted by the international financial community (together with the

international financial organizations, that have reacted too late). What had been saved and accumulated through unregulated financial intermediaries, has left the country.<sup>1</sup>

### III. FISCAL POLICY AND CAPITAL FORMATION

**13. Under the centrally planned allocation, the rate of savings was relatively high.** Actually, it was higher at the time than it is recently in any country of the region. Yet such a propensity to save was basically stemming from the mechanism of forced savings and the shortage phenomenon or—if accompanying by open, price and wage inflation—so-called shortageflation (Kolodko-MacMahon (1987)). Nevertheless, the price distortions and financial disequilibria led to growing allocative inefficiencies and thus the centrally planned economies had been losing momentum and their earlier ability to grow. Consequently, the rate of growth declined and the system has come to the end. So, despite high rate of investment, that is the ratio of investment over GDP:

$$I/GDP (\%) \quad (1)$$

the late centrally planned economies were less and less able to expand. The inefficiency of capital allocation was eating out the high, although forced, rate of savings and investment.

**14.** Thus it was expected, that the liberalization and privatization should bring soon an acceleration of growth by getting rid fast of typical for the late stages of centrally planned economy wasteful allocation of capital. It was presupposed as well, that even if the rate of investment will be not as high as it used to be under the socialist regimes (i.e., within the range of 25-35 percent of GDP), **the investment efficiency ought to be raised fast and by a large margin.** A rationale for such expectations was based upon the assumption that market allocation should, at least to the extent, compensate for a decline in the rate of saving and investment. This, however, has not occurred, because of the new kind of inefficiencies, that have emerged together with the beginning of transition. They are linked to poor institutionalization of the new economic mechanisms and to the weak policies. Therefore, the fiscal policy must take care properly of capital formation, whereas other policies and the self-performing market forces ought to look after its most efficient allocation.

**15.** Capital formation is a function of:

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<sup>1</sup>There is not a reliable evaluation how much capital could flight out of Albania prior to the collapse of fraudulent financial schemes, but some estimation assume that it was as much as two third of an annual GDP. In the case of Russia the estimations vary between US\$40 billion and US\$400 billion, likely being somewhere close to US\$100 billion, that is more then overall capital inflow to this economy during the 1990s.

- a. level of income;
- b. propensity to save, that is:

$$cf(t) = f(i_0, ps(t)) \quad (2)$$

where:  $i_0$ —absolute disposable income in the starting year,  
 $ps(t)$ —propensity to save of the interval  $t$ .

Hence **the fiscal policy, either by direct or indirect means, can influence the process of capital formation through affecting the amount of net disposable income, or through the change of the marginal propensity to save.**

**16.** Fiscal policy, as the means of income redistribution, can be either neutral from the viewpoint of capital formation, or can influence the structure of final absorption of GDP. If the GDP's absorption consists of:

$$GDP = C_t + I_t + G_t \quad (3)$$

where:  $C_t$ —individual consumption over the interval  $t$ ,  
 $I_t$ —investment,  
 $G_t$ —government consumption,

than the **fiscal policy can influence capital formation** either through raising the share of investment in the GDP's absorption (i.e.,  $I_t$ ), or the invested part of the government outlays (i.e., invested fraction of  $G_t$ ). The common feature of the market economy, getting gradually a momentum during transition period, is that whereas the role of private accumulation is ascending, this of the public sector is on descending. However, before emerging private sector and, to some extent, NGOs are able to substitute the services so far provided by the state (quite often under socialism free of charge, for example, a number of education or culture services), the government cannot abandon furnishing such services.

**17.** As for the capital formation and investment from the point of view of direct contribution of the state, it depends on the **composition of government consumption**. It is widely believed – and thus it has a strong impact upon the actual policies carried forward along the line of so-called Washington consensus (Williamson (1990) and (1993), Alesina (1998))—that the smaller is the government, the faster is the pace of growth. Yet this common wisdom has been challenged recently by both strong theoretical arguments (Tanzi (1997), Stiglitz (1998), Kolodko (1999c)) and a convincing set of evidence from different economies, including the countries in transition (World Bank (1997)). In fact,

the size of the government can affect the process of capital formation and thus, *ceteris paribus*, the rate of growth in either way. If a larger government, that is, relatively higher taxation and hence government spending, is due to the larger outlays for the human capital (education, healthcare, R&D, culture, etc.) and the hard infrastructure (roads, telecommunication, transport facilities, etc.), than larger government enhances the ability to grow. If, on the contrary, the bulk of government expenditure goes for unproductive targets (government and local bureaucracy, defense, transfers to support uncompetitive industries, etc.), therefore a relatively larger government does hamper the ability to expand. It has obvious implications for fiscal policy and structuring the budget outlays.

**18.** Amid various growth formulas, some authors rightly emphasize **the implications of human capital formation and the size of the government**. Undoubtedly, in the long run these are the decisive factors sustaining high quality growth and socio-economic development. One of the predictions for growth in the transition economies (Fischer, Sahay and Vegh (1998)) is based upon the following equation:

$$g(t) = f(Y_o, PS_o, SS_o; INV(t), GOV(t), POP(t)), \quad (4)$$

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where:  $g(t)$ —per capita growth during the time interval  $t$ ,

$Y_o$  —per capita income in the starting year,

$PS_o$  —primary school enrollment rate (in percent of total primary school-aged population,

$SS_o$  —secondary school enrollment rate (in percent of total secondary school-aged population),

$INV(t)$ —gross capital formation (in percent of GDP) during the time interval  $t$ ,  $GOV(t)$ —government consumption expenditure (in percent of GDP) during the time interval  $t$ ,

$POP(t)$ —growth rate of the population during the time interval  $t$ .

In this approach also the direction the government expenditure does influence growth is discussed, since such influence is much more ensuing from the composition of these outlays than from their absolute level. Hence, development policies shouldn't insist unconditionally neither for the expansion of the size of the government, nor at its limitations, but on the shift of the government expenditure toward investment in both human capital and hard infrastructure, because both in the long run do facilitate growth.

**19.** It seems to be agreed that more than the overall propensity to save (and thus the rate of capital formation) **fiscal policy is influencing the conduits through which the accumulation of capital occurs**. If the intensive is targeted at increasing the savings through bank deposits rather than at investment in the shares on the capital market, than the capital gains on securities can be taxed, whereas the revenue from interest bearing banking deposits should remain tax free. If the governments are keen to raise the savings of the households—and at the same time to finance their budget deficit

through selling the government bonds and treasury bills at open market—they may even introduce a tax deduction scheme, making appropriate part of personal income spent on the purchase of government papers tax free. Yet under such fiscal preferences rather the structure than the general level of savings is changing. If the preferences are, for instance, aiming for accelerated privatization, than capital gains accrued at stock exchange should remain not taxed. If the priority of economic policy is to finance in noninflationary way (yet debt-creating) the existing fiscal deficit, than the purchase of government papers must be accompanied by some additional tax preferences, especially encouraging the savings of the households.

#### IV. IMPACT OF FISCAL POLICY ON CAPITAL ACCUMULATION IN TRANSITION ECONOMIES

**20.** In transition economies, where various means of fiscal policy have been introduced for the first time—for example, the general taxation of personal income and the value added tax, or VAT, covering if not all, then a vast range of goods and services—the level of disposable income was rather lower than it could be under the alternative arrangements, that is without or with less of taxation. At least in the short and medium term, the **new measures of direct and indirect taxation, particularly *vis-à-vis* the households, did not raise the overall propensity to save.**<sup>2</sup>

Part of the income that was collected by the state for the sake of redistribution was basically channeled into the government consumption (i.e.,  $G_t$ ), especially for the purpose of providing social-related expenditure. Due to the accelerated process of retiring of the governments from direct economic activities it was not invested in the real assets. Hence, at least at the initial stages of transition, the new tax measures have contained net disposable income of the household sector, including its part that could be otherwise saved—if only the taxation was lower than actually. At the other end, the social groups that benefited from such redistribution, were still receiving rather a modest real income and thus their propensity to save was low, too.

**21.** As for the propensity to save, this becomes the earnest concern of fiscal policy only when the financial stabilization is generally accomplished, the economy is relatively stable and the output is already on the rise. As long as there is financial instability, on the one hand, and the production is falling, on the other hand, the fiscal measures cannot change meaningfully the proportions of the income being consumed and saved, that is, invested, on the behalf of the latter.<sup>3</sup>

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<sup>2</sup>Of course, there were many other, simultaneously occurring developments enhancing propensity to save. In the aftermath of the shortage removal effect—the greatest achievement of the post-socialist transformation—the market has become well supplied in durable consumer goods, and so a desire to possess them has become working as a driving force behind growing savings, particularly for relatively better remunerated strata of the society.

<sup>3</sup>And this, unfortunately, is still the prevailing situation amid almost 30 countries going through the process of post-socialist transition to a market economy.

Only in the countries more advanced in transition—because of their ability to consolidate stabilization into stability and their capacity to run the growth-oriented policy—it has become possible to expand the output as well as increase the propensity to save. Consequently, the **marginal propensity to save actually cannot increase as long as the real income is decreasing**. When the real income is falling over a number of years—and its contraction is occurring by a large margin—than even an aggressive fiscal policy, favoring higher rate of savings, is not able to work. Tax intensive are incapable to raise neither the absolute, nor even the relative level of savings, because of the significant lose of the real income.

**22.** Notwithstanding fiscal policy shouldn't be blamed for direct responsibility for falling so much and for so long real income, undoubtedly it has contributed also to this process. **Instead of enhancing propensity to save, fiscal policies and reforms through their negative impact upon net real income have lowered propensity to save.** Fiscal policy is aiming mainly for financial stabilization, not only at the onset of transition. To this end, the main concern was a restraint of overall demand through the budget expenditure cuts as well as the control of the net wages<sup>4</sup> and the pensions<sup>5</sup> through direct and indirect taxation. Consequently, for a long time (lasting even longer than the GDP contraction going from 3 years in Poland to 10 years in Ukraine) disposable income was declining together with shrinking output. Therefore, the fiscal squeeze, imposed upon transition economies for the sake of fast stabilization after liberalization, did contribute to falling real income. At the lower level of real income the savings—and, consequently, the capital formation—became lower, too.

**23.** Like elsewhere, in transition economy too, there are two **contradictory expectations**. On the one hand, there is a strong **pressure to raise taxes** for the purpose of meeting the needs of prudent financing of the mounting government expenditure. On the other hand, there is a **pressure to cut taxes**, this time for the purpose of raising disposable income and than higher savings and capital formation. The former usually is the strong request of the trade unions. The former is one of the most favor arguments of the business circles. And the government is always cruising in between, being inclined to go toward one or the other end, depends on its own political appearance.

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<sup>4</sup>The usual mean of such control was the wage based taxation, often used as an additional anchor in stabilization programmes advised and supported by the IMF. In Poland, it was famous 'popiwiek', lasting from January 1990 until June 1994, when it was abandoned on behalf of the system of partnership's negotiations between the government, trade unions and employers. The latter is much more auspicious for labor productivity growth (Kolodko (1995)).

<sup>5</sup>Growth of pensions—as long as there is pay-as-you-go social security system, what indeed is the case in all transition economies—is directly controlled by the government. Considering the ongoing inflation, usually a system of indexation is used as the instrument of such control. The rate of indexation is a function of the anti-inflationary policy and the ability to accomplish sensible political compromise in each subsequent budget, heavily subsidizing the social security system, because of the latter inability to finance itself from the flow of current contributions (Andrews and Rashid (1996), Hausner (1998)).

The outcome of the confrontation of these two options depends not as much on the accuracy (or inaccuracy) of theoretical arguments with the respect to optimal design of fiscal system, as it relies on the political situation (Alesina (1997)). However, too fast and too far going drive toward either of these ends may ultimately harm the capital formation. Later, the shift toward the opposite end does not offset the damage, since the losses had occurred already; either because the hypothetical savings and investments didn't take place, or because the inflationary pressure deteriorated allocative efficiency.

24. Transition to a market economy means also that the **changes of the composition of general government revenue** must take place. Whereas the ratio of total revenue over GDP is declining, the share of the corporate taxes in GDP is falling much faster than the share of the individual taxes (Table 6).

**Table 6: General Government Revenue by Category  
(In percent of GDP)**

<b>EE economies*</b>	<b>Total revenue</b>	<b>Total tax revenue</b>	<b>Corporate taxes</b>	<b>Individual taxes</b>
Pre-transition	49.5	39.0	9.9	6.6
Currently	39.6	35.5	2.7	6.2
Difference (in percentage points)	9.9	3.5	7.2	0.4
<b>CIS**</b>				
Pre-transition	34.0	26.4	7.0	3.3
Currently	21.8	17.9	3.4	1.7
		In percentage points		
Difference	12.2	8.5	4.6	1.6

Source: EBRD 1998b.

'Pre-transition' refers to 1989, but for Hungary to 1990 and for Armenia, Azerbaijan, Estonia, FYR Macedonia, Georgia, Latvia, Moldova, Slovenia and Ukraine to 1991. 'Currently' is either 1996 or 1997 data.

\* – excluding Albania and Bosnia-Herzegovina, but including the Baltics,

\*\* – excluding Belarus and Uzbekistan.

If prior to transition always the revenue from corporate taxes were larger than accruing from the individual taxes, that is:

$$T_c > T_p \quad (5)$$

in the aftermath of the fiscal reforms executed during the transition to a market system the sequence has been reversed, that is, currently it is:

$$T_c < T_p \quad (6)$$

where:  $T_C$ —corporate taxes,  
 $T_P$ —individual (personal) taxes.

Therefore, as for the revenue from direct taxation, the governments must rely more upon the individual income taxation than on the taxes paid by the business sector. The reasoning for such significant shift is the concern for capital formation and investments carried forward directly by the firms. Since they pay relatively less taxes than they used to do under the centrally planned regime, they are left with relatively higher net income, which can be invested either directly, or through the financial intermediaries, i. e., the banking sector and the emerging capital markets.

Nonetheless, there must be an anxiety for the limits of such dramatic change of structure of revenues. In another words, neither the shift from corporate taxes to individual ones, nor from direct to indirect taxes paid by the households sector should go too far. If that is the case, the burden imposed on the household sector can be too large, why the one imposed upon the business sector relatively too modest. This special kind of disequilibrium is unsustainable.

**25.** Execution of the tax cut for the sake of enhancing propensity to save and hence capital formation is more difficult to accomplish, since at the beginning of post-socialist transition there is a **very weak pro-growth lobby**, unlike the lobby in favor of tax-and-spending policy, which is rather strong, disregarding the political appearance of the ruling parties.<sup>6</sup> Thus the policy aiming for high-speed growth—based upon both higher rate of savings and capital formation, on the one hand, and growing allocative efficiency of the invested capital, on the other hand—requires the formation of a specific, growth lobby. Yet such a lobby, oriented at investment and expansion, increasing productivity and competitiveness, must not rely too much on its insistence on tax cut, because too radical tax reduction can lead to financial imbalances and rising social tensions. Eventually, these occurrences—together

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<sup>6</sup>With increasing long-term propensity to save such a scheme of tax reduction, proposed by the minister of finance, has been implemented in Poland under the program “Package 2000” within the “Strategy for Poland”. Whereas personal income tax was cut, in two steps executed in 1997 and 1998, from 21, 33, and 45 percent to 19, 30, and 40 percent, respectively, the corporate tax has been subsequently reduced from 40 per cent by 2 percentage points yearly since 1997. So, in 1999 it has declined already to 34 percent and in 2000 will fall further to 32 percent. Such scheme should also contribute to higher competitiveness of the economy on the international scale (Kolodko and Nuti (1997)).

with increasing income inequality—may turn against the ability to expand and thus also against the autonomous interests of the emerging growth lobby.

**26.** The best way to manage gradually the growing propensity to save is by reforming the tax system through **shifting the major tax burden from direct to indirect taxation**. Thus a policy fairly better facilitating savings and capital formation is the one containing the ratio of direct income taxes over the gross income, and raising the ratio of indirect taxes (e.g., VAT, excise taxes) over that income. Such policy must take care of gradual introduction of the VAT and widening the range of its application.<sup>7</sup> This process is lasting several years and still is not completed, even among the countries most advanced in transition.<sup>8</sup>

The shift from direct (income) toward indirect (consumption-related) taxes is shifting also the priorities of the households toward the treatment of their personal income and time horizon for the preferences *vis-à-vis* its spending. If the growing share of income is taxed not at the end of the earnings, but at the end of spending, than it is better to earn as much as possible and to save as much as possible, instead of spending the income at the time of, or immediately after, it has been earned.

So far, the times series and the evidence from transition economies are too scanty to support a claim, that in the countries that have tried to exercise fiscal policy along such line, the overall propensity to save has become relatively higher. Yet the anecdotal facts from such countries as Croatia, the Czech Republic, Estonia, Kyrgyzstan, Hungary, Poland, or Slovenia seems to suggest that the fiscal reforms aiming at raising the relative burden of indirect taxation, while ceasing the burden of the direct one, have contributed to growing savings and, therefore, toward the improvements of capital accumulation.

**27.** Of great importance for capital formation are also **the rules regulating the pace and scope of assets depreciation**. As elsewhere, the accelerated depreciation of the assets used by the firms facilitates the process of capital reproduction and thus its formation in the longer run. Although exercising the scheme of accelerated assets depreciation may influence the process of current inflation through pushing relatively higher the costs of production (hence the cost-push inflation mechanism is set in force), in the long term the following increase of productivity and growing competitiveness,

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<sup>7</sup>It must be gradual, considering the point of departure, when many basic goods, for example, food or construction materials, were not taxed at all. Prior to transition, the indirect taxes were often not imposed upon many consumer goods considered as basic, or substantial for cost of living and for house constructing.

<sup>8</sup>From this angle, the recent decision taken by the Russian parliament, the Duma—contrary to the IMF advice—to decrease significantly the rate of VAT has been a severe mistake. Such a move should be not only postponed, as already agreed, but abandoned. Particularly in Russia—the country with vast tax evasion, weak and corrupted tax administration—the best way to improve tax collection is to shift faster and further toward indirect taxation, and not the other way around.

owing to technological progress based upon accelerated replacement of old assets, should offset the negative consequences of such approach. Nevertheless, the particular solutions must be based upon particular cases and analyses, because, under some conditions, an additional cost-push inflation can strengthen already running inflationary spiral, what may hurt the whole process of capital formation.

**28.** Although crucial for sustainable growth are domestic savings and domestic capital formation, meaningful is also an inflow of foreign savings. Of major significance are **foreign direct investments** (FDI), which—at the top of domestic savings—are contributing to the accumulation of capital financing the growth in the long run. Unlike the short-term portfolio investments (often of a speculative nature), the FDI are long-term endeavors and usually facilitate competitiveness, and thus ability of export-led growth.

In transition economies the flow of FDI is a function of several features, yet the most important are:

- the pace of structural reforms;
- progress toward stabilization, both from political and economic perspective;
- the extent of the market.

For these reasons, the economies more advanced in systemic transformation<sup>9</sup>, as well as the countries attracting FDI despite their meager institutional progress yet rich in natural resources (e.g., Azerbaijan or Turkmenistan), attract the core of FDI. In 1990-98, the flow of FDI per capita to the countries considered as “advanced reformers” (IMF 1998, EBRD 1998b) was fourfold larger than to the countries seen as “intermediate reformers” and almost eight times larger than to the countries seen as the “slow reformers” (Table 7).

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<sup>9</sup>Especially the group of five countries invited to negotiate the accession to the EU, that is, the Czech Republic, Estonia, Hungary, Poland, and Slovenia.

**Table 7. Foreign Direct Investment, 1991-97**

	1991	1992	1993	1994	1995	1996	1997 2/	Cummulative FDI inflows		FDI-inflows
								1991-97		Per-capita
								Total	Per capita, \$	1997, \$
Albania	--	32	45	65	89	97	33	369	115	10
Bulgaria	56	42	40	105	82	100	575	1,000	121	69
Croatia	--	13	72	95	83	509	500	1,276	267	105
Czech Republic	511	983	517	749	2,526	1,388	1,275	7,473	726	124
Estonia	--	58	160	212	199	111	131	809	557	90
Hungary	1,459	1,471	2,339	1,097	4,453	1,986	2,100	15,403	1,519	207
Latvia	--	43	51	155	244	379	415	1,287	515	166
Lithuania 3/	--	--	30	31	72	152	327	612	165	88
FYR Macedonia	--	--	--	24	13	12	16	65	31	8
Poland 4/	117	284	580	542	1,134	2,741	3,044	8,442	218	79
	<b>305</b>	<b>662</b>	<b>1,775</b>	<b>1,846</b>	<b>3,617</b>	<b>4,445</b>	<b>6,600</b>	<b>19,250</b>	<b>497</b>	<b>171</b>
Romania	37	77	94	347	404	415	998	2,389	106	44
Slovakia	--	100	156	203	183	177	150	912	912	169
Slovenia	41	113	112	128	176	186	321	1,074	538	161
Eastern Europe	2,184	3,216	4,196	3,753	9,657	8,252	9,885	41,111	357	86
Armenia	--	--	--	3	19	22	26	70	19	7
Azerbaijan	--	--	20	22	284	661	1,006	1,993	262	132
Belarus	50	7	18	10	7	75	100	267	26	132
Georgia	--	--	--	8	6	25	65	104	19	12
Kazakhstan	--	--	473	635	859	1,100	1,200	4,267	272	76
Kyrgyzstan	--	--	10	45	96	46	50	247	54	11
Moldova	--	--	14	18	73	56	71	249	58	17
Russia	--	700	400	584	2,021	2,040	3,900	9,743	66	26
Tajikistan	--	8	9	12	17	20	20	86	14	3
Turkmenistan	--	11	104	103	233	129	108	652	139	23
Ukraine	--	170	200	100	400	526	700	2,096	41	14
Uzbekistan	--	9	73	73	-24	50	60	216	9	3
CIS	50	905	1,321	1,613	3,991	4,750	7,306	19,900	70	26
<b>Total</b>	<b>2,234</b>	<b>4,121</b>	<b>5,517</b>	<b>5,366</b>	<b>13,648</b>	<b>13,002</b>	<b>17,191</b>	<b>61,100</b>	<b>153</b>	<b>43</b>

Source: EBRD 1998a.

1/ Net inflows recorded in the balance of payments. In million s of dollars unless otherwise indicated.

2/ Estimated.

3/ FDI figures for Lithuania are only available from 1993. For 1993-94, figures cover only investment in equity capital. For 1995-96, equity and reinvested earnings are covered, but inter-enterprise debt is excluded.

4/ The second series for Poland (in bold) supplements the data with information from a survey of foreign enterprises that was provided by the State Agency for Foreign Investments. The differences arise, in part, from investments in kind and reinvested earnings.

Additionally, the larger countries, for example, Ukraine or Kazakhstan, for obvious reason of the attractiveness of the scope of their markets, drive more attention than do the smaller economies, for example, Moldova or Tajikistan.

**29.** Post-socialist economies, even more than other emerging markets, may be very vulnerable for **the swings of the short-term capital flow** (EBRD 1998b). Unlike long-term capital flowing as the FDI—which is essentially nondebt creating capital flow—the short-term investment, though it contributes to the growth of saving rate, is the debt creating capital flow.<sup>10</sup> Thus, from the viewpoint of capital formation and growth sustainability, development strategies should focus upon attracting rather nondebt creating than debt creating capital flow. Yet in transition economies—especially with still unstable financial situation and poor fiscal stance—this is not the foremost case.

As the indispensable part of transition, the liberalization of current account has been put forward. Only recently the IMF is keen to admit that such liberalization should be done with great consciousness and only when stabilization has been already accomplished on the sustainable basis. Yet over the years of the first decade of transition, there was rather if not insistence, than at least a clear expectation to liberalize the current account still further. Thus, what followed, were the inflow of short-term capital. It was still more robust, since a number of countries have been running twin deficit, that is, deficit *vis-à-vis* both the government budget (see Table 5) and the current account (Table 8).

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<sup>10</sup>FDI is usually seen—and rightly so—as nondebt creating financing. Nevertheless, at the end it is also repaid as either direct repatriation of the profits, or through the dividends. It is stressed, that: *In the most favorable case, the current account gap can be viewed as being fully financed up to the amount of net FDI inflow* (JP Morgan 1999, p. 10). Good example of such a case can be Poland, where the current account deficit, though exceeding already 4.5 percent of GDP in 1998 (see Table 8), was up to 93 percent financed by the inflow of record high FDI (see Table 7).

**Table 8: Current Account and Trade Balance, 1996-97\***

	Current account balance, 1997 (\$ millions)	Merchandise trade balance, 1997	Current account balance, 1997 (percent of GDP)	Merchandise trade balance, 1997	Change in current account balance, 1996-97 (change in GDP share, percent)	Change in merchandise trade balance, 1996-97
Albania	-195	-415	-8.5	-18.0	0.8	-7.8
Armenia	-428	-559	-23.4	-13.8	-0.4	-6.1
Azerbaijan	-961	-569	-23.6	-8.0	0.2	-5.8
Belarus	-995	-1,497	-7.5	-11.2	-0.7	-1.3
Bulgaria	184	311	1.8	3.0	0.5	0.8
Croatia	-1,900	-4,800	-10.3	-26.1	-5.6	-6.7
Czech Republic	-3,156	-4,600	-6.1	-8.8	1.5	1.7
Estonia	-610	-1,188	-13.1	-25.6	-3.4	-1.6
Georgia	-318	-366	-6.2	-7.1	-1.3	0.8
Hungary	-987	-1,700	-2.2	-3.8	1.6	2.2
Kazakhstan	-1,000	-500	-4.8	-2.4	-1.4	-0.9
Kyrgyzstan	-187	-134	-11.5	-8.2	12.5	12.6
Moldova	-310	-275	-14.9	-13.2	-1.4	0.2
Latvia	-350	-887	-6.4	-16.3	-0.5	-0.4
FYR Macedonia	-254	-343	-8.1	-10.9	-0.8	-2.3
Lithuania	-945	-1,115	-10.3	-12.2	-1.0	-0.6
Poland	-4,300	-11,300	-3.2	-8.4	-2.2	-2.4
Romania	-1,900	1,414	-5.5	4.1	1.8	8.8
Slovakia	-1,500	-1,500	-7.9	-7.9	3.2	4.3
Slovenia	70	-770	0.4	-4.3	0.2	0.4
Russia	3,900	16,600	0.8	3.5	0.3	-0.4
Tajikistan	-15	-5	-1.3	-0.4	5.8	3.2
Turkmenistan	-596	-245	-26.1	-10.7	-28.0	-17.5
Ukraine	-1,500	-4,800	-3.1	-9.9	0.3	0.2
Uzbekistan	-754	-254	-5.2	-1.8	2.7	5.1

Sources: EBRD 1998a.

\*Changes in the current account and merchandise trade balances in 1996-97 represent the difference between the ratios of the current account and merchandise trade balances to GDP in respective years. The current account balance for Armenia excludes transfers.

The policies in a number of transition economies—being not able to close the fiscal gap owing to persisting contraction (see Table 1) and thus weak flow of revenue—were tempted to accept the inflow of short-term capital, while seeing it as helpful for financing their short-term needs.<sup>11</sup> Under the circumstances of a lack of both domestic and external pressure for more gradual and restricted liberalization, the capital had been flowing in. Yet since by its very nature it is rather a speculative flow—aiming for quick profits gained from short-lasting portfolio investments, not necessarily linked to the investments into the real economy and hence not necessarily contributing to the growth of efficiency—when it has only found better alternative opportunities elsewhere and when the situation has turned to look less stable in post-socialist economies, such inflow may be converted into an outflow. Then the particular economy is not absorbing the savings from the outside, but its savings are invested in foreign countries.

Later, if there is still the positive balance of such swings of short-term capital flow, its alternating rampant inflow and outflow does contribute to increase of financial instability. Consequently, it is rather harming than raising overall propensity to save and thus ability to enhance the capital formation on the sustained foundation. Aside the direct effects on these kind of the ups and downs of inflowing and outflowing capital, there is also a contagion effect, stemming from both the aftermath of East Asian crisis (to a lesser degree) and from the Russian crisis (to a larger, though most often exaggerated degree, (Krzak 1998)).

**30.** Capital formation under institutional arrangements of centrally planned economy was relatively high (in international standards), though it was resulting rather from forced savings than voluntary accumulation of capital. Therefore, the slowdown of economic growth in the late 1980s in the EE and FSU economies was due more to misallocation of capital than overall shortfall of it (Kolodko (1986) and (1999c), Poznanski (1996)). Not the lack of the capital, but the increasing allocative inefficiency was main cause of sluggish growth.<sup>12</sup>

Later, already in the transition economies, the **gross capital formation plummeted rapidly**, much more than GDP contracted at the time. It was the outcome of systemic vacuum following the collapse of previous system, whereas the new one had only begun to emerge. The scope of the fall of investment in fixed capital served also as a specific caution against otherwise still deeper decrease of consumption and the fall of the standard of living. As a result, not only the absolute level of capital formation and investment decreased significantly, but so did the rate of investment, that is, its relation

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<sup>11</sup>It has been observed, that: *All advanced reformers have managed to keep their external debt burden roughly constant at an annual average of less than 10 percent of GDP during 1992-97, while attracting progressively rising flows on nondebt capital, especially foreign direct investment, to support their rising deficits* (Valdivieso, 1998, p. 11).

<sup>12</sup>Yet the growth was still taking place, what must be remembered and what does matter, particularly in the countries suffering most from the long lasting depression over the course of the 1990s.

to the falling GDP. Moreover, the fluctuation of the rate of growth of gross investment in fixed capital is by large margin bigger than the fluctuation of the GDP rate of growth (Table 9; see also Table 1).

**Table 9: Gross Investment in Fixed Capital, 1993–98**  
(Annual percent change)

	1993	1994	1995	1996	1997	1998
<b>Eastern Europe</b>						
Albania	30.0	15.0	12.5	23.9	-31.2	5.0
Bulgaria	-17.5	1.1	16.1	-21.2	-22.1	8.9
Croatia	--	--	--	--	--	--
Czech Republic	8.0	17.0	14.8	8.7	-4.9	-8.8
Hungary	2.0	12.5	-4.3	6.7	8.8	9.0
Macedonia	-21.7	-15.1	-5.0	-5.0	2.7	5.8
Poland	2.9	9.2	18.5	20.6	20.6	19.0
Romania	8.4	26.4	10.7	3.1	-15.9	-2.9
Slovakia	13.1	2.1	7.0	40.6	11.7	5.0
Slovenia	11.2	21.1	11.4	6.9	8.7	10.0
Yugoslavia	-37.3	4.4	-16.0	4.8	36.9	4.9
<b>Former Soviet Union</b>						
Armenia	-8.7	44.8	10.0	11.1	22.7	7.2
Azerbaijan	-39.0	89.0	-18.0	110.0	67.0	15.1
Belarus	-14.7	-11.0	-31.0	-5.0	20.0	-8.6
Estonia	22.4	11.3	-2.8	-14.7	9.2	11.0
Kazakhstan	-39.0	-15.1	-43.0	-35.0	-8.0	9.9
Kyrgyzstan	-31.0	-45.0	82.0	19.0	-35.0	-30.8
Latvia	-40.8	7.1	-4.3	5.0	9.2	15.0
Lithuania	-28.7	18.8	9.7	-0.3	10.4	10.8
Moldova	-44.0	-51.0	-17.0	-8.0	-6.0	-0.5
Russia	-11.5	-24.3	-13.0	-18.0	-5.0	-9.0
Tajikistan	0.1	-43.0	-25.0	-22.9	15.5	6.6
Turkmenistan	45.0	-38.2	6.7	-15.2	-13.2	-8.3
Ukraine	-10.3	-22.5	-28.6	-20.0	-7.5	-3.3
Uzbekistan	-5.0	-22.0	4.0	6.9	17.0	4.3

Source: PlanEcon 1998b.

**31.** Such point of departure toward market transition and the following sequence of changes had led to the situation that gross capital formation in the mid-1990s stood at around 22 percent of GDP, on average. In the second half of the decade, it has started to increase gradually and by the end of 1990s can be estimated at close to 25 percent. It is stressed, that:

*While this average figure is comparable to the one prevailing in the industrial countries during the period 1950-73, it is low compared to the average of 30 percent for the fast growing economies during 1985-94<sup>13</sup> (Fischer, Sahay and Vegh (1998), p. 27).*

It should be expected that – as the recovery goes on and the growth is being recouped—that, together with further consolidation of stabilization into stability, **the gross investment in fixed capital will increase both in absolute and relative terms**. This process, recently getting momentum in several countries, is opposite to the one observed at the beginning of transition. It is predicted (PlanEcon (1998a) and (1998b)) that until 2000 the only exceptions from this rule are going to be Russia, Ukraine, Belarus and Yugoslavia, and afterward all transition economies should maintain accelerated rate of growth of investment in fixed capital<sup>14</sup> (Table 10).

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<sup>13</sup>These fast growing economies were, *inter alia*, Chile, Hong Kong, Korea (South), Malaysia, Singapore, Taiwan Province of China, and Thailand.

<sup>14</sup>Of course, as the result of the NATO strike against Yugoslavia one may expect that the situation will deteriorate also in neighboring countries, especially in Albania, Bosnia-Herzegovina and Macedonia (less in Croatia), which shouldn't therefore foresee the chance for fast growing investments soon, even if there was such a possibility prior to the escalation of the military conflict in the region.

**Table 10: Gross Investment in Fixed Capital, 1999-2003**

(Annual percent change)

	1999	2000	2001	2002	2003
<b>Eastern Europe</b>					
Albania	10.0	22.4	13.0	11.6	8.4
Bulgaria	10.6	12.2	12.6	7.8	5.5
Croatia	--	--	--	--	--
Czech Republic	-1.8	1.6	2.0	5.7	6.1
Hungary	6.4	5.0	5.8	5.8	5.6
Macedonia	8.3	8.1	7.1	7.0	8.9
Poland	11.3	8.7	7.2	5.7	5.4
Romania	1.3	5.9	6.2	6.9	4.8
Slovakia	-9.4	0.5	3.2	4.2	3.6
Slovenia	6.4	6.6	5.9	6.3	4.3
Yugoslavia	-2.5	-4.1	10.1	10.7	8.6
<b>Former Soviet Union</b>					
Armenia	1.1	4.6	10.3	10.5	--
Azerbaijan	13.1	11.6	11.1	10.7	--
Belarus	-10.2	-4.3	5.8	7.5	--
Estonia	6.1	6.1	6.4	5.4	--
Kazakhstan	10.9	13.4	15.1	23.1	--
Kyrgyzstan	7.5	21.7	26.3	43.0	--
Latvia	6.1	3.8	4.0	6.0	--
Lithuania	10.5	2.0	3.7	6.5	--
Moldova	-6.2	11.2	10.2	19.9	--
Russia	-13.0	-3.9	12.5	10.5	--
Tajikistan	3.5	7.1	5.6	7.1	--
Turkmenistan	-6.7	10.8	2.1	3.2	--
Ukraine	-10.2	-3.8	9.9	13.1	--
Uzbekistan	3.8	6.6	2.3	4.8	--

Sources: PlanEcon 1998a.

**32.** Taking into consideration the differences between the rates of GDP growth (measured in various ways) and the rates of growth in the absorption of GDP through private consumption and gross investments in fixed capital, one might develop various hypotheses.

First, as a result of ongoing economic liberalization and openness, this time in a context of growth, the gap between GDP counted in constant prices in the domestic currency (see Table 4) and the estimates of GDP on a purchasing power parity basis will tend to decrease. This is a strong tendency, as shown by the 'A' indexes, which measure the ratio of the average annual rate of per capita GDP growth at market exchange rates over the average rate of per capita GDP growth at PPP during the period 1999-2002, that is:

$$A = \frac{\textit{per capita GDP}_{\text{NER}}}{\textit{per capita GDP}_{\text{PPP}}} \quad (7)$$

where:  $\text{GDP}_{\text{NER}}$  – forecast of rate of growth of the gross national product at nominal exchange rate;  
 $\text{GDP}_{\text{PPP}}$  – forecast of the rate of growth of the gross national product at purchasing power parity.

In each case (Table 11)—with the exception of Russia, for which any forecast must be taken with great reservation—the index is greater than unity, and the difference is meaningful. If this trend occurs, then **the market exchange rate and the purchasing power parity exchange rate will move closer**, and the current gap between these rates, usually between 1.5 and 2, will steadily diminish.

Table 11. Indexes of Structural Change, 1999-2002\*

	A	B	C	D	E
Albania	1.134	1.020	1.496	0.931	0.982
Armenia	1.388	1.016	1.156	0.887	1.057
Azerbaijan	1.386	1.047	1.503	0.817	0.964
Belarus	1.581	1.016	1.127	0.934	1.005
Bulgaria	1.411	1.011	1.181	1.009	1.000
Croatia	1.166	0.995	1.112	0.946	0.929
Czech Republic	1.508	1.006	0.979	1.030	0.962
Estonia	1.391	1.009	1.020	0.958	0.975
Georgia	1.346	1.022	1.367	0.839	0.897
Hungary	1.177	1.005	1.087	0.977	0.984
Kazakhstan	1.188	0.998	1.236	0.998	0.963
Kyrgyzstan	1.124	1.057	1.379	0.931	0.981
Latvia	1.149	0.981	1.288	0.942	0.963
Lithuania	1.195	1.003	1.067	0.965	1.000
FYR Macedonia	1.092	1.027	1.138	0.955	0.981
Moldova	1.118	1.008	1.744	0.977	0.990
Poland	1.240	1.004	1.021	0.977	0.904
Romania	1.237	0.991	1.157	0.970	0.981
Russia	0.798	0.985	1.129	1.045	0.958
Slovakia	1.110	1.003	0.939	0.990	1.002
Slovenia	1.074	0.994	1.094	0.960	0.981
Tajikistan	1.460	1.083	1.155	1.057	0.963
Turkmenistan	1.533	1.054	0.849	1.201	0.964
Ukraine	1.269	0.998	1.139	0.972	0.973
Uzbekistan	1.508	1.113	0.956	0.994	0.981
Yugoslavia	1.224	1.016	1.362	0.939	0.962

Source: Author's computation based on data from Plan Econ 1998a and 1998b.

\* A = Ratio of the per capita GDP growth rate at market exchange rates to the per capita GDP growth rate at purchasing power parities. B = Ratio of the real per capita GDP growth rate to the per capita GDP growth rate at PPP. C = Ratio of the growth rate of gross fixed investments to the real GDP growth rate. D = Ratio of the growth rate of private consumption to the real GDP growth rate. E = Ratio of the growth rate of average real wages to the real GDP growth rate.

Second, the 'B' indexes, which measure the ratio of the average real GDP growth rate (in domestic currency, at fixed prices) over the average GDP growth rate at PPP, reveal two likely tendencies in shifts in relative exchange rates.

$$B = \frac{GDP_{NER}}{GDP_{PPP}} \quad (8)$$

where:  $GDP_{NER}$  – forecast of the rate of growth of real gross national product,  
 $GDP_{PPP}$  – forecast of the rate of growth of gross national product at purchasing power parity.

In a number of countries the process of the real appreciation of national currencies will continue, contributing to the closing gap between the value of national income as expressed on a PPP basis and its value as expressed in constant prices in the national currency. If this index is higher than unity, then the relative efficiency of the economy is growing, and therefore the competitiveness of the economy is improving, too. If it is less than unity, the relative efficiency and competitiveness are declining.

The index of only about one-third of the transition economies is anticipated to be (slightly) below '1', indicating that there may be a limited depreciation in the national currencies. With an index significantly lower, only 0.985, the Russian economy, which was forecast before the financial crisis in the summer of 1998 to grow at a rate of 4.1 percent over 1999-2002 (in terms of real GDP at constant prices in 1998 rubles), should still grow, but due more to extensive than to intensive factors. In any case, both tendencies mean that the integration of these countries with the world economy should continue.

Third, the 'C', 'D', and 'E' indexes indicate a growth tendency in all but a few of these nations. The 'C' Indexes, which measure the ratio of the average rate of growth of gross fixed investments over the real GDP growth rate, that is:

$$C = \frac{I_R}{GDP_R} \quad (9)$$

where:  $I_R$  – forecast of the rate of growth of investment in fixed capital;  
 $GDP_R$  – forecast of the rate of growth of gross national product,

show that the process of capital formation should gather speed. This will result from an increasing propensity to save and thus a declining marginal propensity to consume, both of which are apparent in the 'D' and 'E' indexes, that is:

$$D = \frac{C_P}{GDP_R} \quad (10)$$

where:  $C_P$  – forecast of rate of growth of private consumption, and

$$E = \frac{W_R}{GDP_R} \quad (11)$$

where:  $W_R$ —forecast of rate of growth of real wages.

If these indexes are below '1', then capital formation should rise more quickly than consumption and GDP, and this should create a strong foundation for more growth. For rapid and sustained expansion, domestic capital formation is always more decisive than the inflow of foreign savings. Only for the Czech Republic, Slovakia, Turkmenistan, and Uzbekistan are the 'C' indexes forecast to remain below '1', which means that consumption is going to increase more quickly than investment. If this does happen, then 'eating the fruits of the future' may take place, and the rate of growth may slow after 2002.

## V. POLICY CONCLUSIONS

**33.** Over the first decade of post-socialist transition to a market economy (1990-99) the expectations for growth and improvement of standard of living have not been met. While GDP has contracted much more than foreseen both by the governments and the international organizations, the income inequality has been on the rise over the whole period. **The challenge to shift transition economies from financial destabilization and economic slowdown of late centrally planned period toward stabilization and growth has turned to be paramount**, beyond the common expectations. It is also true that the policies advised and implemented with the support of the Bretton Woods organizations *vis-à-vis* transition economies somewhat dissatisfied and were not able to deliver what had been earlier foreseen.

**34.** Relatively more successful have been the countries more advanced in institutional building, which were managing stabilization policies in rather gradual yet comprehensive and determined way, without

any unnecessary and harmful shocks. Stabilization, ongoing within the framework of liberalization, is more fruitful if supported by sound attempts at new, market institutional arrangements, and if enhanced by the government structural policies. However, even among the countries leading in transition, **stabilization still must be consolidated into stability.**

**35.** So far, in transition economies the main concern of fiscal policy was financial stabilization and reforms of the system of the public finance. Hence, the matter of raising propensity to save and capital formation was rather an auxiliary concern. However, in the countries that have tried to use the fiscal system and its adjustment as a means for savings enhancement, through , for example, lenient or not at all taxation of capital gains, decreasing taxation brackets, or narrowing the tax brackets, **domestic savings have been growing faster than at the initial stage of transition.** These policies should be continued.

**36. The shift of the fiscal burden from direct to indirect taxation** ought to be considered as one of the main elements of fiscal policy aiming at savings facilitation and capital formation. By and large, if only there is a critical progress accomplished *vis-à-vis* stabilization and the recovery is getting momentum, such direction of changes occurs in a number of countries. In the longer run, an accent on taxing the expenses (through VAT and excise taxes) will encourage savings—and thus capital formation—whereas relatively lenient taxation of income should raise labor incentive and hence its productivity. In consequence, such attempts stimulate competitiveness and growth.

**37.** While new institutional arrangements are being just established and when the new capital is most needed, **the capital gains** (especially from interest rates on banking savings of the household sector<sup>15</sup> and gains earned on emerging stock exchange), **should not be taxed.** In transition economies the policy instruments can be composed in such a way, that even if the absence of taxation does contribute to growing inequity,<sup>16</sup> it may be also contributing to growing income and hence overall poverty reduction. It must be, however, supported by other means of structural reforms and policies, especially as far as income and labor policies are concerned. Introduction of taxation of capital gains must be introduced only when the economy is at the path of fast and sustainable growth. It may be on the agenda at the onset of the 2000s, at the earliest.

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<sup>15</sup>Hence the proposal presented by the IMF mission to Poland (Ebrill, Escolano and Stotsky 1998) to introduce within the next stage of fiscal reform taxation of income received from interest bearing bank deposits must be seen as inappropriate. It may improve the clarity of the system, though such a reform then should call for the taxation of all capital gains. At the current stage of developments it would change not only the structure of savings (by shifting a part of money from banks accounts toward stock exchange), but also could harm the propensity to save.

<sup>16</sup>Indeed, most often this is a fact both in developed market economies as well as in transition economies. Nevertheless, in the latter case, if there is a sound strategy for development and the economy is on the path of growth, inequality can be to some extent contained (Kolodko (1999a)).

**38.** Considering the current stage of transition to a market economy – that is the scope of liberalization and privatization as well as the openness of the EE and FSU countries, on the one hand, and the advancement (or delay) of new institutional arrangements, on the other hand—there are many policy options. The whole region of post-socialist countries at the end of the decade is even more diversified than it was at its beginning. Thus the fiscal policies cannot be uniformed, too. In countries still lagging behind with systemic transformation and working development strategies, the fiscal policy must take care firstly of the matter of stabilization, yet the issue of capital formation must not to be overlooked either. In the countries more advanced in institutional changes and relatively more stable, fiscal policy must take care much more of the issue of capital formation. It means that fiscal policy should encourage savings, since in the longer run growing propensity to save serves also the purpose of financial stability. The policy conclusion is that **it should be a routine—including the IMF missions and technical assistance—to monitor the fiscal policy and reforms from an angle of their influence upon the long-term capital formation.**

**39.** Although the considerations presented so far have been emphasizing mainly the formation of physical capital, **fiscal policy must aim at the improvement of the human capital**, too. Despite the multiplying and complex tax deductions and other fiscal incentive are tended to spoil the fiscal system (especially under the circumstances of weak tax administration, what is rather a typical feature of transition economies), it is worth a serious attempt to use such means for the purpose of increasing investment in the human capital. Of crucial importance here are the investments in education. Tax deductions encouraging higher share of households expenditure on education should be advised and implemented. In long term it improves, not deteriorates, the fiscal situation, since it contributes to durable and balanced growth. Thus, it serves well the purpose of sustainable development, that is the utmost aim of economic policy.

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