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Fiscal Transition in the Baltics

Abstract

In market economies we can clearly make a distinction between the area of public finance and the area of private finance. In the centrally planned economies the distinction between private and public finance did not actually exist, because all economic activities as well as all finance were public. Given that, one can argue that transition from a centrally-planned to a market economy includes a radical fiscal restructuring.

In principle, fiscal policy in transition economies was aimed at promoting economic recovery and creating favourable conditions for economic operators while maintaining reasonable social security. The fiscal stability was seen as an important signal of the government's commitment to economic stabilization. This, in turn, would increase public confidence in government. After the brake-up of the Soviet Union, most of the successor states experienced large fiscal deficits. Compared to other countries of the FSU, the Baltic states were able to maintain rather moderate deficits. One explanation for this can be that the initial fiscal position in all three Baltic states was better than in Russia and the transition economies in central Europe, and partly because of the early budget reforms in 1990-91. The Baltic countries practised tight fiscal policies right from the start of their independence. Another explanation for the Baltics' better success in maintaining fiscal stability can be explained by the fact that during the old Soviet system, the Baltic countries, especially Latvia and Lithuania, contributed large net transfers to the Soviet Union's budget. Once the Soviet Union collapsed, these transfers were abolished and the Baltic countries's financial balances improved significantly. The initial surplus in the fiscal accounts and better revenue performance made it easier to implement strict cash rationing as a means for expenditure control. Tight cas rationing has been an effective way to cut spending. Moreover, an additional factor explaining the success in expenditure policies has been the development of social security benefits. The shares of these transfers have remained fairly stable in all three Baltic states. Finally, it seems that Baltic governments have also been quite successful in reducing subsidies to very low levels. Despite the success, all three Baltic states have had trouble collecting budget revenues. Tax administration as well as control and payment mechanisms are still underdeveloped. In addition, due to a fact that many new private firms were not captured in the tax net, both taxes on wages and salaries, and VAT and other indirect taxes, may not have been fully collected from them. Budget revenues have further been negatively affected due to increase in tax arrears and falling profitability in state enterprises.

Although the Baltic the Baltic countries managed to keep their fiscal deficits at quite low levels, deficits still emerged and therefore financing for these deficits had to be found. In respect of domestic financing, the government deficit has been mainly financed in the form of government bonds. The level of foreign financing, however, has been low due to a limited access to foreign capital markets.

The future challange for economic policy in the Baltic countries is to ensure the availability of resources necessary to maintain growth, In this respect, fiscal policy should encourage savings, because they form the base for financing the high levels of investment required for sustained economic growth. One of the future challanges in all Baltic countries is the collecting of timely accurate, and accessible fiscal data that are consistent with the international standard of government finance statistics methodology. Also, we cannot ignore that social safety nets are under severe strain as a result of weak financial and administrative capacity. Further efforcts will focus also on tax policy; on improving the effectiveness of taxes by further broadening the tax bases and removing of various tax exemptions. There are also the challanges faced by tax administration. In general, tax administration could be improved by better organization of auditing, registration, taxpayer information, returns processing etc. Finally, even the best plans and fiscal reforms can be destroyed by lack of competence, corruption or breaking of legislation.

Keywords: the Baltic states, transition, fiscal policy, taxation, budget

1 Fiscal Evolution – From Plan to Market

In market economies we can clearly make a distinction between the area of public finance and the area of private finance. Furthermore, countries that have had a market economy for at least several decades have some sort of working fiscal system in place as well.

In the centrally planned economies the distinction between private and public finance did not actually exist, because all economic activities as well as all finance were public. Given that, one can argue that transition from a centrally-planned to a market economy includes a radical fiscal restructuring. The policy of macroeconomic stabilization, liberalization and privatization has influenced public finances by increasing the demands on public expenditure and decreasing public revenue. Planning the budget has become an instrument of economic policy instead of an automatic political and accounting-related move as it was under central planning. Transition economies have started a process of replacing the old system with systems better suited to a market economy. This process has taken place at the time when the market economy itself is not fully in place. Fiscal revolution has required not only the creation of many new institutions and the learning of many new skills, but a deep change in attitudes as well. Policy makers, business owners, workers and the population as a whole have had to be educated on how to function in a new system.

At the beginning of transition, the fiscal systems of these countries shared similar features:

- The public sector played a still overwhelming role in both resource allocation and income distribution.
- Public spending was high, equalling about 40–50 % of GDP.
- The tax system, although generating revenue, relied significantly on tax base definitions characteristic of central planning. Not surprisingly, huge chunks of the tax base vanished once transition started, leading to huge falls in tax revenue.
- Reconstruction in the state enterprise sector resulted in further cuts by shrinking the remaining tax bases, i.e. profits, wages and consumption.
- Fiscal institutions such as tax administration, customs, budget offices and treasuries either did not exist or were underdeveloped.[1]

As transition progressed, both budgetary as well as tax reforms became necessary. First, it became evident that the entire system of raising revenue had to be changed. Countries started out with high levels of taxation by international standards. Later, since maintaining of high tax ratios was no longer possible, large cuts in the level of public spending were necessary. This meant cancelling many government programmes and the elimination of subsidies to consumers and enterprises. (See World Development Report 1996).

One of the main fiscal reforms has been the introduction of value-added tax. VAT has replaced complex transaction or turnover taxes through which centrally planned economies collected a large share of their tax revenues. Further, corporate income taxes have begun to substitute for profit taxes and transfers. Systems of personal income taxation have been developed.

Another big issue in fiscal reform has been that of social protection. Since the fall in the public revenue also required reductions in public spending, there has been a strong need to restructure social benefits system for fiscal as well as social reasons.

All this has been rather problematic as policy makers have found it difficult to accept the more limited role of public spending, public authority and government activity in general. As a consequence, spending cuts have often been insufficient, and possibly misdirected. Deficits are thus reduced through arbitrary cuts in government spending, non-payment of bills and shifting of expenditures off budget, with the result that fiscal deficits widen even further. Some governments have financed this deficit by printing money or borrowing. Underdeveloped capital markets and

[1] in Economies in Transition, edited by Vito Tanzi (Washington:International Monetary Fund,See World Development Report 1996 and Fiscal Policies 1992).

constraints on foreign borrowing have made money printing a tempting way to finance deficits, thereby adding to inflationary pressures.[2] Large deficits, inturn, tend to slow growth of an economy.

Fiscal transition is particularly tricky from the legislative standpoint (IMF publications & McGee 1995). Goverments regularly issue rules that are vague or incomplete because it is impossible for those writing the rules to anticipate situations that might arise when implementation is started. As a consequence, changes have been made as problems arise. Such an approach again slows down the process of fiscal transition.

Transition economies frequently change their tax rules. While its a good idea to search for the best tax policies, frequently changing tax rules make it difficult for government officials and businesses to keep up with the changes. In particular, a rapidly changing business environment increases investment uncertainty and makes planning for the future difficult.

Every government has some problems with tax collection, but for transition economies the problem is considerably more acute as their tax systems are not yet in place. On one hand, taxpayers may not keep detailed records concerning their tax liability, and some groups in the private sector may treat taxation as voluntary rather than an obligation. On the other hand, government officials may not be aware of certain businesses, especially small businesses or those dealing mostly with cash, making it quite impossible for the government to collect taxes effectively. Thus a generally weak tax administration lets many small enterprises get away without paying taxes, and instead raises base tax rates. The higher rates, of course, only serve to encourage tax evasion on an even wider scale. (see eg IMF Occasional Paper 127/95)

All these factors have made fiscal transition a very colourful process indeed. Perhaps one of the most fundamental issues connected with fiscal transition is the now common distrust of government and politicians. Government is often considered more an enemy rather than a friend of the people. This sentiment, together with all the other problems, has made it especially difficult for governments in transition countries to implement required reforms and collect needed revenue.

2 Fiscal policies in the Baltic states

In principle, fiscal policy in transition economies was aimed at promoting economic recovery and creating favourable conditions for economic operators while maintaining reasonable social security. The fiscal stability was seen as an important signal of the government's commitment to economic stabilization. This, in turn, would increase public confidence in government.

After the break-up of the Soviet Union, most of the successor states experienced large fiscal deficits. Before continuing, it is important to define a fiscal deficit. In principle, a fiscal deficit is the difference between income and expenditure (excluding debt contracted and repaid) of the central government, the Social Security fund and all levels of local government. Together these constitute general government. In 1992, the unweighted average general government deficit in the region of the FSU rose to 13 % of GDP, compared with 8.5 % in the Soviet Union in 1989.[3] Compared to other countries of the former Soviet Union, the Baltic states were able to maintain rather moderate deficits. (See Tables 1 and 2). Through 1992, the Baltic fiscal balances remained roughly in balance and the same trend continued also through 1993. Only during the last couple of years have deficits developed in Latvia and Lithuania.

Why did the Baltic countries succeed in maintaining rather small deficits compared to other countries of the former Soviet Union? One explanation can be that the initial fiscal position in all three Baltic states was better than in Russia and the transition economies in central Europe, and partly because of the early budget reforms in 1990–91. The Baltic countries practised tight fiscal policies right from the start of their independence. In their first fiscal programmes (from mid-1992 to mid-1993), Estonia and

[2] See more Economic Policy in Transitional Economies, Kluwer Academic Publishers, Volume 6 No.3, 1996.

[3] Kluiwer Academic Publishers, Economic Policy in Transitional Economies, Volume 6, No 3, 1996.

Table 1 **Evolution of general government surplus, 1992–1995 (percentage of GDP)**

	1992	1993	1994	1995
Estonia	–0.3	–0.7	1.3	0.3
Latvia	–0.8	0.6	–4.0	-3.4
Lithuania	0.8	–4.9	–4.7	-3.0

Source: 1) IMF, 2)Kluwer Academic Publishers, Economic Policy in Transitional Economies, Volume 6 No. 3, 1996.

Table 2 **Fiscal deficits in the FSU and some CEECs, 1991–1995, (percentage of GDP)**

	1991	1992	1993	1994	1995
Armenia		34.8	56.2	16.5	8.7
Azerbaijan		–2.8	15.3	10.9	5.4
Belarus		–0.1	4.3	2.8	2.6
Georgia		37.3	26.2	16.5	5.7
Kazakstan		7.3	1.2	6.8	2.5
Kyrgyz Rep.		17.4	13.5	8.0	11.3
Moldova		23.4	8.9	6.4	4.3
Russia	16.0	18.8	8.0	10.1	4.9
Tazhikistan		29.9	23.5	5.4	7.3
Turkmenistan		–13.2	0.5	1.5	1.6
Ukraine		24.2	11.7	9.2	5.2
Uzbekistan		18.8	9.4	6.7	3.4
Poland	6.5	6.7	2.9	3.0	
Hungary	2.1	5.5	6.7	8.0	
Czech Rep.	1.9	3.6			

Source: 1) IMF, 2) Kluiwer Academic Publishers, Economic Policy in Transitional Economies, Volume 6, No. 3, 1996.

Lithuania aimed at balanced budgets (measured by financial balance, i.e. overall fiscal balance minus net lending), while Latvia's programme allowed for a small deficit of 1–2 % of GDP. The second programmes (from mid-1993 to end-1994) allowed for deficits, 1–2 % of GDP, in all three Baltic countries. In next two programmes (1995 and 1996), Estonia approved balanced budgets, while Lithuania's programmes allowed deficits of 1.9 and 2.3 % of GDP. Latvia's programmes for the same years included deficits of 2 % of GDP. For 1997, Estonia & Latvia have drafted balanced budgets. According to Lithuanian own estimates, the 1997 budget calls for a decifit roughly around 2.5 % of GDP.

Another explanation for the Baltics' better success in maintaining fiscal stability can be explained by the fact that during the old Soviet system, the Baltic countries, especially Latvia and Lithuania, contributed large net transfers to the Soviet Union's budget. Once the Soviet Union collapsed, these transfers were abolished and the Baltic countries' financial balances improved significantly. According to the IMF report (44/1995), Latvia's net transfer was estimated to have reached 14 % of GDP in 1988 and 1989, and in Lithuania 6 % of GDP 1989–90 on average. Estonia had reduced its earlier higher transfer to some 2 % of GDP by 1989.[4]

Further explanation for the Baltic success in their fiscal policy can be seen by looking at the evolution of general government revenue shown in Table 3.

One can observe that among the Baltic countries, Lithuania faced the largest shortfall in revenues. However, the drop in revenues in the Baltic countries was not as dramatic as in the countries of the former soviet Union on average. Generally, it can be said that the most significant reforms of regional tax structures in the Baltic states took place quite early in transition. This meant, most of all, that enterprise reform and the replacement of the turnover tax by VAT. Particularly Estonia and Latvia established new tax systems to raise revenue from the start of their independence, while Lithuania was slower in its reforms. Estonia established a value-added tax system in 1991. Lithuania, by contrast, introduced VAT in the spring of 1994.[5]

Despite the better success of Estonia and Latvia, all three Baltic states have had trouble collecting budget revenues. Further, these problems and revenue losses have been broadly similar in magnitude suggesting that the pace of reforms has not been critical, i.e.

- Tax administration as well as control and payment mechanisms are still underdeveloped. Collection especially of corporate taxes has turned out to be problematic.
- Due to a fact that many new private firms were not captured in the tax net, both taxes on wages and salaries, and VAT and other indirect taxes, may not have been fully collected from them.
- Budget revenues have been negatively affected due to increase in tax arrears and falling profitability in state enterprises.

On the other hand, the structure and management of public expenditures contributed the relatively good fiscal performance in the Baltic states. (See Table 4).

The initial surplus in the fiscal accounts and better revenue performance made it easier to implement strict cash rationing as a means for expenditure control. Tight cash rationing has been an effective way to cut spending (particularly in non-priority sectors such as in purchases of goods and services). It also proved an effective means for keeping the lid on local government spending and social security funds, which often were dependent on central government budget transfers.

The Baltic countries also have implemented some institutional arrangements to improve expenditure control. For example, Estonia has a law which forbids the central bank from financing the government's budget deficit. In Latvia and Lithuania, central bank financing was first possible, but only up to a certain limit. Later, in

[4] IMF Working Paper 44/95, Stabilization in the Baltic Countries: A Comparative Analysis, April 1995.

[5] Lainela and Sutela, The Baltic Economies in Transition, Bank of Finland, 1994.

Table 3 **The evolution of general government revenue, 1991–1995 (percentage of GDP)**

	1991	1992	1993	1994	1995
Average FSU	35.1	33.1	30.3	28.6	23.9
Estonia	41.0	33.3	39.9	41.2	41.2
Latvia	37.4	28.2	35.8	36.3	36.0
Lithuania	43.0	33.7	28.4	24.5	23.5
Russia		41.6	37.5	33.6	27.0

Source: 1) IMF, 2) Kluwer Academic Publishers, Economic Policy in Transitional Economies, Volume 6 No. 3, 1996.

Table 4 **The evolution of general government expenditure, 1992–1995 (percentage of GDP)**

	1992	1993	1994	1995
Average FSU	45.8	44.1	37.9	29.5
Estonia	33.6	40.6	39.9	40.4
Latvia	29.0	35.8	41.2	39.7
Lithuania	31.3	33.3	29.3	27.0

Source: Kluwer Academic Publishers, Economic Policy in Transitional Economies, Volume 6 No. 3, 1996. IMF statistics.

Table 5 **The share of pension benefits to average wage ratio, 1991–1994**

	1991	1992	1993	1994
Estonia	–	46.3	35.0	38.9
Latvia	26.0	34.6	30.7	33.5
Lithuania	44.3	52.5	49.4	45.9

Source: Golinowska S., State Social Policy and Social Expenditure in Central and Eastern Europe, CASE Centre For Social And Economic Research, Warsaw, May 1996.

1994, Lithuania introduced the currency board, and the central bank credit to finance government expenditure was no longer possible. With these practices, cash rationing has worked effectively in the Baltic countries.

A final factor explaining the success in expenditure policies has been the development of social security benefits. The shares of these transfers have remained fairly stable in all three Baltic states. In this respect, low official unemployment as well as tight pension policies have helped to keep social security benefits in control. The share of pension benefits to average wage ratio in 1991–1994 can be seen in Table 5: In addition, it seems that Baltic governments have also been quite successful in reducing subsidies to very low levels. Estonia has been the most radical in this respect since it has abolished all price subsidies apart from energy. In Lithuania, however, price regulation still exists to a larger extent than in two other Baltic countries and therefore, budget subsidies are obviously the largest. As a comparison, in 1994 budgetary subsidies in the Baltic countries averaged 3–4 % of GDP whereas in Russia subsidies amounted to 9 % or in the Ukraine 17 % of GDP.[6] Finally, the small size of the Baltic economies has most likely contributed to the fiscal transition. It is quite obvious that reforms and changes are implemented easier in the small country like Estonia than a big country like Russia.

All of the Baltics have experienced banking crises. Estonia experienced its banking crisis in 1992. In Latvia, the crisis took place in May 1995 and in Lithuania in December 1995. Due to banking crisis, financial health of public, business as well as private sector have severely been distorted. This naturally has had some fiscal implications.

3 Fiscal reform in Estonia

Tight fiscal policy was a crucial element in Estonia's economic transition. The fiscal discipline was seen as an indicator of the government's commitment to stabilisation. During independency, Estonia has mainly approved a balanced budget apart from years 1993–1994 which allowed a small deficit of 1–2 % of GDP. As suggested, since the beginning of fiscal reform (1992), main efforts focused on increasing government revenue and cutting the expenditures. An additional burden to increase government revenue in Estonia resulted from the currency reform introduced in mid-1992. A strong revenue package amounting to 5–6 % of GDP was then introduced to support the currency reform.

In respect of revenue, several existing taxes were increased and new taxes introduced. In addition, the net of taxable items was widened. The general aim was to put more emphasis on indirect taxes. As a result, revenue from direct taxes remained broadly stable while the share of indirect taxes increased. In particular, VAT rates increased. Indeed, Estonia was the first of the Baltic states to establish a VAT system in 1991. Currently the rate is 18 % .

Among others, Estonia also introduced an excise tax. Recent developments have been related to the large increases of these taxes mainly on alcohol, tobacco and gasoline. Increases in excise taxes have significantly contributed to government revenue. Due to Estonia's liberal trade policy and almost complete absence of customs duties, revenues from foreign trade have remained modest.

Another important source of revenue in Estonia has been income tax, particularly personal income tax. At the beginning of the fiscal transition, both corporate as well as personal income taxes were increased to gain more budget revenue. Important modifications in personal and corporate income tax system were made in the beginning of 1994, when the equal proportional tax rate of 26 % for individuals and corporations was introduced. However, the income tax system has often been accused of being complicated because of various exemptions. The general trend in budget revenues since 1992 can be seen in the Figure 1 and 2.

In respect of government expenditure, the general trend is shown in Figures 3. and 4. Given the initial surplus in the fiscal accounts due to the abolition of transfers to the Soviet Union state budget, and reasonably good revenue performance (revenue-to-GDP ratio was not dramatically declining), it was easier to implement strict cash

[6] World Development Report 1996, From Plan to Market.

Figure 1 **Budget Revenue 1992–1994 in Estonia**

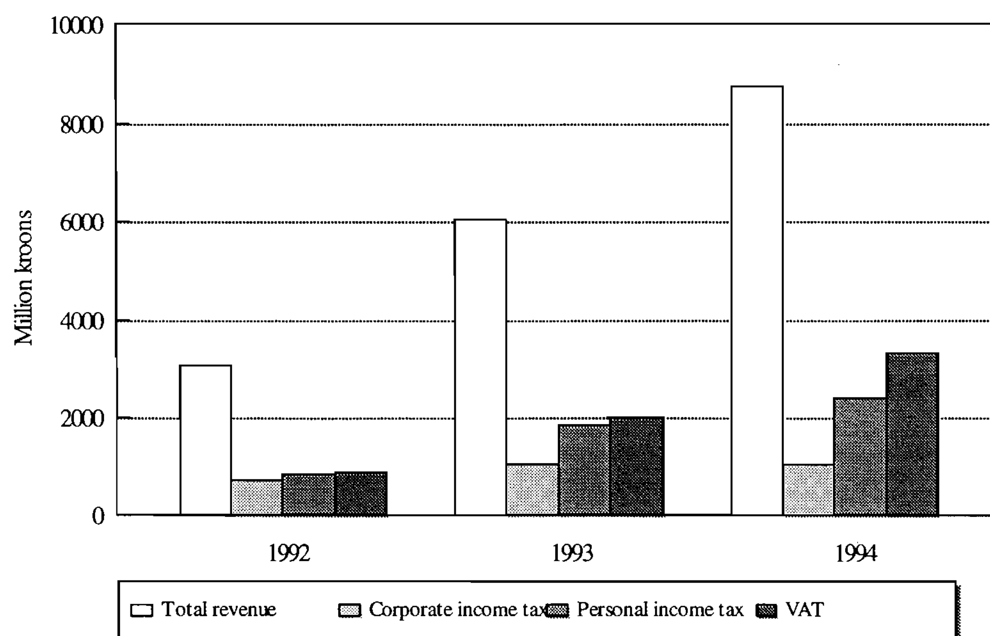
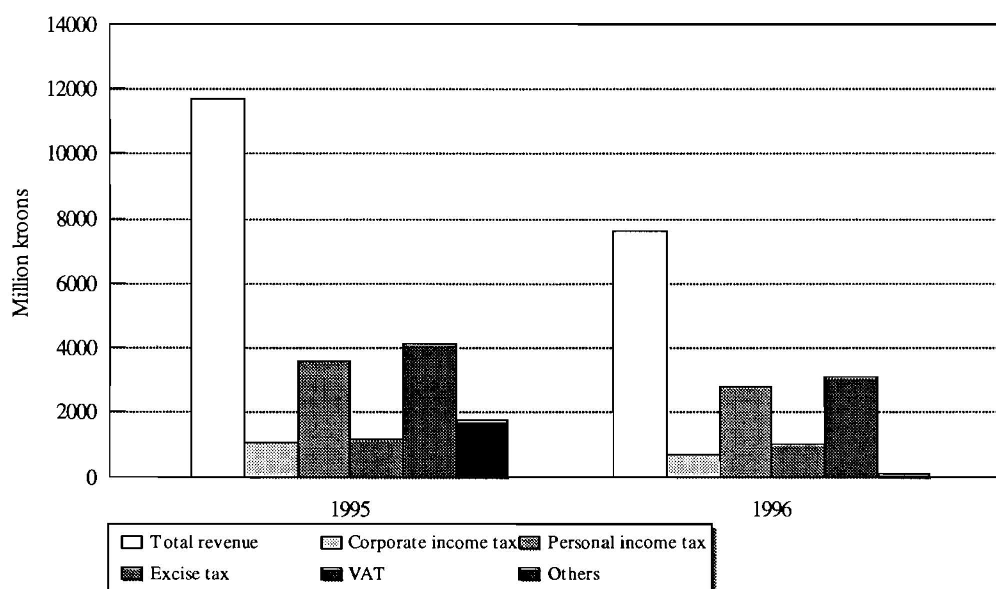


Figure 2 **Budget Revenue 1995–1996 in Estonia**



Source: State Statistical Yearbooks 1993–1996, Eesti Statistica 9/96. Budget revenue 1996 includes revenues collected up to September 1996.

Figure 3 **State budget expenditure 1992–1995 in Estonia**

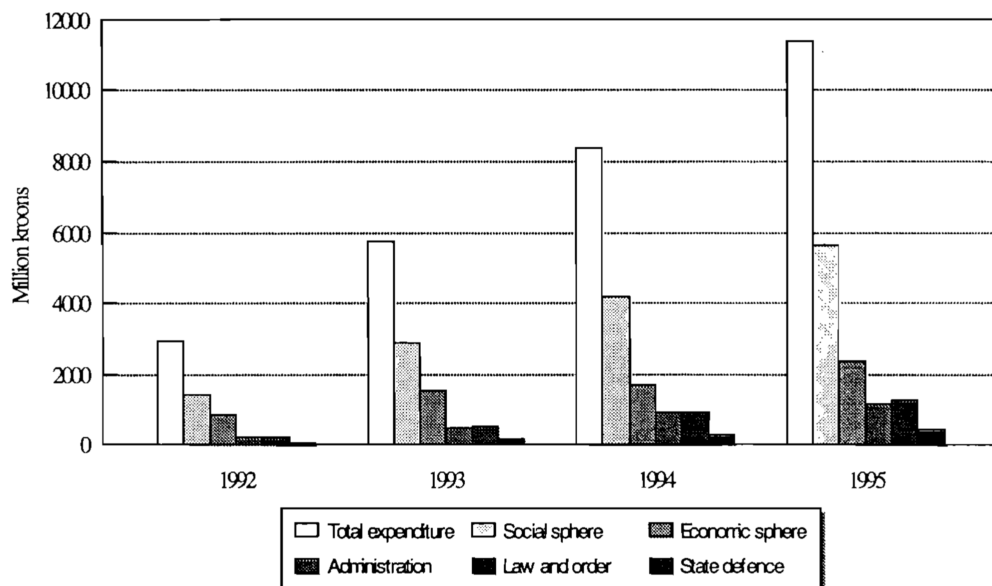
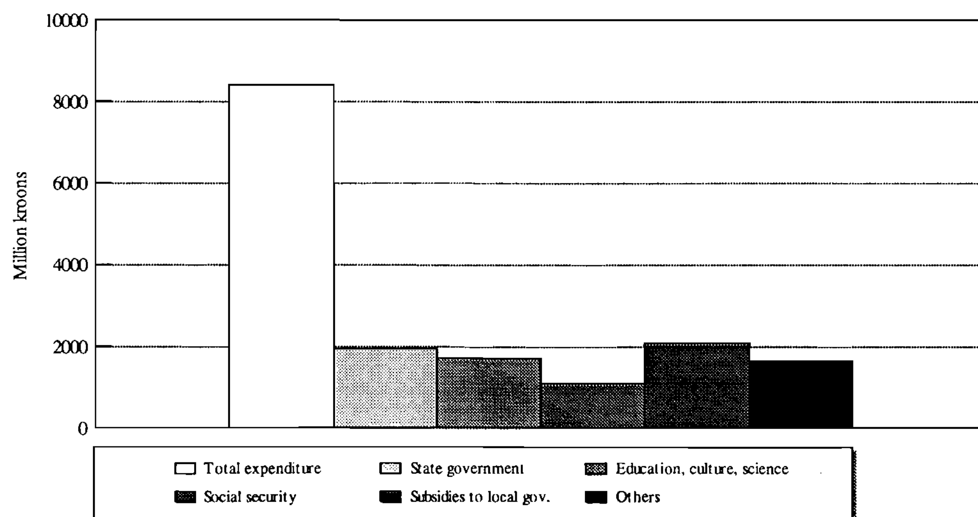


Figure 4 **Budget expenditure 1996 in Estonia**



Source: State Statistical Office, Statistical Yearbooks 1992–1996. Estonian Statistics 9/96, 1996 budget expenditures include expenditures up to September 1996.

rationing as a means for expenditure control. In spite of the need to restructure several sectors of the economy, the total investments from the fiscal system to the social infrastructure have been kept very low in Estonia. The main tendency has been to cut costs apart from those which are related to the restoration of Estonia's independent statehood, i.e. defence and maintenance of civil law and order. One of the remarkable achievements is the almost total liquidation of various subsidies paid previously to enterprises. Other expenses such as social insurance and health insurance have been formed from payroll taxes. Collecting of these funds has, however, been very problematic because in private sector, some parts of salaries are often paid in cash or in some other form to avoid the payment of payroll taxes.

On the institutional side, it is very important to note that in the Estonian system, central bank credit to finance government expenditures have been eliminated completely due to a currency board system. In respect of other institutional arrangements, the State Treasury started operating from January 1996 and is currently the only body responsible for managing the government's finances. In the earlier, decentralized system different governmental agencies had direct access to commercial banks. Some governmental agencies had deficits while others big surpluses reflecting inefficient use of budget funds.

In spite of establishment of State Treasury, collecting the budget revenue remains still a great problem. Efficiency of tax administration in general is low because control mechanisms and tax administration are still underdeveloped. This applies especially to distribution of information describing what is or is not taxable, how to calculate tax liabilities, what happens in case of non-payment, etc. In practice, tax payers and tax officials have various disputes due to their different understanding of the tax laws.

Further, tax avoidance is still common, particularly in the private sector. Improving the performance of indirect taxes may prove to be extremely difficult in the future due to smuggling, illicit production, hoarding and falsification of trade records.

Finally, although the tax officials would find taxpayers, there still remains the problem of massive tax arrears. Either the large still state-owned or recently privatized enterprises do not have enough capacity to pay their taxes, or then there are just misunderstandings concerning the tax laws in question.

Despite of the problems mentioned, fiscal transition continues in Estonia and future efforts will be focused especially on harmonization of tax laws, broadening the tax base and improving the efficiency of tax administration. Since EU membership is one of the main policy goals for Estonia, the pre-accession strategies provided by the Union play a crucial role in economic decision-making and implementation. In particular, the Union's White Paper on approximation of laws is a useful basis for law harmonization. The Paper includes detailed instructions on what to do in order to fulfill the requirements of internal market in the European Union (see more in Commission's White Paper 1995).

In order to improve tax administration, some key issues still need to be dealt with. In particular, a national audit plan and basic bookkeeping needs to be developed. Also the taxpayer identification system needs to be improved. Moreover, promotion of cooperation between the National Tax Board and the National Customs would be quite useful. One can assume that in the future improved tax administration will most likely focus on economic activities themselves rather than on individual taxes or taxpayer groups. (See more on the Estonia's fiscal transition: IMF publications 1995–1996, WB country study 1993, Vensel 1996)

4 Fiscal reform in Latvia

In 1991, Latvia drafted its own budget for the first time in the post war era. A new tax system and new tax measures were introduced. The general government budget registered a surplus of 6 % of GDP in 1991.[7] This surplus can partly be explained by tight expenditure controls and revenue gains from price liberalization. In addition, budgetary balance improved

[8] Inna Steinbuka & Martins Kazaks, Fiscal Adjustment in Latvia under transition, Centre for Economic Reform and Transformation, Discussion Paper No 1/96, Heriot-Watt University Edinburgh 1996.

significantly since large net transfers (14 % of GDP) to the old Soviet Union's budget were abolished.

In 1992, the situation changed. Production fell, inflation was high and both the private and financial sector struggled through heavy restructuring. The States's financial condition weakened due to a decline in budget revenues, an increase in expenditures and due to weak tax administration. Since the economic and political situation was changing rapidly, (particularly high inflation of 960 %) the budget was drafted separately for the first and second half of the year. Initially, the projections were optimistic allowing a surplus of around 1–2 % of GDP. Despite problems as the year progressed, the budget was kept on track and the fiscal deficit at the end of 1992 amounted to only 0.8 % of GDP. This could at least partly be explained by large cuts in expenditure combined with the revenue gained from establishment of a "turnover tax" and other new tax rates.[8]

In 1993, discussions of fiscal policy continued to heat up, delaying budget approval. There were several issues at stake. First, despite the new taxes, the share of tax revenues to GDP continued to fall. Second, public investment and financing for social and cultural activities was considered insufficient. Pensioners and low-income residents were also unsatisfied with the level of pensions and other social payments. Taxpayers and entrepreneurs, meanwhile, complained of high taxes which were set to compensate continuous tax evasion. Finally, the whole tax administration and collection was seen ineffective. As a consequence, the whole fiscal system had to be reformed.

The fiscal reform had eight main objectives (see more: Ministry of Finance of the Republic of Latvia 1995–1996):

1. Revenues and expenditures (both central and local) should be matched so that the general government deficit did not exceed 2 % of GDP (i.e. consistent with acceptable maximum levels specified by International Monetary Fund).

2. Within next five years tax revenues should reach 38–40 % of registered GDP.

3. Provide financing for social safety net during the transition, for culture and science, defence and public protection.

4. Stimulation of savings.

5. Stimulation of investment.

6. Improvement tax administration, harmonization of legislation according to EU standards.

7. Further actions to prevent tax avoidance.

8. Stimulation of production to prevent the negative influence of taxes on business activity and promote and speed up the economic growth in Latvia.[9]

As mentioned, one of the major tasks in this fiscal reform was the harmonization of tax legislation. It had to be brought closer to that of both other Latvian legislation and that of the European Union. Tax reform implied a gradual change in tax structure away from income towards consumption and towards indirect taxation. As a result, a new tax package was worked out and gradually implemented in 1993–1995. In particular, the roles of value-added and excise taxes increased, whereas the corporate tax became less important. VAT gradually supplanted turnover tax until 1995, when it completely displaced the turnover tax. Currently, the VAT rate is 18 % .

Changes in excise taxes aimed mainly at improving tax administration by introducing various certificates. Further, excise taxes were increased on several occasions. In 1995, tax reform also merged the personal income tax and the corporate profit tax at a rate of 25 % . Tax legislation changes were also applied to payroll taxes, mainly in income and social taxes. In respect of income tax, the tax basis was widened,

[9] Turnover taxes were characterised by a multitude of tax rates which have now been replaced by VAT.

[10] See Ministry of Finance of the Republic of Latvia Bulletin, Strategy and Goals for Fiscal reform in Latvia 1994 Nr. 1.

Figure 5 **Budget revenue 1992–1994 in Latvia**

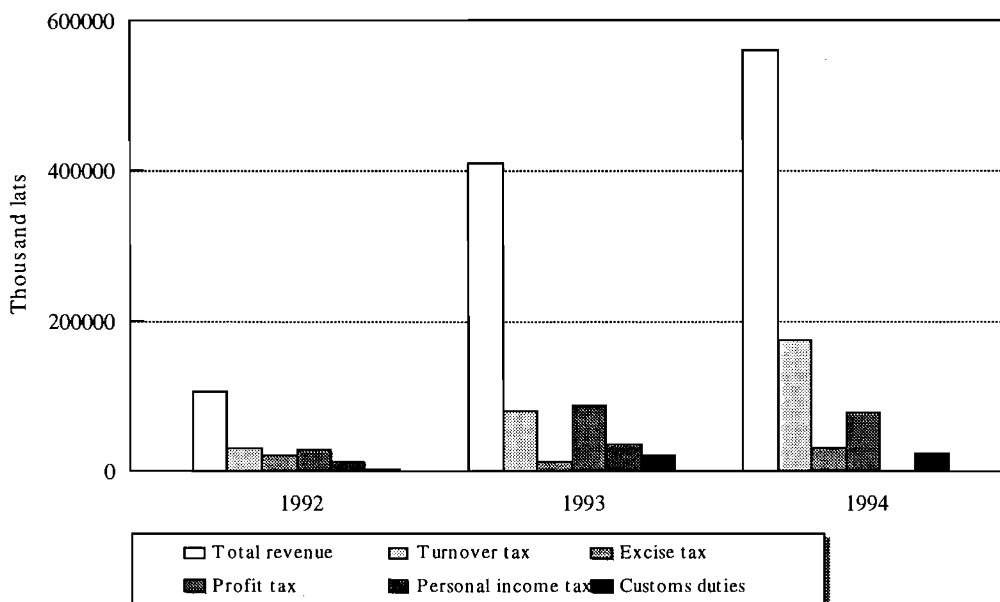


Figure 6 **Budget revenues 1995–1996 in Latvia**

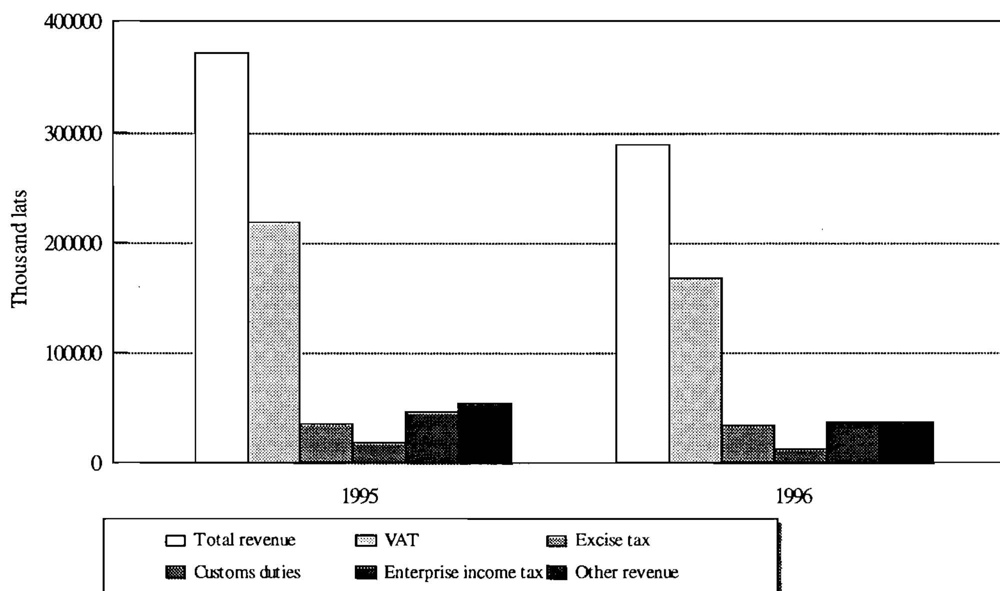


Figure 7 **Budget expenditure 1992–1995 in Latvia**

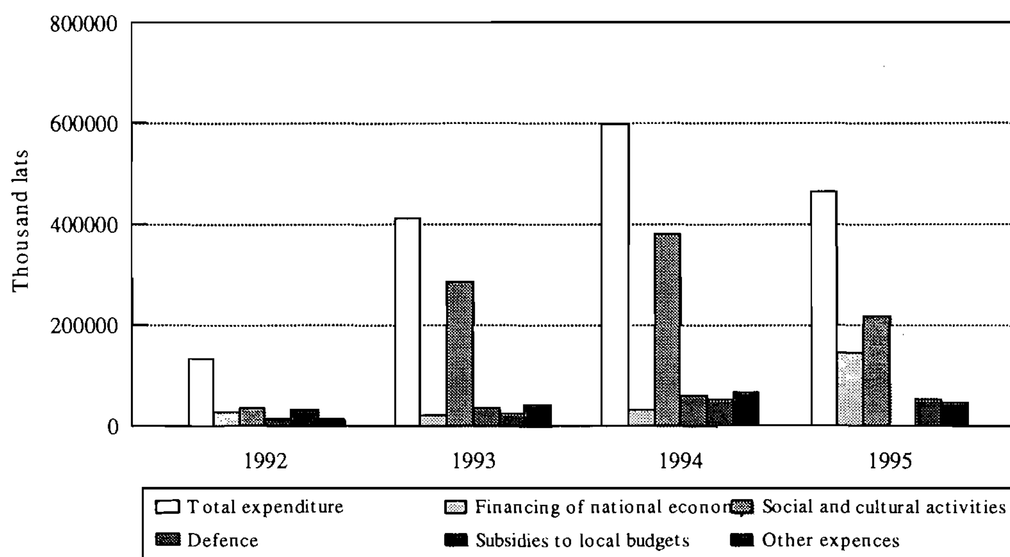
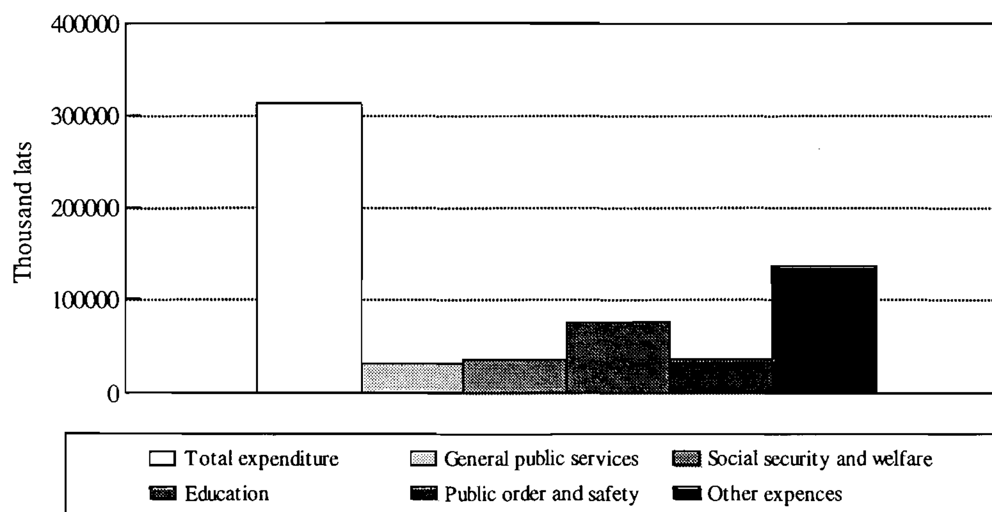


Figure 8 **Budget expenditure September 1996 in Latvia**



Source: Statistical Yearbooks of Latvia 1992–1996, Monthly Bulletins of Latvian Economy 1995–1996. Revenues & expenditures up to September 1996.

progressive tax rates were replaced by two other rates, a common and extra rates. In respect of the social tax reform, the situation was particularly problematic since, in Latvia, the state is fully responsible for pensions and other support payments for the elderly. However, some discussions were held concerning the distribution of the tax burden between employers and employees. These discussions continue. Since July 1996, there has been a tendency to decrease the contribution of employers and increase the contribution of employees. [10]

Certain actions have been taken particularly to protect domestic producers and improve tax administration. Changes were made in customs duties to take into a consideration Latvia's trading agreements with its trade partners and setting the import duties accordingly. Further, since the undervaluation of imports decreases tax revenues and encourages fraud, world prices are now used as a basis for calculating import duties. The general trend in budget revenues and expenditures can be seen in Figures 5–8.

Recently, the aim in tax policy has focused on convergence with EU tax standards by increasing the tax base and reducing taxes. In addition, efforts have focused on improving monitoring and follow-up action against those who fail to make payments. Latvia has issued regulations for an improved taxpayers' register, so that every tax payer must register with the State Revenue Service; financial institutions will not be allowed to open accounts for any business or individual without a taxpayer code. Yet, in spite of the government's attempts to improve resource allocation and tax administration, the fiscal system still suffers from tax avoidance and lack of adequate control mechanisms. In this respect, there is still much to be done. (See e.g. IMF publications, Lainela & Sutela 1994, Shteinbuka & Kazaks 1996, WB country study 1993, Latvian Ministry of Finance 1995–1996).

[11] Until July 1996, the base rate for employers was 37 % and for employees 1 %. Then the rates were changed to 33 % and 5 % respectively. By 2002, it has been planned that the base rate for employers would be 28 % and for employees 9 % .

5 Fiscal reform in Lithuania

In 1992, despite of contraction in GDP and a decline in total government revenues, the fiscal balance of the Government remained quite well in balance. In 1993, the situation changed and the fiscal balance recorded a deficit of 4.9 % of GDP due to a substantial increase in the net lending operations of the Government. Ever since, fiscal deficits and the decline in revenues have been the principal features of fiscal developments in Lithuania. In general, Lithuanian tax revenues declined at the beginning of transition and since then have stayed clearly below that in Estonia and Latvia.

One of the main reason for revenue decline was marked adjustment in the distribution of factor incomes away from wages. In 1992, real wages had risen and downward adjustment was necessary in response to the increase in imported oil prices. As a consequence, real wages fell by some 55 % by mid-1993. This large and rapid fall in wages led to a market shift in the composition of income from wages to profits. Since wages were more highly taxed than profits, this shift contributed significantly to the decline in revenue.

Revenue decline was further enhanced by a decline in consumption. Since household consumption constitutes a large part of the base for the general excise tax, decline in consumption affects revenues stemming from it. Revenue decline has been affected by the fact that Lithuania has generally been slower in adopting tax reforms than Estonia and Latvia. For example, Lithuania replaced the General Excise Tax (sometimes also called turnover or transaction tax) with VAT in May 1994 whereas most of the Central and Eastern European countries as well as countries of the Former Soviet Union had already done so in 1991–1992.[11]

The underlying shifts in the distribution of income and slower pace of tax reforms in general does not fully explain the decline in tax revenues in Lithuania (even when uncertainties with national accounts are considered). One important factor certainly has been the inefficiency of tax collection, which has lagged behind that of the

[12] See IMF Occasional Paper 133/1995, Ed. by Daniel A. Citrin and Ashok K. Lahiri.

other two Baltic countries. In particular, the newly privatized firms became increasingly difficult from a tax administration point of view. The new private firms were not always captured by the tax net, so it was quite impossible to gain tax revenue from them. On the other hand, since these firms were also poorly captured by the statistics, one must remember that it is also unclear how much they contributed to the decline in the revenue as a whole.

As in Estonia and Latvia, the problem of tax arrears has contributed to revenue decline in Lithuania. In particular, the General Excise Tax, individual excises and profit taxes suffered from tax arrears.

Each of the major taxes, i.e. enterprise taxes; taxes on wages and salaries, VAT and other domestic indirect taxes, contributed to revenue decline. This excluded, however, the old Soviet period trade taxes which were substituted with tariffs and therefore did not affect to government revenues much.

In terms of government expenditures, the trend has been similar to that in other Baltic countries. In other words, revenue decline had to be matched with expenditure cuts. Precise quantification of the developments in different expenditure categories has, however, been difficult, since the introduction of the clear economic classification of expenditures took place only in 1993.

Referring to expenditure cuts, the main moves in 1992 and 1993 included cuts in social benefits (pensions, social and unemployment benefits) and public sector wages. While these expenditure contractions occurred across all levels of government, the share of investment expenditure by budgetary organizations remained quite low (about 2.5 % of GDP in 1993) but stable.

In 1994 and 1995, fiscal policy remained tight and general government budget deficit shrunk from 4.9 % of GDP in 1993 to 4.7 % in 1994 and further to 3.0 % of GDP in 1995. This was mainly achieved through improvement in tax collection, notably VAT collection. With respect to government expenditure, an additional burden was faced in 1995 and 1996 when the banking crisis took place.

In 1996 and in 1997, the fiscal balance is forecast to deteriorate slightly. According to some estimates, the deficit will be around 3 % of GDP. Revenues are likely to increase as a result of continued improvement in the enforcement of existing tax laws and regulations, and an increase in excise taxes for alcohol, tobacco and gasoline. On the expenditure side, banking sector restructuring will continue to affect on public spending. Additional costs will be created due to government payment arrears on wages, transfers to energy companies and social sectors. In the medium term, the question of growing public pension expenditures will need also to be dealt with.

As in the other Baltic countries, the fiscal transition has included an adjustment of legal system to new demands. Harmonization of laws according to those of the European Union will play an increasingly important role in Lithuania's future. The general trend in fiscal revenue and expenditure can be seen in Figures 9 and 10.

6 Financing alternatives for the budget deficits

After the collapse of the Soviet Power, the Baltic States as well as other countries of the former Soviet Union begun a large scale restructuring of their economies. While some countries proceeded faster than others, restructuring entailed inevitable fiscal costs. This included, among others, capital injections into enterprises and banks, reorganizing of tax administration and civil service, the reform of the legislative and accounting systems, compensation to displaced workers and new investment (particularly in infrastructure). Naturally, these activities had limited possibilities to be carried out by the newly emerging private sector, so the biggest burden had to be carried by the governments. As was seen in Tables 1 and 2, some of the countries succeeded keeping their budgets in balance, whereas others struggled with sizable fiscal deficits.

In relation to these upward pressures on government expenditure, the issue of financing the deficits became evident. In particular, the scarcity of financing was, and still remains, a major problem to many transition countries. Privatization receipts have often been smaller than expected, tax revenue from private sector has

Figure 8 **Budget Revenue 1993–1995 in Lithuania**

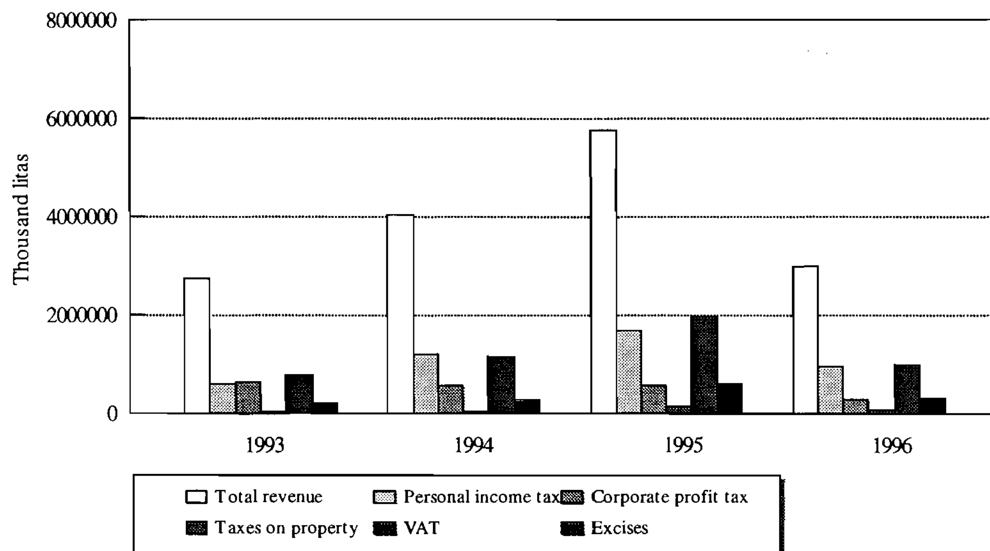
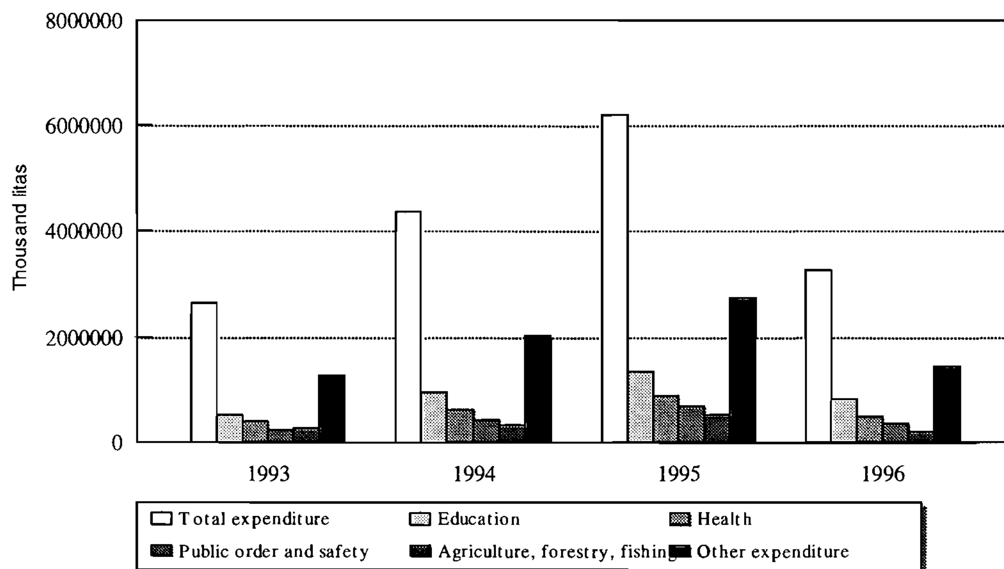


Figure 9 **Budget expenditure 1993–1996 in Lithuania**



Source: Lithuanian Statistical Yearbooks 1992–1995, Economic and Social Development in Lithuania, monthly bulletin 3/96 & 9/96, Department of Statistics to the Government of the Republic of Lithuania. Revenue & expenditure up to September 1996.

Table 6 **Non-bank Financing other than Privatization Receipts (percentage of GDP)**

	1992	1993	1994	1995
FSU average	–0.6	0.4	0.6	0.1
Russia	1.1	0.2	1.5	0.9
Estonia	–	–	–	–
Latvia	0.8	–0.8	0.5	0.4
Lithuania	–	0.8	0.5	1.1

Table 7 **Bank Financing (percentage of GDP)**

	1992	1993	1994	1995
FSU average	10.7	5.6	4.0	1.9
Russia	5.6	5.4	8.6	4.1
Estonia	–1.2	–2.8	–2.6	–2.5
Latvia	0.3	–0.6	1.9	1.8
Lithuania	–2.1	–4.6	1.5	0.4

Table 8 **Foreign Financing (percentage of GDP)**

	1992	1993	1994	1995
FSU average	1.2	4.1	2.2	2.0
Russia	11.7	2.0	0	–0.2
Estonia	1.4	3.5	1.3	2.2
Latvia	–0.3	0.8	1.8	1.4
Lithuania	2.9	6.9	2.2	2.7

Source: * IMF, * Nomisma, Economic Policy in Transitional Economies, Most-Most, 1996 Kluwer Academic Publishers.

suffered from ineffective tax collection and tax evasion, and other sources of financing (the issue of government paper, international bodies, etc.) have also met with limitations. The general trend in budget financing can be seen in Tables 6, 7 and 8.

Although the Baltic countries managed to keep their fiscal deficits at quite low levels, deficits still emerged and therefore financing for these deficits had to be found. In respect of domestic financing, it was first predicted that demand by individuals and enterprises for domestic financial assets would grow after 1992. Furthermore, it was also thought that market for government paper would be relatively easy to develop and would provide a significant non-inflationary source of financing for the budget. However, these projections did not realize as planned. First, on average, non-bank financing has remained quite modest. This can be seen in Table 6. Second, as Table 7 indicates, bank financing in the Baltic countries (including bond financing) has been quite low or even negative compared to the other countries of the former Soviet Union. With respect to central bank financing, Estonia and Lithuania have prohibited this method by law and by adopting the currency board system. In Latvia, central bank financing was limited. It seems then that most of the domestic financing of the government deficit in the Baltic countries has been mainly in the form of government bonds. In addition, the tendency has been more towards paying earlier debts instead of taking on new ones.

Originally, it was thought that the new governments would find it relatively easy to borrow from abroad because of low initial levels of external debts. Yet in all transition countries, the use of foreign capital and its contribution to the deficit has varied considerably from country to country and year to year. At the beginning of transition, the Baltic countries were able to cover more than half of their fiscal deficits (though small) with foreign funding. This was better than any of their FSU counterparts managed. In 1994–95, as more countries of the former Soviet Union entered into programs with the IMF, foreign finance became a common means to overcome budget difficulties. On average, however, net foreign financing has been quite small. The evolution of foreign financing for the government deficit can be seen in Table 8. The low level of foreign financing can partly be explained by the fact that all former soviet countries have had, to some extent, a limited access to foreign capital markets. In addition, as time has passed, debt service costs have grown rapidly (together with high inflation) and in some countries become large enough to offset the budgetary contribution of the inflows. (see Vito Tanzi/IMF1992).

In order to describe the difficulties of financing of budget deficits, we next look at the situation in Estonia. One of the obstacles in conducting of fiscal policy in Estonia has been the lack of coordination between central and local governments. According to the budget law, the Estonian fiscal system consists of the state budget and the local budgets as independent parts. As a consequence, the government does not set targets for local governments either in terms of overall fiscal objectives or limits on loan financing. To ensure proper control over fiscal policy in the future, sudden policy changes are very likely. For example, intergovernmental coordination could be improved by creating clearer practices in revenue sharing arrangements and equalization mechanisms. Better fiscal control could be further enhanced by efficient control over municipal borrowing. Finally, instead of offering automatic gap-filling, transfers from the central to local governments should provide incentives for local governments to raise their own revenue and manage expenditure. This feature in Estonian fiscal system is stressed even more by the fact that the Bank of Estonia is highly independent from the Government and is not allowed to lend either to central or local governments. This requires a very high fiscal discipline on the government's part because there is no source for inflationary financing of the budget deficit. (As a result, Estonia has a balanced state budget.) Given the limited policy instruments available, it has been especially important that fiscal operations take full regard of all government activities and different forms of financing.

8 Future challenges in Baltic fiscal policy

The future challenge for economic policy in the

Baltic countries is to ensure the availability of resources necessary to maintain growth. In this respect, fiscal policy plays a key role. Fiscal policy must aim at eliminating fiscal deficits, while at the same time provide necessary financing for social objectives; social safety nets, enterprise and bank restructuring etc. Further, fiscal policy should encourage savings, because they form the base for financing the high levels of investment required for sustained economic growth. (See Östekonomiska Institutet, Stockholm Institute of East European Economics, Working Paper No.116, Sachs & Warner; Achieving Rapid Growth in the Transition Economies of Central Europe). Given these challenges of fiscal policy in raising savings, ensuring adequate social protection and maintaining economic growth, there are several concrete actions and changes to be made in the future. These changes focus both on the expenditure as well as on the revenue side.

One of these future challenges in all Baltic countries is the collecting of timely accurate, and accessible fiscal data that are consistent with the international standard of government finance statistics methodology. In particular, it is necessary to improve the quality of fiscal data on government operations and concentrate on such problems as coverage of data, classification codes, level of aggregation, consolidation practices, and integrity of data (see Montanjsse, Government Finance Statistics in the Countries of the Former Soviet Union: Compilation and Methodological Issues).

Also, we cannot ignore that social safety nets are under severe strain as a result of weak financial and administrative capacity. According to a recent IMF study (Ke-young Chu and Sanjeev Gupta), the present situation calls for the following actions:

- Eligibility and benefits standards governing the distribution of social benefits must be reformed.
- Tax collection efficiency must be improved.
- Budgetary expenditure disciplines must be strengthened and the efficiency of public expenditure and social welfare protection programs should be increased.
- Effective targeting mechanisms to the provision of benefits must be incorporated (see IMF Survey, August 12, 1996).

Future efforts will also focus on tax policy (IMF World Economic Outlook 1996 & IMF Occasional Paper No. 133/95). In the short- and medium-term perspective tax policy reform should focus on improving the effectiveness of taxes on the traditional sectors. Higher tax revenues are likely to be achieved by further broadening the tax bases and blocking loopholes rather than by raising tax rates. This means mainly the removal of various exemptions. In general, there are numerous exemptions that should be removed or restricted. First, enterprise tax exemptions should be eliminated because there are several sectors that benefit from them and therefore also contribute to a lower level of collected tax revenue. In particular, state and collective farms, small businesses, manufacturing for export, and enterprises with foreign investment are among those, who often benefit from exemptions. In addition, exemptions concerning taxes on wages and salaries as well as VAT exemption should be eliminated. As regards taxes on wages and salaries, the main efforts should focus on broadening of the definition of taxable income to cover all forms of income. With respect to VAT exemptions, changes would include extending VAT to most services, also to services such as education, financial services and health.

What comes to the tax rates themselves, there are still some rationalization to be done. High tax rates and a large number of different tax rates complicates tax administration and often also creates inequalities. Therefore, harmonization of rates might produce some revenue gains through improved efficiency. In practice, it may be very difficult to implement immediate reductions in tax rates. Instead, they have to be gradually reduced as revenue collections improve.

Another fiscal challenge for the Baltic countries is to improve the tax collection of private small-scale business. The efforts in this area should focus on overcoming the difficulties in tracking them down and assessing their tax liability.

Raising revenue by taxing trade is not likely since in all Baltic countries currently favour liberalization and free trade.

Finally, there are the challenges faced by tax

Table 9 **Budget balances (percentage of GDP)**

	1996	1997
Estonia	–1.4	–0.5
Latvia	–0.7	0.6
Lithuania	–3.5	–2.4

Source: IMF, The World Economic Outlook 1996.

administration. As have been observed, poor tax administration has been one of the main reasons for revenue decline. In general, tax administration could be improved by better organization of auditing, registration, taxpayer information, returns processing etc. In particular, new taxpayers in emerging sectors must be better registered and captured. Further, shortcomings in documentation practices should be improved. It is also important that taxpayers are given clear information on what is taxable, how to calculate a tax liability, when taxes apply and so forth. Taxpayers should also be educated that if they fail to pay their taxes according to the tax law, they will be punished for it as well. Finally, all above mentioned fiscal goals require that there are well educated fiscal experts available. Even the best plans and fiscal reforms can be destroyed by lack of competence, corruption or breaking of legislation.

Given the above mentioned future challenges and after analyzing some of the main issues connected with the fiscal transition in the Baltic countries, one might be interested to know how the Baltic countries will do in the near future. The World Economic Outlook gives some idea about how well the Baltic countries are projected to manage their fiscal policy and budget balance last year as well as next year. This can be seen in the Table 9.

Overall, fiscal reform has gotten a good start in the Baltic countries and there is still plenty of work ahead. During recent years the policy goals of the Baltic states have stressed integration with Western Europe (especially the EU). We have every reason to expect that the Baltics will continue on their current path towards a western fiscal system. This, in turn, should give greater confidence to both domestic and foreign investors, whose inputs play a crucial role in maintaining economic growth in the Baltic region.

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