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## Budgeting and Fiscal Management in Transitional Countries

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**BUDGETING AND FISCAL MANAGEMENT IN  
TRANSITIONAL COUNTRIES**

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## 1. INTRODUCTION

The past ten years have been witness to one of the largest experiments in economic history, namely the transition of centrally planned economies to market-based economies.<sup>1</sup> While policy reform in transitional countries has encompassed virtually every sector of the economy, modernization of public sector budgeting practices and fiscal management techniques have been widely recognized as critical to the success of the economic transition experiment. However, the breadth and pace of fiscal management reform in countries in transition (CITs) has largely fallen short of expectations; a decade into the economic transition, none of the transitional economies has fully adopted modern budgeting and fiscal management techniques similar to those in western countries.<sup>2</sup> A less efficient and less controllable public sector has made the task of macroeconomic management more difficult and overall has retarded economic recovery and growth in transitional countries. This paper investigates the main reasons for why fiscal management reform has failed to take hold during the first decade of the economic transition and discusses what challenges remain ahead in budget policy reform.

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<sup>1</sup> This paper focuses on the reform process of former planned socialist economies in Central and Eastern Europe and the former Soviet Union. There are a number of countries outside the former Soviet Union and Central and Eastern Europe that are experiencing similar economic transitions, including Cambodia, China, Cuba, Mongolia, and Vietnam. In addition, there are many similarities between the fiscal management reform issues in transitional economies and those in many developing countries.

<sup>2</sup> It is widely accepted that effective budgeting and fiscal management tools in a market-oriented economy form the basis for macroeconomic stability, ensure the efficient allocation of public resources, and serve as a precondition for economic growth. There is also broad-based agreement on what constitutes sound fiscal management. See, for example, Campos and Pradhan (1996), World Bank (1998), and Schick (1998).

In our attempt to construct an explanation for the slow pace of fiscal management reforms in CITs, we examine the institutional context of the transition and evaluate the incentives for and against reform in budgeting and fiscal management faced by policy makers in transition economies. It is clear that the differences in the pace and scope of reforms among CITs reflect a variety of factors, including differences in political conditions (Shleifer 1997), variations in the speed of the economic transition, and differences in history and even geographical neighbors. To some extent, with hindsight, the existing disappointment with the slow pace of policy reform is due to the optimistic expectations held by policy makers in CITs, which often were shared by Western experts and multilateral development agencies, about the relative complexity and the time needed to complete the reform process. A more rudimentary explanation for the slow pace of fiscal policy reforms is that CITs have displayed a learning curve in responding to the evolving needs of the economic and political environment during the transition. There appears to be a consistent pattern of fiscal policy reform across many CITs, suggesting that the dynamics of economic and political transition themselves have to a large degree dictated the pace and depth of fiscal management reforms.

While the exact timing of the transformation of the budgeting process from essentially a pure accounting mechanism during the communist era to a true fiscal management tool has not been identical in all CITs, the evolution of the reform process can be broken down into three distinct periods. During the first period, the early transition, most transitional economies saw some important economic reforms but a lack of budgeting and fiscal management reforms. Budget officials either felt comfortable with the status quo and felt little pressure to change the budget system inherited from the socialist regime or actively sought to preserve the budget institutions

inherited from the previous regime. In the second transition period, CITs put in place a set of fiscal policy and fiscal management reforms, practically always in response to a macroeconomic crisis, which in some ways was brought about by the initial lack of fiscal management reform. However, as discussed below, this wave of reforms during the second transitional period was generally of an emergency nature and failed to establish a sound framework for fiscal discipline and accountable and efficient expenditure policies. As a result, renewed fiscal crisis spurred more structural fiscal reform efforts during the third, ongoing period of transition.

The chronological timing of these three phases naturally varies across CITs. While transitional countries of Central and Eastern Europe (CEE) generally experienced a more accelerated process of reform, transitional countries in the former Soviet Union (FSU) typically lagged behind.<sup>3</sup> For instance, in the Russian Federation the early transition period lasted roughly until 1992. A variety of austerity measures and crisis reforms were introduced in 1993-94, after which the Russian government's crisis reform efforts dwindled. Ongoing fiscal problems, culminating with the Russian economic crisis of August 1998 spurred a renewal of reform efforts indicative of the third transitional period (Martinez-Vazquez and Boex 2000). In contrast, the early stages of fiscal management reform took place much earlier and were completed quicker in reform-oriented countries, such as Poland. The beginning of the Polish transition process in 1989 was followed almost immediately by a fiscal austerity program in 1990, while the Polish government pursued systematic fiscal policy and fiscal management reforms in the years thereafter (CASE 1997; EBRD

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<sup>3</sup> Considerable variation also exists within the two broad groups of countries. Among the FSU countries, the Baltic States have also been more firmly devoted to the transitional reform process; Albania and Romania have been the slowest reformers among CEE countries (EBRD 1999).

1999). But despite the fact that CITs have chosen different reform paths and have increasingly followed varied fiscal management policies, both FSU and CEE countries still face many of the same problems in the modernization of their fiscal management process, due in large part to their common history with the planned socialist system and their common goal (albeit not always shared with equal enthusiasm) of putting into place public sector institutions supportive of a market-oriented economy.

By addressing the question of what may account for the lack of comprehensive reform in budgeting and fiscal management in CITs, this paper also seeks to give a review of the status, issues, and challenges of budgeting and fiscal management reform in transitional economies. While we draw upon the experiences in a large number of transitional economies in the FSU and in CEE, it is beyond our scope to provide individual country reviews of fiscal management reforms.<sup>4</sup>

The rest of this paper is organized as follows. In the next section we review the significance of the legacy of central planning in determining the early performance of CITs. In Section 3 we discuss the reforms in budgeting and fiscal management (or rather, the lack thereof) during the early transition years. In Section 4 we examine the first serious attempts at fiscal management reform induced by the unsustainable fiscal policies and fiscal crises most CITs went through sooner or later in the transition process. Section 5 addresses the absence of hard budget constraints during much of the transition period, which often contributed to the failure of this initial wave of budgetary reforms.

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<sup>4</sup> A variety of sources are available that provide reviews of transition reforms in individual countries. For example, see the *IMF Economic Reviews* (IMF 1999,2000); the *Transition Report* (EBRD 1999); SIGMA's *Public Management Profiles of Central and Eastern European Countries* (OECD 1999); and USAID (2000). More detailed reports on fiscal management practices in individual countries are also available for selected countries, such as *Fiscal Management in the Russian Federation* (World Bank 1996) or *Kazakhstan: Public Expenditure Review* (World Bank 2000).

In Section 6, we review the progress and ongoing reforms in different CITs in the adoption of modern fiscal management techniques. Section 7 concludes.

## **2. TRANSITIONAL FISCAL MANAGEMENT: THE LEGACY OF CENTRAL PLANNING**

The current problems with budgetary and fiscal management practices in CITs are best understood within the context of their historical origins. The shared starting point for public sector reform in CITs was the budget system of the former Soviet Union. This common background has had and continues to have a significant legacy most of all on the budget systems and practices of the republics that constituted the FSU. Additionally, many CEE countries under planned socialism followed the practices of the Soviet Union and imitated many Soviet institutions and policies.<sup>5</sup> The review of the budget practices in place during the planned economic system is quite revealing about the challenges which CITs had to overcome and many other challenges which CITs are still facing in the reform of their fiscal management systems. Instead of providing a complete overview of budgetary practices in the former Soviet Union and other centrally planned economies, we highlight the most salient features of the Soviet budgeting system which have had an impact on the evolution and difficulties with the reform of budgeting practices in CITs (Premchand and Garamfalvi 1992; Vanagunas 1995; Gaidar 1999).

*Subordinate role of budget formulation process.* In contrast to the role of budgeting and fiscal management in market-based economies, the main purpose of the Soviet budget formulation

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<sup>5</sup> There were, of course, exceptions. Yugoslavia was different in some important aspects from other transitional economies. In particular, the economic and fiscal system in Yugoslavia was much more decentralized, which was reflected in a highly fragmented budgetary system.

process was to translate the government's economic plans (such as the Soviet Union's Five Year Plans), which were specified in terms of material and physical inputs and outputs, into public sector inputs and outputs in financial terms. Thus, instead of the budget formulation process controlling the allocation of public resources, the fiscal planning process itself was controlled by the government's overall economic plan. The absence of a tradition of independent budget policy formulation represented a significant institutional hurdle for most transitional economies, especially during the early years of the transition. In some cases, it took several years for the Ministry of Finance to take control over the budget process, which was formerly under the purview of the central planning agency.

*Lack of delineation of public and "private" sector activities.* The role of budget planning and fiscal management under planned socialism was further diluted by the unclear and inconsistent delineation of enterprise and public sector activities. Productive enterprises were regularly tasked to carry out social welfare functions for its employees, such as health care, child care, recreational facilities as well as public housing and utilities. Since enterprise budgets were excluded from the public sector budget, this entanglement of the public and productive sectors resulted in selective coverage of the Soviet budget system. Nor was it unusual for government agencies to engage in market-like economic activities in addition to their budgetary tasks; such activities were frequently financed and accounted for through extra-budgetary funds. Both the selective coverage and the reliance of the Soviet budget system on extra-budgetary funds left important legacies for transitional economies to resolve. First, there was a need to de-couple enterprises from their public sector responsibilities which in itself created a host of problems, not the least of which was to determine what level of government should take them over and how to finance them. Second, since the extra-



budgetary funds were excluded from the formal public sector budget (and more or less from central control), these funds presented budget units with a way of hiding funds from higher-level governments and informally reallocating fiscal resources for alternative uses. This contributed to the reduced level of central control and supervision over budgetary resources and the difficulties of transitional economies in establishing a comprehensive budget approach.

***Centralization of fiscal policy.*** Budgetary policies in the Soviet Union were made on a highly centralized basis.<sup>6</sup> The Soviet principle of “democratic centralism” meant that the budgets of lower-level organizations were systematically included in the budgets of higher-level organizations. Under planned socialism, the national budget included the budgets of the central government as well as those for regional governments, which in turn included the budgets of local governments. Lower-level spending units would prepare their budgets in conformity with centrally determined guidelines and national spending norms. These budgets would then be reviewed by, and consolidated into the budgets of the higher-level organizations, essentially causing budgets of different levels to be nested like *Matrushka* dolls. As a result, the budget process in the Soviet Union was essentially a passive exercise involving not much more than the aggregation of resource requests according to pre-established rules. Following that tradition, budget systems in many CITs still remain hierarchically interlinked and often provide quite limited budget autonomy to spending units and lower levels of government (Bird, Ebel and Wallich 1995; Dunn and Wetzel 1999).

***Pervasive use of budget norms.*** A significant feature of budgeting under planned socialism was the use of thousands of detailed spending norms, often defined in physical terms based on

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<sup>6</sup> The practice of fiscal centralism dates back the early years of the Soviet Union (Premchand and Garamfalvi 1992). This practice was followed in many other command economies, including those in Central and Eastern Europe (with the exception again of the former Yugoslavia).

infrastructure levels controlled by spending units and lower-level governments (i.e., funding based on the number of hospital beds or school buildings). The centralized control over the budget process, combined with the extensive use of spending norms, created extraordinary rigidities in the resource allocation process. In contrast to modern budgeting techniques, expenditure requests remained essentially unscreened as they proceeded through the administrative chain. In addition, the use of central expenditure norms contributed to the solid entrenchment of expenditure levels. This passive, norm-based approach to budget formulation inherited from the Soviet budget process has been a significant source of difficulties in transitional economies. Budgeting from a perspective of needs (as defined by pre-established norms) without accounting for resource availability has been an important cause for the development of unrealistic budgets and the absence of aggregate fiscal discipline. In addition, norm-based budgeting, especially when physical norms were used, failed to provide budget units with incentives to prioritize expenditures or achieve operational efficiency. In fact, the use of physical norms induced inefficiency by rewarding budget units that kept idle or unneeded physical capacity.

***Reliance on the banking system for budget control.*** Budgetary institutions in most centrally planned economies had no well-developed budget execution and budget control systems. Instead, the official government banking system played the key role in the execution stage of the budget. All transactions involving government revenues and expenditures were carried exclusively through the central bank and the state monopoly banking system. These banks were in effect the ones responsible for keeping the public sector accounts and exercising control over budget execution. The effective use of banks for fiscal control purposes fell apart early in the transition, when the banking sector was privatized or at least divested of its public sector responsibilities and concentrated on commercial

banking activities. The sudden disappearance of the traditional methods of control over budget execution created a significant vacuum in the budget process of CITs, which no doubt contributed to the lack of fiscal discipline exhibited by government spending units in many CITs.

*Lack of an independent external audit function.* In the former Soviet Union and the socialist countries of CEE, no independent external audit mechanism existed. Budget enforcement and supervision largely originated from the totalitarian control exercised by the Communist Party. As such, the collapse of Communist control in the FSU and CEE countries caused the disappearance of the ultimate instrument for ex-post control over the entire budget process. The lack of tradition with independent external audit institutions in the FSU and CEE has made it particularly difficult to develop effective supreme audit institutions in many CITs.

### **3. REFORM DURING THE EARLY TRANSITION PERIOD**

Communist rule collapsed throughout Central and Eastern Europe in 1989-90, which was followed by the effective disintegration of the Soviet Union in 1991. This political sea-change event spelled the end of the planned socialist economic system and the beginning of a transition period which was to reshape the economic structures of these countries into market-oriented economies. The exact timing and preconditions for the transition process in each CIT were different for each country. As the Warsaw Pact unraveled and the Soviet Union disintegrated, many countries in CEE and the FSU reinstated political and legal institutions which had been in place before communism. While this assured that the transition process in each country would have certain unique features, the transition processes in the different CITs had many features in common as well.

During the first years of the transition, many radical changes took place in the economic structure of CITs as governments set about the task of separating the public sector from the productive sector, and privatizing productive enterprises (CASE 1997; Hussain and Stern 1993; Shleifer 1997; Vanagunas 1995). Because the final years of communism were characterized throughout the FSU and CEE by sharp declines in GDP, the main preoccupation of policy makers early in the transition was to halt the process of economic decline. While frequently overlooked by foreign observers, equally important to policy makers during these early years was to maintain a minimum level of political and social stability. Most governments in transitional countries in their own ways sought to bring about positive economic reform conditioned on the political objective of maintaining power. Thus economic reforms were pursued while minimizing disruptions in social services, maintaining economic and social stability, and avoiding extreme economic hardship for the populace (Hussain and Stern 1993; Rodrik 1996).

This early period of the transition saw almost exclusive emphasis on structural economic reforms, while the institutional transformation of the public sector was relegated to a distant second place. In particular, this period typically only saw minor reforms in budgeting and fiscal management. Both the institutions and the processes of fiscal management were largely a continuation of the Soviet era system. Only the most basic fiscal management reforms were pursued in order to adapt the budget process to the discontinuation of central economic planning and the new political and economic reality.

One of the main budgetary reforms that took place during the early transition was to redefine budget formulation from its traditional role of being an appendix to the economic planning function. The responsibility for fiscal policy was shifted towards the Ministry of Finance and away from the

central planning agency, which was typically eliminated and converted into a Ministry of Economy. As mentioned above, it was often hard for the Ministry of Finance to assert itself over the entrenched bureaucracies in the Ministry of Economy, especially in the early years of reform. However, currently, in most transitional economies it is indeed the Budget Department of the Ministry of Finance that fulfils the core functions of budget planning and formulation within the executive branch. Nevertheless, even now the Ministry of Economy and other government agencies often still play a role in the budget formulation process, especially in the realm of public infrastructure planning and the formulation of budget expenditure norms.

Significant changes also occurred during the early transition in budget execution. As briefly discussed above, under the planned economic system the public monopoly banking system had played a central role in budget execution. All flows of funds and payments were recorded and authorized through these banks. Thus, in a way, the monopoly banks acted as the arms of a treasury function. This important role of the monopoly banks in budget execution was significantly reduced (as in the case of the former Yugoslav republics) or completely eliminated (as in most other CITs) with the transformation and privatization of the banking sector. In addition, the falling away of totalitarian, central oversight and control by the Communist party sharply reduced transitional governments' capacities to exert budget control. In the absence of alternative internal control and external budget oversight mechanisms, the severely impaired ability of transitional governments to properly execute and control budget implementation allowed for the shift in budget culture from hard to soft budget constraints (Gaidar 1999).

The lack of more pro-active fiscal management reforms and the absence of budgetary controls during the early years of the transition led to lax fiscal discipline and to the escalation of the

general government's deficit in most CITs during the early years of the transition (Table 1). Real public expenditure typically showed sharp declines in the early transition period (EBRD 1999), reflecting the privatization of productive enterprises and a real reduction in actual public sector spending. However, the drop in real government revenues often outpaced the declines in expenditures in the early transition due to sharp declines in economic activity, inadequate tax structures, and the inability to enforce tax collections (Martinez-Vazquez and McNab 2000).

Still largely excluded from international lending and lacking domestic capital markets, many CITs resorted to printing money to finance their deficits. Naturally, monetization of the large budget deficits during the early transition period led to high rates of inflation (Table 2). Although the dismal economic performance during the early years of the transition could be attributed to the lack of an adequate budget process and the continued reliance on Soviet budgetary practices, to be fair, it is doubtful that the introduction of modern budgeting and fiscal management techniques during this early stage could have made a significant contribution to resolving the economic crisis. As mentioned earlier, in light of dramatic declines in the real economy, most CITs struggled to avoid social and political unrest by maintaining existing expenditure programs. Had absolute fiscal discipline been imposed in the environment of the early transition, the failure to provide basic government services could have caused political chaos, reduced support for positive economic reforms, or could have even caused a reversion back to some form of command economy.

#### **4. FISCAL AUSTERITY AND INSTITUTIONAL SHORTCOMINGS**

It is a well-known principle in the political economy of public policy reform that reforms are best introduced in response to a major economic crisis when their need is most evident and the

resulting political fallout is minimized (Rodrik 1996; EBRD 1999). In response to the episodes of hyperinflation of the early transition, CITs, often in cooperation with international financial institutions, implemented a number of budget reforms and imposed fiscal austerity measures to end the macroeconomic instability brought about by excessive budget deficits and the resulting inflationary episodes. During this second transition period, fiscal policy measures were introduced to lower deficits by cutting expenditures and increasing revenues, while loans were obtained from international lending agencies. The monetization of public deficits was contained and often entirely discontinued while domestic capital markets were set up to facilitate partial financing of the deficit through issuance of domestic debt instruments. In response to these measures, inflation was successfully controlled in many transitional economies, at least temporarily (Table 2).

Of course, the specific policy reforms put in place in each country depended on the severity of the preceding economic crisis and the speed and depth with which the government acted in response to the economic crisis. This makes it hard to identify a single sequence of policy reforms that signals the beginning of the second transition phase. One available indicator of the beginning of the policy reforms that characterize this second phase of the transition is the introduction of a domestic treasury bill market (Table 3), which signaled the serious intention of the government to use domestic capital markets to alleviate the inflationary pressures brought about by the monetization of the deficit. While the timing of this second phase varied across CITs, the second transition phase roughly coincided with the period between 1991 and 1994 in many CEE countries and 1993-1997 in the FSU (CASE 1997; EBRD 1999; Polackova Bixi, Papp and Schick 1998; Shleifer 1997; Vanagunas 1995). Among the CEE countries, Albania, Romania, and Croatia were late to shift to domestic financing of the deficit. Yet despite the introduction of a domestic treasury bill market,

Albania and Romania have continued to rank among the highest inflation countries in CEE (Table 2). Among the republics of the FSU, the Baltic states, Kyrgyzstan and the Russian Federation were relatively quick to initiate a domestic market for placing government debt. However, their ability or need to borrow domestically did not necessarily translate into greater fiscal discipline. This point is illustrated by the difficulties that Kyrgyzstan and Russia have experienced in reducing their overall fiscal deficits (Table 1).

While there may have been the intention that these crisis-induced measures would form the basis for comprehensive budgeting and fiscal management reforms, most of the reforms during this period were of an emergency nature and lacked depth. Lasting fiscal management reforms generally failed to materialize during this second phase of the transition; the austerity measures provided a temporary reprieve from the underlying budgetary pressures but failed to resolve the underlying fiscal imbalances. The sustained economic crises and the social strains of the early transition years thus only partially explain the delay for fundamental budgetary reforms; other factors should be considered to account for the lack of progress in budgetary and fiscal management reforms during the period of recovery following the early transition. The core of the fiscal policy and management problems during this period was that in many CITs this initial wave of fiscal austerity measures was enacted without sufficient consideration of the political dynamics, the organizational structures, budget procedures, and the incentives faced by budget organizations as part of the budget process.

The single most important feature of this period was the failure to put in place hard budget constraints for spending agencies and subnational governments.<sup>7</sup> This failure was due to the

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<sup>7</sup> In fact, it could be argued that the pursuit of fiscal discipline in the absence of solid budget constraints during this second transition period has actually complicated future budgetary reforms, as it further limited the coverage of the formal budget process over the allocation of public resources.



inability of CITs to rapidly overcome past organizational shortcomings and their failure to address the presence of the wrong incentives to instill fiscal discipline. Table 4 provides a summary of these organizational shortcomings and incentive problems faced as part of the budget process in CITs during the second phase of the transition, which are discussed in detail next. The methods that spending agencies and subnational governments used during this phase of the transition to circumvent the austerity measures and spending limits are discussed in the next section.

*Difficulties with parliamentary budget consideration.* The organizational design of legislative institutions in some transitional countries stood, and in some cases still stands, in the way of the routine conflict management and consensus building essential to budget development in a democracy.<sup>8</sup> The political transformation from a one-party totalitarian regime to a multi-party democracy often failed to include mechanisms in the legislative process to promote reaching consensus, achieving compromise, or building coalitions needed to make decision-making possible in a multi-party democracy. The inability of legislatures in many transitional economies to pass the annual budget before the beginning of the budget year was evidence of this problem. While these problems were widespread throughout the FSU and CEE, the Russian Federation arguably provided one of the best examples how the ineffective organization and the political mind-set of the legislative branch worked to prevent legislative decision-making (Ostrow 2000). The main organizational culprit for legislative deadlock and late approval of annual budgets was the unlinked structure of

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<sup>8</sup> Political structure may also have had an effect on fiscal outcomes. Hallerberg and von Hagen (1999) have argued that electoral institutions may affect the ability of countries to control budget deficits. In particular, proportional representation electoral systems are more likely to lead to minority governments and thus might be inherently more unstable than pluralist electoral systems in which each district only elects one representative. But interestingly, it appears that among transitional economies a positive relationship has existed between the greater political competition in parliamentary systems and a faster pace in economic reform (EBRD 1999).

political factions and legislative committees in Russia's lower house of parliament, the State Duma. The functioning of the State Duma was in fact so politicized that when two opposed faction leaders demanded the position of chair of the budget committee, the leadership simply created two competing legislative committees, each claiming responsibility for the same set of policy issues (Ostrow 2000).

An example of similar problems within CEE countries during this period was provided by Hungary, where parliamentary consideration of the government's budget was fragmented and lacked clarity and unity (LeLoup et al. 1998). In conflict with statutory budget procedures, for example, parliamentary consideration of the total expenditure envelope coincided with the consideration of the sectoral budget proposals. The lack of observance of the formal budget calendar and other budget formulation procedures resulted in delays in budget approval, budget instability, and the need for repetitive budgeting through supplemental budgets. While some transitional countries, including Hungary, have made greater progress towards streamlining the legislative budget process during the third transitional period (Polackova Bixi, Papp and Schick 1998), similar problems still continue to exist in other CITs.

Many CITs also suffered from lack of experience with parliamentary institutions. In FSU countries, it was not uncommon for legislators during this period to vote for unrealistically large budgets based on artificially inflated revenue forecasts with full knowledge that these budget plans would never be implemented. The prevailing mentality among legislators, in many ways unchanged from Soviet times, was that the "declarative" identification of desirable spending programs could produce political gains by protecting the interests of powerful constituents and sectoral advocacy groups, and could legitimize spending increases during the process of budget execution or in future

years. The formal budget formulation process was clearly not seen as providing a blueprint for actual budget implementation but functioned much more as an inclusive statement of desirable government programs.<sup>9</sup>

The failure of the formal budget process to impose a realistic budget envelope facilitated achieving political consensus, but did so at the cost of rendering the formal budget formulation process meaningless. The practice of approving unrealistic budget plans led to repeat budgeting exercises and, more frequently, to budget sequestration. As a result, budget officials in charge of execution were thrust into a position of making the tough budget decisions that legislators refused to make. This greatly reduced the spending and oversight powers of the legislative branch and basically allowed the executive branch to change the priorities espoused by the legislature.<sup>10</sup> In addition, the frequent reliance on sequestering caused substantial instability and disruption to the budget execution process. The budgetary uncertainty was a major contributing factor to the increased reliance of spending agencies on alternative, off-budget sources of funding.

Many transitional countries during this phase of the transition lacked adequate, at times even rudimentary, fiscal analysis capabilities within the legislative branch. The absence of capacity to develop independent budget projections deprived legislators of the ability to adequately assess the government's budget proposal. But the absence of credible alternative budget estimates also conveniently allowed legislators to play politics by criticizing the government's estimates and

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<sup>9</sup> Measures restraining parliamentarians to propose additional expenditures without proportionally reducing other expenditures were not common among CITs in this period of the transition.

<sup>10</sup> The only recourse legislators had in many cases was to mandate a list of "protected" budget items, such as wages and salaries or food and medicines, which meant they could not be cut in the sequestering process. However, the executive often failed to observe such restrictions.

increase spending on their preferred expenditure programs on the basis of optimistic revenue estimates, all without being held accountable for increased budget deficits. Budget process laws in CITs during this period remained quite naive by not recognizing the role of incentives in achieving fiscal discipline. As discussed in Section 6, reforms of the budget process later in the transition often incorporated measures to induce greater responsibility among policy makers, including the introduction of restraints limiting the ability of legislators to increase expenditures without simultaneously reducing other expenditure programs.

*Divided budget formulation authority in the executive branch.* Despite the reform intentions and austerity measures introduced during the second phase of the transition period, typically the process of budget formulation by the executive branch of government remained ill-suited to guide the development of a budget plan consistent with the desired level of aggregate fiscal discipline. The roles of organizational structures, budget procedures and incentives also were to a large extent still ignored in this phase of the budget process.

A key element to achieving aggregate fiscal discipline is to reach a political balance where advocates of central interests (supporters of fiscal discipline) are strong vis-a-vis advocates of sectoral interests (supporting increased sectoral spending). Achieving fiscal discipline is facilitated by a broad, consistent and transparent government-wide fiscal strategy supported by the highest authority, such as the president, cabinet, or ruling coalition. When this support is lacking, the struggle for funds between sectoral ministries and subnational governments can cause discord, strife and delays in the budget process, and ultimately compromise fiscal discipline. In Hungary, the divergence of interest among line ministries and the Ministry of Finance consistently led to delays in the submission of the government's budget proposal to parliament (LeLoup et al. 1998). Similar

struggles are reported for Ukraine (Kravchuk 2000) and Russia (World Bank 1996), where passage of the budget during this period of the transition habitually occurred well into the actual budget year.<sup>11</sup>

The fragmentation of responsibilities over the budget formulation process added to the difficulties in many CITs for achieving fiscal discipline during the second phase of the transition. Often, the Budget Department's control over budget formulation was contested by a number of unlinked agencies within the executive branch. Ostrow's (2000) discussion of the institutional organization of the executive branch in the Russian Federation illustrates how organizational problems can prevent the effective formulation and adoption of budget plans within the executive branch. In the case of Russia, the special advisor to the President, the separate presidential administration, the prime minister's office, and the Ministry of Finance held (and still hold) competing claims over budget policy and engaged in recurring struggles for control over the process and the content of the budget. While administrative duplication and competing claims in the executive branch are not unique to the Russian Federation, these issues do appear more prevalent in FSU countries that adopted strong presidential systems, such as Russia, Kazakhstan and Ukraine, than in the CEE countries.<sup>12</sup>

***Weak budget execution and control.*** The ability to make good on the austerity and fiscal discipline intentions of many CITs during this period was most seriously compromised by the

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<sup>11</sup> While this type of delays is not unique to transitional economies, developed market-based countries have introduced a number of budget techniques that minimize the occurrence and importance of the delays. Most CITs lacked those instruments during the second phase of the transition.

<sup>12</sup> See, for example, World Bank (2000).

weakness (and in some cases the outright failure) of effective budget controls. This weakness was best evidenced in the rapid accumulation of budget arrears and other unorthodox forms of budget financing during this period. Two organizational factors contributed to the weakness or failure of budget control.

First, most CITs lacked a systematic and unified approach to budget formulation and execution. The lack of unity and universality in the transitional budget process was part of the legacy from the previous regime. The budgetary system in place during the planned socialist era did not clearly delineate the public and “private” sectors and had a proliferation of extra-budgetary funds. In fact, the budget accounting systems that CITs inherited from the planned socialist era were so fragmented that in many cases it proved virtually impossible to accurately determine the true size of the public sector (LeLoup et al. 1998; Sundberg and Morozov 1999; World Bank 2000).

Second, most transitional economies still lacked the institutional capacity to execute the public sector budget plan and control budget execution in a concerted manner. As mentioned earlier, under the planned socialist system the state monopoly banking system played a key role in providing centralized control over the budgetary process during the budget execution stage. This control over the banking system gave the government a practical way to transfer funds to the spending units, as well as an effective tool for verification and control over budgetary outlays at the payment stage, to the point that under planned socialism, other budget control mechanisms were deemed nonessential. However, the privatization of the banking sector early in the transition effectively stripped the public sector of its most effective, if not the only available, budget control mechanism. Without a substitute control mechanism, spending units were able to over-commit public resources at the cost of accumulating budget arrears.

*Absence of external audit and budget performance analysis.* The practical absence of budget evaluation and ex-post audits during this phase of the transition was a feature inherited from the budget philosophy and practices of the previous regime, which placed almost exclusive emphasis on the ex-ante allocation of inputs and basically ignored budget outcomes and effective performance of programs. The traditional lack of emphasis on ex-post reviews was so pervasive that during this period of the transition most CITs were still struggling to establish “supreme audit” organizations for ex-post external audit. In those CITs where external audit institutions were introduced, the scope of the organizations in charge of conducting it typically continued to be limited to traditional compliance audits, which emphasized conformance with accounting procedures and to some extent, the proper use of budgetary norms used in budget preparation. Yet even if there had been a conscious effort to conduct performance-based audits, it is unlikely that the requisite trained personnel and resources would have been available to successfully carry them out.<sup>13</sup>

## **5. THE ABSENCE OF HARD BUDGET CONSTRAINTS**

With the wisdom of hindsight, it is clear that sustained fiscal reforms failed to take hold during this second transition phase because the institutional framework and incentives structures in the transitional public sector simply were insufficient to support the desired fiscal policy and management reforms. While the crisis-induced reforms and austerity measures increased the emphasis on budget discipline and put in place a more stringent budget envelope, as we have

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<sup>13</sup> In addition, it may not be reasonable to expect CITs to advance their budget processes so fast. After all, it is a fairly recent event that a growing number of western fiscal management systems introduced performance criteria as an important element of the budget formulation process (Schick 1998; Shand 1998; OECD 1998; World Bank 1998).

reviewed above, there was no systematic improvement in the functioning of budget formulation and execution mechanisms during this period. Perhaps, the best way to summarize the situation during this period is that the fiscal management system failed to provide spending units with a hard budget constraint and ultimately failed to sustain aggregate fiscal discipline.

In order to reduce the overall government deficit, austerity measures and ex-post budget sequestering were imposed from the top down, placing great fiscal strains on central budget organizations and subnational governments alike. This harsh reality stood in great contrast with the norm-based budget philosophy, which in the past was predicated on providing spending units with sufficient funds to sustain at least a minimum level of services. Thus, during this second period of adjustment most CITs were *de facto* forced to abandon their normative approach to budget formulation. But old habits die hard and many CITs, especially those in the FSU, continued to try to use some type of normative approach to expenditure budgeting. To make it operational, the resulting budget allocations were either subsequently scaled down either by individual negotiations or by across-the-board cuts in expenditures, or the previous norms were systematically substituted by “new norms” that were essentially past levels of expenditure adjusted by an often negotiated price level adjustment.

Within the context of the new constraints each individual spending unit, pursuing the limited goal of fulfilling a narrow sectoral policy objective or simply fighting for survival, had an incentive to increase its expenditures beyond its planned expenditure limits. This incentive problem, known as the tragedy of the commons, is universal to all budget processes (Campos and Pradhan 1996). However, in developed economies the incentive problem is abated by administrative mechanisms and control procedures that impose hard budget constraints to ensure that no agency or sector robs



the common fund by exceeding its expenditure limits. The absence of such budget controls in transition economies during this period caused spending units to find in a number of avenues that allowed them to engage in spending at a level in excess of the centrally imposed expenditure limits. Thus by unwittingly leaving the budgetary backdoor open, the imposition of austerity measures in many cases failed to achieve an effective reduction of the budget deficit, but instead caused the deficit to be “squeezed” or hidden in a number of different ways. While, by their very nature, it is hard to quantify budget activities that take place outside the formal budget process, as discussed next, available evidence suggests that the share of public sector funding provided through these alternative avenues was quite substantial in many CITs (Polackova 2000).

*Off-budget funding and extra-budgetary funds.* One frequent response by spending agencies in CITs to the strict expenditure limits during this phase of the transition was to finance an increasing share of their activities off-budget, while maintaining their official level of expenditures within the official spending limits. For instance, many spending units maintained unofficial or off-budget bank accounts, allowing them to underreport budget revenues or user fee collections. In addition, spending agencies and subnational governments regularly attempted to channel additional funding through established extra-budgetary funds. Since extra-budgetary funds were not formally part of the public sector budget, the central budget authority was unable to detect or control these practices in a timely manner.

The practice of funneling resources through extra-budgetary funds and off-budget accounts has its roots in the pre-transition period. Extra-budgetary funds under planned socialism, with the exception of major state funds (such as social security funds), commonly served to finance auxiliary items or support activities conducted by budget units outside their main budgetary scope, such as the

provision of recreational facilities for employees or other market-like activities. During the final years of the communist era, extra-budgetary funds spawned a large variety of activities and often encompassed a significant share of public sector activities. While due to their off-budget nature no consistent estimates exist of extra-budgetary activity, estimates of quasi-public spending from off-budget accounts in Russia for 1998 (excluding the major extra-budgetary state funds) range from 1.2 percent to 10 percent of GDP (Morozov and Sundberg 1999).

While generally undesirable, neither central spending units nor lower level governments are to be blamed exclusively for resorting to off-budget methods of financing. These budget agents typically responded in a rational fashion to a budget systems strife with poor incentives. Diverting and hiding funds was a rational and understandable response in a system where budget departments or upper-level governments systematically practiced clawing back any additional resources that decentralized governments and central spending unit accumulated through operational cost savings or increased fiscal effort (Martinez-Vazquez and Boex 2000; Zhuravskaya 1999).

*Unfunded mandates.* Another undesirable budgetary response to increased budget pressures, especially prevalent in fiscally decentralized systems, was for the central authorities to react to increased fiscal tightness by imposing unfunded mandates on local or regional governments or off-loading additional expenditure responsibilities without transferring comparable resources to these subnational government levels. This practice of balancing the central government's deficit at the expense of subnational governments was particularly notorious during the first several years of the transition in the Russian Federation (Martinez-Vazquez and Boex 2000) but quite common in many other CITs (Bird, Ebel and Wallich 1995; Dunn and Wetzel 1999). However, since many subnational governments were unable to support the resulting sharp increases in expenditures, the

imposition of such mandates frequently resulted either in federal programs not getting implemented at the subnational level or the occurrence of subnational budget deficits.<sup>14</sup> Thus, the devolution of budgetary responsibility and unfunded mandates frequently resulted in the proverbial buck being passed around in a circle and ultimately being dropped.

***Soft budget loans and mutual settlements.*** The clearest manifestation of operating with soft budget constraints in the public sector was the extensive use of soft budget loans and mutual settlements. Early in the transition, a large share of the budget deficits of spending agencies and subnational governments were financed by budget loans from the central authorities, with the expectation (by the recipients, at least) that these loans would eventually be forgiven. Similarly, in the realm of intergovernmental fiscal relations, federal or central governments frequently relied on the practice of mutual settlements, especially in the FSU countries. Mutual settlements are fundamentally intergovernmental transfers arranged after the annual budget has been adopted. However, in actuality mutual settlements form an umbrella category of ex post, non-transparent, negotiated transfers that include compensation to regional governments for federal mandates or the delivery of federal government programs, transfers to compensate regions for changes in legislation during the budget year, as well as emergency transfers. The negotiated and non-transparent nature of these budget loans and mutual settlements contributed to providing spending agencies and subnational governments with a soft budget constraint, and therefore, negative incentives to contain expenditures, mobilize revenues and achieve aggregate fiscal discipline.

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<sup>14</sup> Some of the politically unpopular but economically desirable reforms, such as the discontinuation of large socialist subsidy and price support programs, were effectively discontinued by devolving these responsibilities to subnational governments with the knowledge that these programs would be unsustainable at the subnational level (Martinez-Vazquez and Boex 2000).

***Budget arrears.*** A fourth device commonly used by budgetary units to cope with sharply curtailed funding was budget arrears. This was possible because, following the Soviet budget approach, central budget offices still controlled cash outlays and not commitments. Therefore, subnational governments and spending units could knowingly commit more resources than available in the budget plan without direct detection or punishment. By making expenditure commitments (purchasing goods and services and employing public workers) in excess of the available budgeted resources, subnational governments and spending units counted on the central budget authority to resolve the problem of their budget arrears to prevent social and political unrest. The problem of budget arrears, both when considering the overall level of budget arrears as well as the accumulation of new budget arrears, posed, and often continue to pose, a massive budgetary problem in many CITs. For example, the stock of accumulated budget arrears in Kazakhstan stood at 3.2 percent of GDP at the end of 1998. During the first six month of 1999, Kazakhstan's stock of payment arrears grew by over 30 percent, suggesting that over 15 percent of expenditure commitments in Kazakhstan over this time period resulted in budget arrears (World Bank 2000). Similarly, the stock of budget arrears in the Russian Federation increased by Rb. 43 billion in 1998, which is equivalent to 1.6 percent of GDP or 5 percent of consolidated budget expenditures for that year (Morozov and Sundberg 1999).

***Other forms of off-budget activity.*** A variety of other, creative and unorthodox means have been relied on in many CITs to finance activities outside the formal budget process. These ways included the assumption of contingent liabilities, accepting payments-in-kind (barter) , the use of tax

offsets (offsetting budget arrears against tax arrears by enterprises),<sup>15</sup> government borrowing from banks controlled or owned by the government itself, and the off-budget issuance of promissary notes or veksel (Commander and Mumssen 1998; Freinkman, Treisman and Titov 1999; Polackova 2000).

In summary, due to loopholes in budgetary procedures and controls, institutional shortcomings, and poor incentives in the formulation and execution of the budget, the legislative imposition of fiscal tightness during this period of austerity reforms caused budgetary units to use a variety of coping mechanisms to maintain spending levels in defiance of aggregate and sectoral spending constraints, causing dramatic increases in budget arrears and other types of off-budget funding. Although general budget deficits came down, the deficit problem was merely shifted off-budget in many CITs rather than actually resolved.

## **6. ACCEPTING THE NEED FOR FISCAL MANAGEMENT REFORM**

While the second phase of transition witnessed the realization across transitional economies that fiscal balance plays a central role in achieving economic stability, as we saw in the previous section, the fiscal policy reforms that were introduced during this period generally failed to provide the fiscal discipline and hard budget constraints necessary to achieve overall fiscal balance on a sustained basis. The third period that can be conceptually identified during the transition is

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<sup>15</sup> The reliance on budget arrears and tax offsets as a means to circumvent budget constraints is a particularly worrisome approach due to the perverse incentives it generates. The lack of payment by government agencies sparks further arrears, including tax arrears and inter-enterprise payment arrears. In addition, the practice of tax offsets provides enterprises with an incentive to discontinue paying taxes and accumulate tax arrears, thus reducing tax compliance and increasing enforcement and collections costs (Martinez-Vazquez and Wallace, forthcoming).

characterized by the broad acceptance of the premise that sound budgeting and fiscal management practices are a precondition for achieving fiscal balance and increasing the overall efficiency of the public sector.

This realization often occurred gradually in CITs, making it difficult to clearly and exactly identify the beginning of this third transitional period.<sup>16</sup> Naturally, there continue to be substantial differences among CITs with regard to the depth and speed of these reforms. For instance, as mentioned earlier, the Polish government began pursuing reform of its fiscal management practices and budgetary institutions in 1990-91, virtually immediately after encountering near-hyperinflation and instituting fiscal austerity measures in 1989 (CASE 1997). Another example of a transitional economy that has successfully pursued comprehensive budgetary reform early on in the transition is Estonia. Estonia's *State Budget Law*, which was introduced in 1993, established a budget calendar, a detailed process for resolving budgetary disputes and clear directions for budget submission and approval (Martinez-Vazquez 1997). Some of the other CITs have been considerably slower in addressing important fiscal management issues. Typical in this regard are the experiences of the Russian Federation and Kazakhstan, where new Budget Codes specifically incorporating fiscal management reforms were not approved until 1998 and 1999, respectively (Martinez-Vazquez and Boex 2000; World Bank 2000). Ukraine also approved a new Budget Code in 2000, in many ways similar to those of Russia and Kazakhstan.

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<sup>16</sup> One of the few transition countries where this realization may not yet have occurred is Belarus, which has the unfortunate distinction of being one of the slowest reformers among the transitional economies of the FSU. Since 1994, both economic and democratic reforms have deteriorated. In fact, the World Bank and the International Monetary Fund have suspended operations in Belarus due to the lack of progress on policy reform and the country's failure to comply with agreements (USAID 2000).

Regardless of the beginning date of this third transition period for each CIT, it is fair to say that this third transition stage is ongoing in all CEE and FSU countries, as essentially all CITs are currently distancing themselves from the legacy and practices of the Soviet budgeting system and are seeking to adopt modern budget institutions and practices. However, it is also fair to say that most CITs have yet to achieve a budgeting and fiscal management system that is on par with those in developed economies. As such, there exists a high degree of consistency with regard to the budgetary and fiscal management issues current being addressed by transitional economies (EBRD 1999; IMF 1999,2000; USAID 1999). Our discussion of ongoing budgeting and fiscal management reforms in the remainder of this section discusses progress on four broad reform objectives which are consistently pursued in CITs:

- (i) Achievement of a comprehensive budget approach;
- (ii) Resolution of the issue of budget arrears;
- (iii) Building capacity and institutional strengthening in budget formulation and execution;
- (iv) Establishment of sound intergovernmental budgetary relations.

### **Achieving budget comprehensiveness and unity**

An important thrust in the ongoing fiscal management reforms in CITs has the objective of achieving budget comprehensiveness (IMF 1999,2000; OECD 1999; USAID 2000). The Soviet budgeting tradition, we have seen, paid little attention to the comprehensiveness and unity of the budget. Instead, public activities financed outside the government budget through state enterprises and the proliferation of extra-budgetary funds were all quite common and officially encouraged.

Extra-budgetary funds, although not always officially sanctioned or encouraged, continued to flourish in many CITs during the transition because it provided a coping mechanism for budget units and subnational governments to hide fiscal resources during a period of drastic fiscal retrenching.

While some CITs (particularly the Baltics states, many CEE countries, and Kazakhstan among the CIS) have made more progress than others towards the goal of budget comprehensiveness, most of these reforms are still ongoing, among other reasons because of the complexity of the issue. Budget comprehensiveness essentially requires four distinct lines of policy reform: (i) the adoption of a standard fiscal classification and reporting system within all budget organizations; (ii) the incorporation of extra-budgetary funds into the budget; (iii) the integration of capital budgets or public investment programs into the budget process in a flexible manner and (iv) integrating other off-budget phenomena into the budget, such as government loan guarantees and other contingent liabilities.

Of these issues, most progress has generally been made with the adoption (yet not always resulting into full implementation) of standard, GFS-based budget classification and reporting systems. Even traditional budget reform laggards, such as Armenia and Albania have adopted unified charts of accounts with their 2000 budgets.

There has also been progress among many CITs with reigning in and controlling extra-budgetary funds. During the transition, most CITs have substantially reduced or eliminated many of the extra-budgetary funds that were present at the beginning of the transition period. Progress reforming extra-budgetary funds has typically been slower at the subnational level in countries that have more decentralized systems of finance. Yet, progress has been uneven among CITs and



sometimes must be measured by the number of extra-budgetary funds remaining.<sup>17</sup> Among the successful reformers of extra-budgetary funds is Kazakhstan, which eliminated all extra-budgetary funds at all levels of government in the 1999 *Budget System Law*. However, reform in this area has typically fallen short of eliminating all extra-budgetary activities. It rather has taken the form of eliminating some of these funds and then requiring full accounting and reporting of the remaining extra-budgetary funds within the ordinary budget process. These requirements have typically also been extended to the social security funds (pensions, health, disability and unemployment funds), which for many years were outside the submission, approval and reporting requirements applicable to the main budget. The most recent reformers in this direction include Lithuania with its new *Organic Budget Law* (2000), Ukraine with the new *Budget Code* (2000) and Russia also with the *Budget Code* which finally came into force in 2000. For example, Lithuania's *Organic Budget Law* provides for inclusion of most extra-budgetary funds in the annual government budget and further requires that the budgets of extra-budgetary funds that remain outside the budget be reported to the Seimas (parliament) in conjunction with the regular budget process, and that these reports also be made public. Other recent reformers include Bulgaria and Macedonia which eliminated many of the existing extra-budgetary funds and required the inclusion of the remaining funds into the treasury's single account.<sup>18</sup>

Progress has been slower with the integration of public capital investments into the regular budget process. Many CITs have some sort of development budget or public investment program

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<sup>17</sup> For example, Armenia reduced the number of extra-budgetary accounts from 358 in July 1999 to 100 in December 1999 (IMF 1999).

<sup>18</sup> Many CITs still keep separate accounts for foreign financed projects, as required by foreign donors and international lending agencies.

(PIP, which lists the capital investment projects to be financed from the central government's budget in the current year, as well anticipated projects for the next few years. The PIP as a separate document is not always realistic as to what actually can be financed by available resources, while PIPs also often lack provisions or mechanisms to assure funding for operation and maintenance of new capital infrastructure. An important factor that has contributed to these problems is that while the regular budget is put together by the Ministry of Finance, the PIP is typically the responsibility of the Ministry of Economy.<sup>19</sup> In some reform-oriented CITs, the process for inclusion of capital projects in the PIP has tightened and the coordination with the national budget has increased, as for example in Bulgaria, Macedonia, Kazakhstan and Kyrgyzstan. In other cases, authority over the PIP has been transferred to the Ministry of Finance altogether, as for example in Lithuania. In most CITs, little progress has been made in integrating the multi-year PIP within the context of a multi-year framework for the national budget.<sup>20</sup>

Achieving budget comprehensiveness remains most problematic in accounting for actions that indirectly affect the public sector's fiscal position (Polackova 2000). In addition to regular budgetary expenditures, budget liabilities increase through the use of tax expenditures such as tax holidays and other forms of preferential tax treatment, the provision of soft loans, and the granting of government loan guarantees. As a rule, none of these budgetary burdens are explicitly accounted for in the budgetary process of CITs. Slowly there has been an admission that these practices should be brought into the budget process and placed under the same budgetary scrutiny as regular

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<sup>19</sup> The Ministry of Economy is typically the new incarnation of the central planning authority of the previous regime and has been notoriously slow to modernize in many CITs.

<sup>20</sup> See Boex, Martinez-Vazquez and McNab (1999).

expenditure outlays. Thus recent budget codes (including Russia, Kazakhstan, Ukraine, and Lithuania) are requiring the inclusion of planned government loan guarantees in the annual government budget, and some, such as Kazakhstan, are requiring the explicit formulation in the budget plan and approval by parliament of a maximum annual level of budget guarantees. Soft budget loans have been on the decline among CITs, but are by no means extinct. On the other hand, extremely few CITs have adopted the OECD practice of introducing a tax expenditure budget attached to the annual regular budget.

### **Containing and paying back budget arrears**

Another central thrust in the ongoing budgeting and fiscal management reforms in CITs (especially in FSU countries) is the containment and eventual elimination of budget arrears. As we discussed above, budget arrears arose from a combination of drastic fiscal constraints and a flawed budget process. The reform strategies addressing budget arrears invariably include plans to prevent the further increase in arrears and less frequently, explicit plans to repay existing arrears within tight fiscal constraints.

Many FSU countries (including Russia, Ukraine, Kazakhstan, and Kyrgyzstan) are implementing a number of reforms to prevent the further accumulation of budget arrears. A first step in this direction is the improvement of revenue forecasts and the overall realism of budgets. The goal here is to reduce, if not eliminate, the cycle of budget instability and sequestering that characterized much of the transition period and which formed a significant contributing factor to expenditure overruns. A second step is to move toward a system of budget execution in which agencies are awarded budget authority in specified amounts and expenditure controls are implemented at the

commitment stage through a treasury system. Third, the new comprehensive budget process laws in some transitional countries have introduced explicit administrative procedures and sanctions to hold public managers accountable for unauthorized spending. Some of the new budget process laws, however, do not hold individual officers accountable and instead penalize the budget unit for expenditure overruns with lower funding.

A more difficult question is how to address the outstanding stock of expenditure arrears that has been accumulated over the transition period.<sup>21</sup> The main obstacle is the tight fiscal constraint which most of these countries continue to face, and options are few. The use of tax offsets in the past (offsetting budget arrears with tax arrears) invited further accumulation of budget arrears as well as tax arrears. Payment of budget arrears with long term financing resolves the immediate problem but shifts the burden for past spending to future generations of taxpayers. The most encouraging sign in this regard is the explicit inclusion in the budget of a separate line item which underlines a government's commitment to cancel these debts; for example, this has been done in the most recent budgets of Georgia, Kazakhstan, and Kyrzygstan.

### **Institutional strengthening and capacity building**

A third important theme in fiscal management reform has been institutional strengthening and capacity building at all stages of the budget process.<sup>22</sup> The needs for institutional strengthening

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<sup>21</sup> An often used method of "payment" during the transition was to let the real value of arrears erode with inflation. This (unfair) form of solution has vanished with the sharp decrease in inflation rates across most CITs.

<sup>22</sup> As remarked by the former IMF director, Mr Camdessus (IMF 1998), there is considerable scope for strengthening fiscal management and budget execution in most transitional economies, including the improvement of tax administration, establishing effective treasury systems and

and capacity building vary very significantly from countries like Albania, which in many ways is starting at zero, and Poland, Hungary and the Czech Republic, which have already built a strong institutional base. To proceed with further reforms, many of the CEE countries and the Baltics have the powerful incentive of accession to the EU (OECD 1999).

Efforts to build fiscal analysis capacity have concentrated on the Ministry of Finance and to a lesser extent on the legislative branch. The most significant needs for capacity building are in revenue forecasting and fiscal analysis (for example, quantifying the impact of tax reform options) and strategic medium term fiscal planning. Parliamentary fiscal analysis offices are still their infancy in most CITs. As a result, many parliamentary budget committees in CITs still only have a limited ability to develop independent budget projection, thus continuing to suffer from the inability to adequately assess the government's budget proposal. There are some exceptions. For example, with the help of international technical assistance, Ukraine has introduced quite adequate parliamentary budget analysis capabilities in recent years.

The single-most dominant theme in institutional development in CITs has been and continues to be the establishment and full implementation of a modern Treasury system for budget execution with a single account and ledger, uniform accounting, cash and debt management systems, procurement controls, and so on. Several CEE countries and Estonia got an early start with implementation of a treasury system, but over the past several years almost all transition countries have been involved in either introducing a treasury function or improving the existing treasury system. While many FSU countries (including Armenia, Azerbaijan, Kazakhstan, Moldova, Russia, Tajikistan and Ukraine) have begun introducing a treasury system, many of these FSU countries have

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ensuring adequate budget controls and the efficient implementation of government programs.

not yet been able to complete a treasury function that performs all basic treasury operations satisfactorily (IMF 1998; 1999; 2000).<sup>23</sup> Still other transition countries, such as the Republic of Georgia, have not yet started the task of building a modern treasury function.

Finally, ex-post external audit and the evaluation of budget performance remain the two areas with the highest needs for institutional strengthening and capacity building. While supreme audit institutions at the central level are now commonplace in CITs, many remain understaffed, lack basic resources, and in some cases, such as in Kazakhstan, lack independence from the executive branch. The need to improve and reform of budget evaluation and audits capabilities are more pronounced at the subnational level.

### **Reforming intergovernmental budget relations**

The fourth major thrust in budgeting and fiscal management reform in CITs deals with intergovernmental budgetary relations. While this issue has had a larger importance in large and ethnically diverse CITs, such as Russia, Kazakhstan or Ukraine, intergovernmental budgetary relations have also been the focus of important reforms in CEE countries such as Poland or Hungary, and have even been at the forefront of reform in very small countries, such as Estonia and Latvia. With very few exceptions, CITs continue to embark at the present time on further reforms of their systems of intergovernmental fiscal relations. The major themes have been democratic consolidation

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<sup>23</sup> Some CEE countries, such as Bulgaria, face similar problems in the implementation of their treasury system.

and the devolution of fiscal powers (mostly on the expenditure side of the budget) in the search of greater efficiency in the public sector.<sup>24</sup>

In many ways, the reform of intergovernmental budgetary relations overlaps and intersects with many of the budgetary and fiscal management reforms discussed above: comprehensiveness of the budget system, control of budget arrears, and institutional strengthening to develop a greater capacity to formulate and execute budgets. Other areas of reform are quite specific to intergovernmental fiscal relations. Frequently unresolved issues in the process of reform are the appropriate degree of fiscal autonomy to be granted to subnational governments and how to make the new fiscal arrangements incentive-compatible. While, as pointed out above, nominally subnational governments have been granted expenditure autonomy within the functions assigned to them, *de facto*, this autonomy has been restricted through expenditure mandates, budget norms and central regulations of all sorts. With very few exceptions, subnational governments in CITs have not been granted any meaningful degree of autonomy to raise their own revenues. Increasing expenditure efficiency and revenue mobilization at the subnational level has been an uphill battle in most CITs. However, for the time being most CITs would appear to have found an uneasy equilibrium between the desire to decentralize their finances and the center's wish to retain control over the major aspects of fiscal policy on the heels of a tumultuous period of economic, institutional, and political transformation. The two main objectives of decentralization reform, the consolidation of democratic institutions and the increased efficiency of the public sector, have therefore only been partially

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<sup>24</sup> For a review of these reforms see Bird, Ebel and Wallich (1995) and Dunn and Wetzel (1999).

achieved and fiscal decentralization reform is likely to continue to be a major policy issue in CITs in the coming years.

## **7. SUMMING UP AND THE ROAD AHEAD**

As with other aspects of the transition from central planning to market based economies, the process of fiscal management and budgeting reform in CITs has been an unprecedented experiment in policy-making and institution building. In retrospect, the main lesson of the past ten years is not a surprising one. Transforming the fiscal management and budgeting systems of these countries has been a very time intensive process and only has taken hold after these countries, each at their own pace as determined by many other political, historical, and cultural factors, have gone through a well-delineated sequence of stages that necessitated reform.

We identified three phases of budgetary and fiscal management reform in CITs over the last decade. In the first phase the emphasis was on political transformation and fundamental economic reform with basically no reform of fiscal management and budgeting practices. Because of unsustainable macroeconomic imbalances, in the second phase many CITs were forced to implement drastic fiscal austerity programs. However, these austerity programs were not sustainable in the absence of budgeting and fiscal management reforms, so that the public sector continued to be a drag on any chances of economic recovery and growth. In the third phase, most CITs have embarked in a process of transformation of the budget process and are regaining a measure of fiscal control by including fiscal fringe activities in the budget, controlling the growth of budget arrears, strengthening budget institutions and building analytical capacity, and seeking to increase the overall efficiency of the public sector by decentralizing fiscal decision making.



Although it is hard to make a general statement about the overall accomplishments of CITs due to the diversity of country experiences, substantial progress has been made in recent years in the reform of the budgeting process and fiscal management practices. Most transitional countries have laid the foundations of a modern budgeting system which will allow governments to implement their fiscal policies with increasing effectiveness and efficiency. However, further work in implementing modern budgeting techniques lies on the road ahead. In this respect, CITs should focus on three emerging global trends in the reform of budgeting and fiscal management, including the introduction of a multi-year fiscal strategy; the inclusion of performance-based budgeting techniques; and the devolution of fiscal responsibilities to line ministries and subnational governments (OECD 1998).<sup>25</sup> In fact, some CITs have already taken initial steps to implement these budgeting techniques and fiscal management practices.<sup>26</sup>

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<sup>25</sup> For a review of the multi-year budgeting techniques, application of performance-based budgeting techniques and devolution of government authority in the context of CITs, see Campos and Pradhan (1996), Schick (1998), Shand (1998), and World Bank (1998).

<sup>26</sup> For example, several CITs, including Russia, Kazakhstan, and Hungary have already begun to include some features of a multi-year budget approach. For a review of multi-year budgeting in transitional economies, see Boex, Martinez-Vazquez and McNab (2000).

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TABLE 1  
General Government Fiscal Balance in Countries in Transition (CITs): 1989-1998

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
<b>Baltic States</b>										
Estonia	--	--	5.2	-0.3	-0.7	1.3	-1.3	<b>-1.9</b>	2.2	-0.3
Latvia	--	--	6.0	-0.8	0.6	-4.0	-3.9	<b>-1.7</b>	0.1	-0.8
Lithuania	--	--	2.7	0.5	-3.3	-5.5	-4.5	-4.5	-1.8	<b>-5.8</b>
<b>CIS</b>										
Armenia	--	--	-1.9	-13.9	<b>-54.7</b>	-10.5	-11.0	-9.3	-5.9	-5.2
Azerbaijan	--	--	-5.0	2.8	<b>-15.3</b>	-12.1	-4.9	-2.8	-1.7	-4.2
Belarus	--	--	3.6	0.0	-1.9	<b>-2.5</b>	-1.9	-1.6	-0.7	-0.3
Georgia	--	--	-3.0	-25.4	<b>-26.2</b>	-7.4	-4.5	-4.4	-3.8	-4.4
Kazakhstan	--	--	-7.9	-7.3	-4.1	-7.5	-2.7	-4.7	-6.8	<b>-8.0</b>
Kyrgyzstan	--	--	4.6	<b>-17.4</b>	-13.5	-11.6	-17.3	-9.5	-9.0	-9.9
Moldova	--	--	0.0	<b>-26.2</b>	-7.4	-8.7	-5.7	-6.7	-7.5	-8.1
Russian Federation	--	--	-31.0	<b>-42.6</b>	-15.9	-9.7	-5.9	-9.1	-8.1	-5.4
Tajikistan	--	--	-16.4	<b>-30.5</b>	-23.4	-5.4	-11.9	-5.8	-3.3	-3.8
Turkmenistan	--	--	2.5	13.2	-0.5	-1.4	-1.6	-0.2	0.0	<b>-2.7</b>
Ukraine	--	--	-13.6	<b>-25.4</b>	-16.2	-9.1	-4.9	-3.2	-5.6	-2.7
Uzbekistan	--	--	-3.6	<b>-18.4</b>	-10.4	-6.1	-4.1	-7.3	-2.3	-3.8
<b>Former Yugoslav Republics</b>										
Bosnia	--	--	--	--	--	<b>-17.0</b>	0.0	-4.0	-2.0	-3.0
Croatia	--	--	<b>-5.0</b>	-3.9	-0.8	1.6	-0.9	-0.4	-1.3	0.6
Macedonia	--	--	-3.6	-9.6	<b>-13.8</b>	-2.9	-1.2	-0.5	-0.4	-1.7
Slovenia	0.3	-0.3	2.6	0.2	0.1	-0.3	-0.5	-0.2	<b>-1.7</b>	-1.4
<b>Other CEE Countries</b>										
Albania	-9.0	-15.0	<b>-31.0</b>	-20.3	-14.4	-12.4	-10.3	-12.1	-12.6	-10.4
Bulgaria	-1.4	-12.8	<b>-14.7</b>	-5.2	-10.9	-5.8	-6.4	-10.4	-3.0	1.0
Czech Republic	-2.8	-0.2	-1.9	<b>-3.1</b>	0.5	-1.1	-1.8	-1.1	-2.1	-2.6
Hungary	-1.4	1.0	-3.0	-7.2	-6.6	<b>-8.4</b>	-6.4	-3.0	-4.8	-4.8
Poland	<b>-7.4</b>	3.1	-6.7	-6.7	-3.1	-3.1	-2.8	-3.3	-3.1	-3.0
Romania	8.4	1.0	3.3	<b>-4.6</b>	-0.4	-1.9	-2.6	-4.0	-3.6	-3.3
Slovak Republic	-2.8	0.1	-2.0	<b>-13.1</b>	-7.0	-1.3	0.2	-1.9	-4.4	-5.8

Source: EBRD (1999).

Notes: Data for 1989-97 represents the most recent official estimate of outturns as reflected by publications from the national authorities, the IMF, World Bank, OECD, PlanEcon and the Institute for International Finance. Data for 1998 are preliminary actual price data, mostly official government estimates. "--" signifies data not applicable or not available.

TABLE 2  
Inflation in Countries in Transition (CITs): 1989-1998

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
<b>Baltic States</b>										
Estonia	--	--	303.8	<b>953.5</b>	35.6	42.0	29.0	15.0	12.5	4.4
Latvia	--	--	262.4	<b>959.0</b>	35.0	26.0	23.1	13.1	7.0	2.8
Lithuania	--	--	<b>345.0</b>	161.1	188.8	45.0	35.5	13.1	8.5	2.4
<b>CIS</b>										
Armenia	--	--	25.0	1341.0	<b>10896.0</b>	1885.0	31.9	5.8	21.8	-1.3
Azerbaijan	--	--	126.0	1395.0	1294.0	<b>1788.0</b>	84.5	6.5	0.3	-7.6
Belarus	--	--	93.0	1559.0	<b>1996.0</b>	196.0	244.0	39.3	63.4	181.7
Georgia	--	--	131.0	1176.9	<b>7487.9</b>	6474.4	57.4	14.3	7.2	10.7
Kazakhstan	--	--	136.8	<b>2984.1</b>	2169.0	1160.0	60.4	28.6	11.3	1.9
Kyrgyzstan	--	--	170.0	1259.0	<b>1363.0</b>	95.7	31.9	35.0	14.7	18.3
Moldova	--	--	151.0	<b>2198.0</b>	837.0	116.0	23.8	15.1	11.2	18.2
Russian Federation	--	--	161.0	<b>2506.1</b>	840.0	204.4	128.6	21.8	10.9	84.5
Tajikistan	--	--	204.0	1364.0	<b>7343.7</b>	1.1	2133.3	40.5	163.6	2.7
Turkmenistan	--	--	155.0	644.0	<b>9750.0</b>	1328.0	1262.0	446.0	21.5	19.8
Ukraine	--	--	161.0	2730.0	<b>10155.0</b>	401.0	181.0	39.7	10.1	20.0
Uzbekistan	--	--	169.0	910.0	885.0	<b>1281.0</b>	117.0	64.0	50.0	26.0
<b>Former Yugoslav Republics</b>										
Bosnia	--	--	114.0	<b>73109.0</b>	44069.0	780.0	-4.0	-25.0	14.0	
Croatia	--	136.0	249.8	938.2	<b>1149.0</b>	-3.0	3.8	3.4	3.8	5.4
Macedonia	--	--	229.7	<b>1935.0</b>	241.8	55.0	9.0	-0.6	2.6	-3.1
Slovenia	<b>2772.0</b>	104.6	247.1	92.1	22.8	19.5	9.0	9.0	8.8	6.5
<b>Other CEE Countries</b>										
Albania	--	--	104.1	<b>236.6</b>	30.9	15.8	6.0	17.4	42.1	8.7
Bulgaria	10.0	72.5	338.9	79.4	63.8	121.9	32.9	310.8	<b>578.6</b>	1.0
Czech Republic	1.5	18.4	<b>52.0</b>	12.7	18.2	9.7	7.9	8.6	10.0	6.8
Hungary	18.1	<b>33.4</b>	32.2	21.6	21.1	21.2	28.3	19.8	18.4	10.3
Poland	<b>639.5</b>	249.0	60.4	44.3	37.6	29.4	21.6	18.5	13.2	8.6
Romania	0.6	37.7	222.8	199.2	<b>295.5</b>	61.7	27.8	56.9	151.4	40.6
Slovak Republic	1.5	18.4	<b>58.3</b>	9.1	25.1	11.7	7.2	5.4	6.4	5.6

Source: EBRD (1999).

Notes: Inflation measured as change in year-end price levels. Data for 1989-97 represents the most recent official estimate from the national authorities, the IMF, World Bank, OECD, PlanEcon and the Institute for International Finance. Data for 1998 are preliminary actual price data, mostly official government estimates. Data for Bosnia-Herzegovina is based on annual average. "--" signifies data not applicable or not available.

TABLE 3  
Reducing monetary financing of the fiscal deficit during the transition:  
Introduction of treasury bill market in selected CITs

<b>Baltic States</b>	
Latvia	December 1993
Lithuania	July 1994
<b>CIS</b>	
Armenia	September 1995
Azerbaijan	September 1996
Belarus	February 1994
Georgia	August 1997
Kazakhstan	April 1994
Kyrgyzstan	May 1993
Moldova	March 1995
Russian Federation	May 1993
Turkmenistan	August 1996
Ukraine	March 1995
Uzbekistan	March 1996
<b>Former Yugoslav Republics</b>	
Croatia	July 1996
<b>Other CEE countries</b>	
Albania	August 1994
Bulgaria	July 1991
Czech Republic	February 1992
Hungary	January 1992
Poland	May 1991
Romania	March 1994
Slovak Republic	February 1992

Source: EBRD, 1999.

TABLE 4  
Common institutional failures in transitional budget and fiscal management process  
during the second phase of the transition

	Organizational Structure	Incentives
Legislative budget formulation	Structure of legislature not conducive to budget formulation  No independent analytical capabilities	Political incentive to increase expenditures
Executive budget formulation	Fragmented control over budget formulation process  Weak budget formulation and analysis capability, often based on the inertia of historical norms  Lack of necessary budget-related data	Tragedy of the commons - Conflicting incentives cause poor coordination between central budget authority and spending units
Budget execution	Absence of effective budget information management system  Lack of effective control at the commitment stage	Tragedy of the commons - Budget units seek and find avenues to allocate additional resources in excess of budget plan
Budget performance	Absence of effective external controls and performance measures	Spending units benefit from limited transparency and lack of accountability