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A myth of soft budget constraints in socialist economies

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TIGER Working Paper Series

No. 140

**A MYTH OF SOFT BUDGET CONSTRAINTS IN SOCIALIST
ECONOMIES**

Vladimir Popov

Warsaw, April 2020

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ABSTRACT

Most of the time the budget constraints in the socialist economies were harder than in developing countries and no less hard than in developed countries. The soft budget constraints (SBC) in socialist economies were not pervasive, as most authors believe, but selective, i.e. involved subsidization of some enterprises/industries at the expense of the other. This type of selective subsidization is a classic case of industrial policy: it may be good or bad, leading to success (China, Vietnam) or failure (USSR, Eastern Europe), but cannot be regarded as an intrinsic feature of the socialist centrally planned economy and an example of pervasive SBC.

Pervasive SBC should be associated with permanent government budget deficit, debt accumulation, high inflation and other forms of macroeconomic populism. In the Soviet Union in the post-war period (after the monetary reform of 1947 and until the Gorbachev financial and monetary expansion that started in 1987) budget deficit and debt were very low, open and hidden inflation was less than several percent a year – a better record than in most Western countries. But in the 1990s in Russia, other former Soviet republics and most East European countries budget constraints were weakened dramatically and inflation increased to hundreds and thousands percent a year.

SBC is just one type of this populist macroeconomic policy that was rare in socialist countries, but is found in abundance in many developing countries (especially Latin America and Sub-Saharan Africa) and transition economies (especially FSU states).

Keywords: Soft budget constraints, socialist economies, industrial policy

JEL: H6, O25, P34, P35, P40, P43.

A MYTH OF SOFT BUDGET CONSTRAINTS IN SOCIALIST ECONOMIES

Vladimir Popov

Introduction - what is considered a soft budget constraint?

One of the most important papers on soft budget constraints by Kornai, Maskin and Roland (2003) characterizes the phenomenon as follows:

“The term “soft budget constraint” (SBC), introduced by Kornai (1979, 1980 and 1986), has become a familiar part of the economics lexicon. Originally formulated by Kornai to illuminate economic behavior in socialist economies marked by shortage, the concept of SBC is now regularly invoked in the literature on economic transition from socialism to capitalism. Indeed, SBC problems currently constitute a central policy issue in transition economies. But the concept is increasingly acknowledged to be pertinent well beyond the realm of socialist and transition economies. A host of capitalist phenomena, ranging from the financial difficulties of Chrysler in the 1980’s to the collapse of the banking sector of East Asian economies in the 1990’s, can be usefully thought of in SBC terms” (Kornai, Maskin, Roland, 2003).

Kornai’s idea was that state-owned enterprises in socialist countries were not allowed to fail even when being unprofitable. Virtually always they were bailed out with financial subsidies or other instruments. There were no bankruptcies in former socialist economies and virtually never socialist enterprises were going out of business, even though often they were restructured and forced to change their profile.

The SBC are often linked to another phenomenon described by Kornai (1980) – shortage economy. Lindbeck (2007) claimed that “Kornai’s two most celebrated characterizations of real world socialist economies – “shortage economies” and production units with “soft budget constraints” – are analytically closely connected”.

On the one hand, when the state covers the losses of the unprofitable enterprises, wages and profits exceed the value of output produced, so consumer and investment

demand can exceed the supply of goods. If prices are controlled and not allowed to rise to clear the market, shortages emerge. This phenomenon is known also as forced savings or monetary overhang or delayed demand.

On the other hand, enterprises themselves do not have any constraints in expanding their demand for resources, so shortages emerge. “As a result of the soft budget constraint, – writes A. Lindbeck, – firms tend to expand investment and production until they encounter nonfinancial resource constraints (hence shortages). This assertion was based on the rather realistic assumption that managers in such economies are mainly interested in the size, or rate of expansion of production” (Lindbeck, 2007).

Some authors pointed out that the correlation between shortages and SBC is not inevitable, that “sufficiently high prices for consumer goods would nevertheless be able to abolish any consumer goods' shortages” (Gomulka, 1985), but somehow the two concepts are regarded as an indispensable characterization of the socialist (centrally planned) economies and entered textbooks on Comparative Economic Systems.

This paper makes a non-conventional argument that there were less SBC in socialist economies than in other countries – most of the time budget constraints under central planning were much harder than in market economies with similar level of development. The argument in a nutshell is that pervasive SBC (with respect to all or most enterprises or industries) should be associated with the government budget deficit, but it was not the case in former socialist economies. Most of the time the government budget deficit was quite modest, whereas open and hidden inflation¹ was relatively low. Hence, SBC in socialist economies were not pervasive, as the Kornai, Maskin, Roland (2003) believe², but selective, i.e. subsidization of some enterprises/industries at the expense of the other. This type of selective subsidization

¹ Hidden inflation – increase in the gap between demand and supply of goods at fixed prices. It emerges when prices are not allowed to increase to clear the market and monetary overhang accumulates.

² “In pre-reform socialism, SBC’s permeated all organizations” (Kornai, Maskin, Roland, 2003).

is a classic case of industrial policy: it may be good or bad, leading to success (China, Vietnam) or failure (USSR, Eastern Europe), but cannot be regarded as an intrinsic feature of the socialist (centrally planned) economy and an example of pervasive SBC.

SBC under central planning

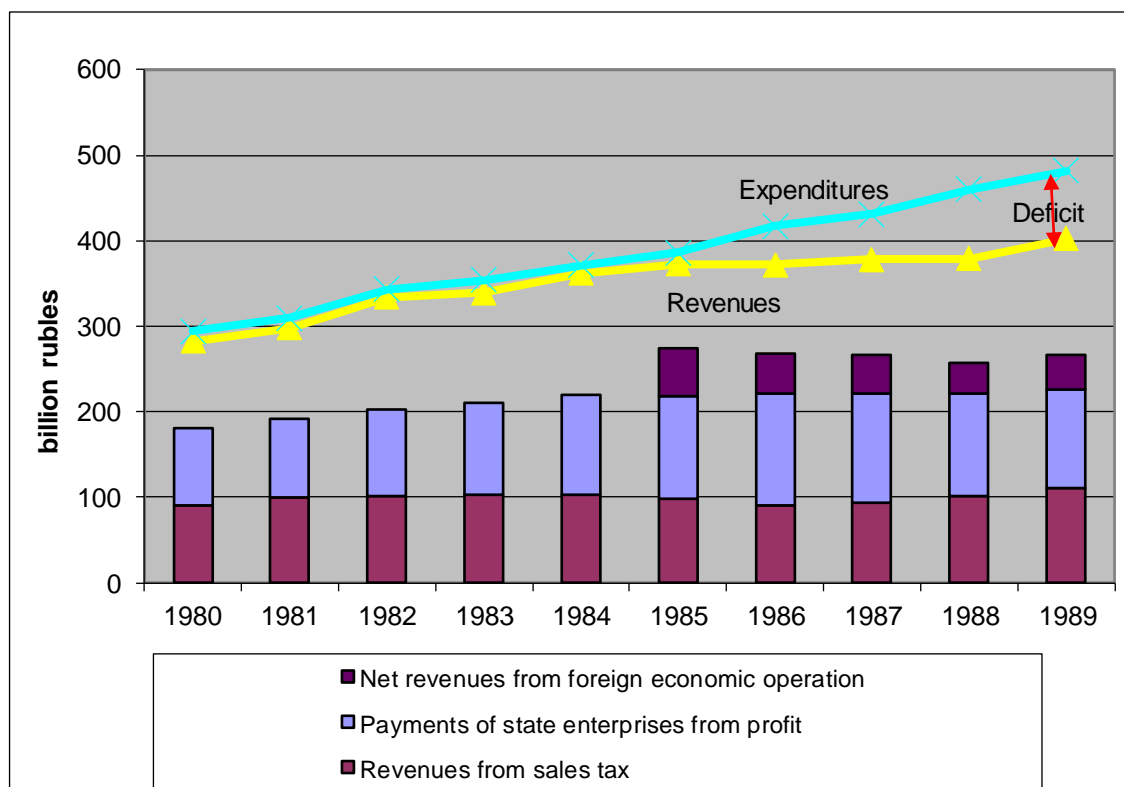
It is said that SBC could exist in different types of economic systems, but are more often found in centrally planned socialist economies. Elements needed for the emergence of SBC “come together more frequently and in a wider set of cases under socialism and post-socialist transition than under systems where socialism has never arisen” (Kornai, Maskin, Roland, 2003). The central argument of this paper is exactly the opposite – in socialist countries institutional capacity of the state was stronger than in most similar income level developing countries, the socialist state had better ability to raise taxes, better control over government spending and government budget deficit; whereas subsidies in socialist countries were common, they were not pervasive and were financed via taxes or through price controls that redistributed rent from resource to other industries.

Government budget in the USSR (1922-91) had a surplus most of the time, even if the purchases of the governments bonds by the population (which were virtually obligatory and hence should be really treated as taxes) are excluded. The only periods when the Soviet budget was in deficit were the 1930s (industrialization), the Great Patriotic War (1941-5) and the late 1980s (the beginning of the transition to the market). In contrast, in the Russian Empire in 1803-1914 only in 6 out of 112 years government budget was in surplus (Tabata and Tabata, 2019).

As fig. 1 shows, government budget deficit in 1980-85 was miniscule (only 1 to 2% of GDP), and increased to 9% of GDP only in 1988 as a result of reforms. Government debt was less than 20% of GDP until 1985, annual growth rates of money supply (M1) were below 7% until 1985 (fig. 2).

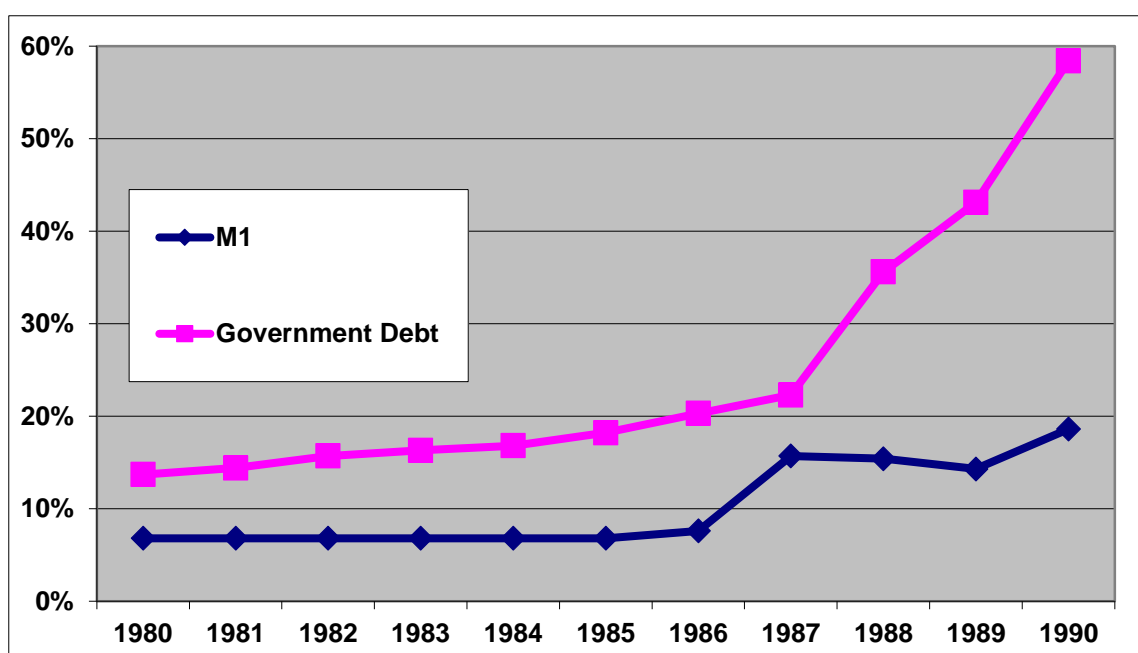
There were shortages of many consumer goods (as well as excess inventories of the other goods), but generally prices were clearing the consumer market before 1985.

Fig. 1. Government budget revenues, expenditures, and deficit, billion rubles



Source: Goskomstat.

Fig. 2. Money supply growth rates (%) and government debt as a % of GNP

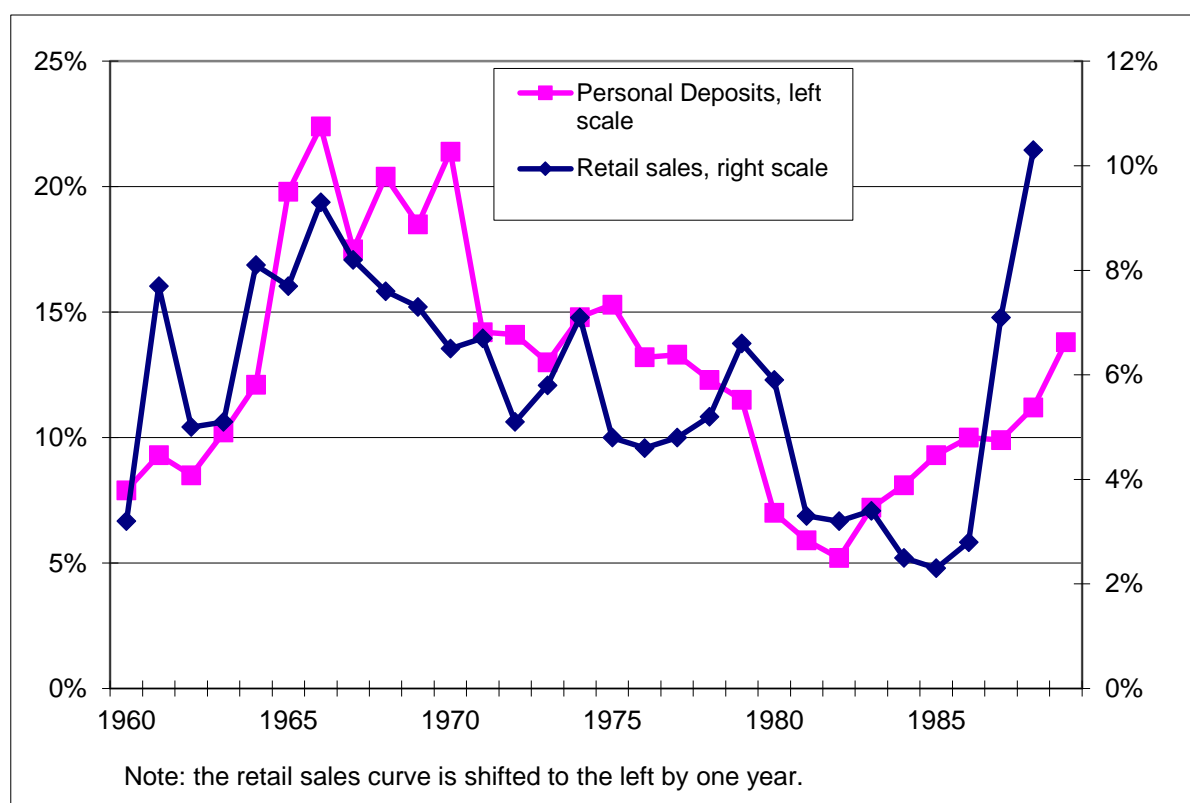


Source: Goskomstat.

There was no general monetary overhang at the consumer market, or, to use the planning terminology of that time, personal income of households and their expenditure were roughly balanced.

The growth of retail sales at current prices was roughly in line with the increase in the most important component of household money supply – bank deposits of population (fig. 3), that is to say, prices for consumer goods were generally set at a level that cleared the market. In the 1960s, when real growth was high – between 5 to 10%, retail sales were increasing at 6 to 10% rate; in the 1970s these rates fell to 5 to 7%; in the early 1980s – to 2 to 3% (fig. 3). Personal deposits increased at a rate roughly 2 times faster – this was largely voluntary accumulation of the financial assets by households (fig. 3).

Fig. 3. Personal bank deposits and retail sales in current prices, annual growth rates, %

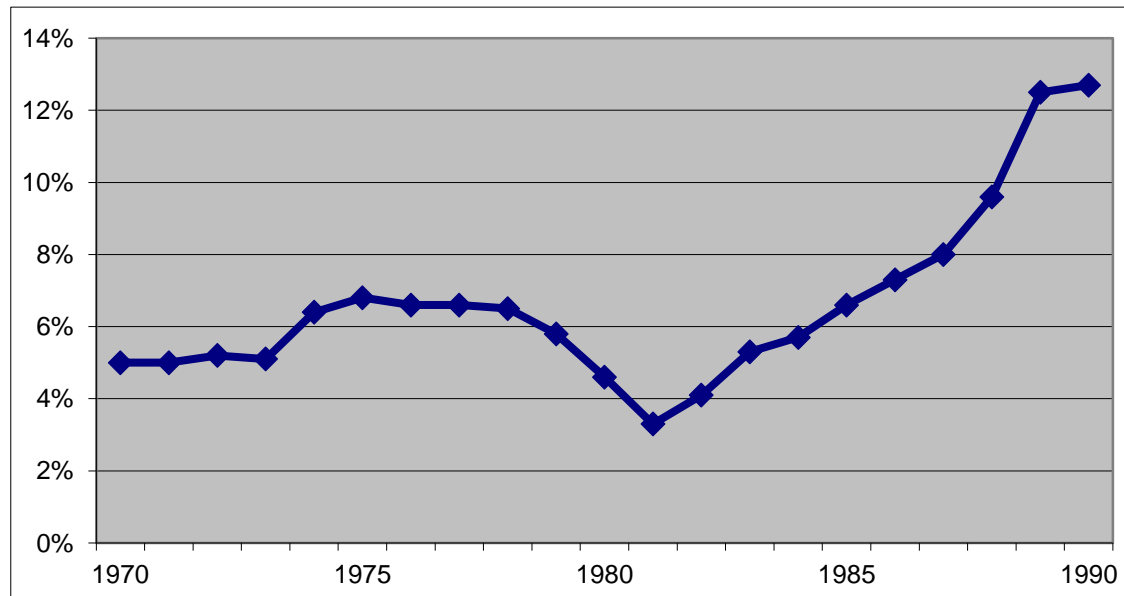


Source: Goskomstat.

An important evidence of the absence of monetary overhang at the consumer market until the end of the 1980s is the dynamics of household savings rate – it remained

relatively stable in 1970-85 (around 5%) and even decreased in 1975-82 before it started to rise above the historical 5-6% average in the second half of the 1980s – this is exactly when the forced savings/monetary overhang emerged and started to increase (fig. 4).

Fig. 4. Household savings rate, as a % of personal disposable income



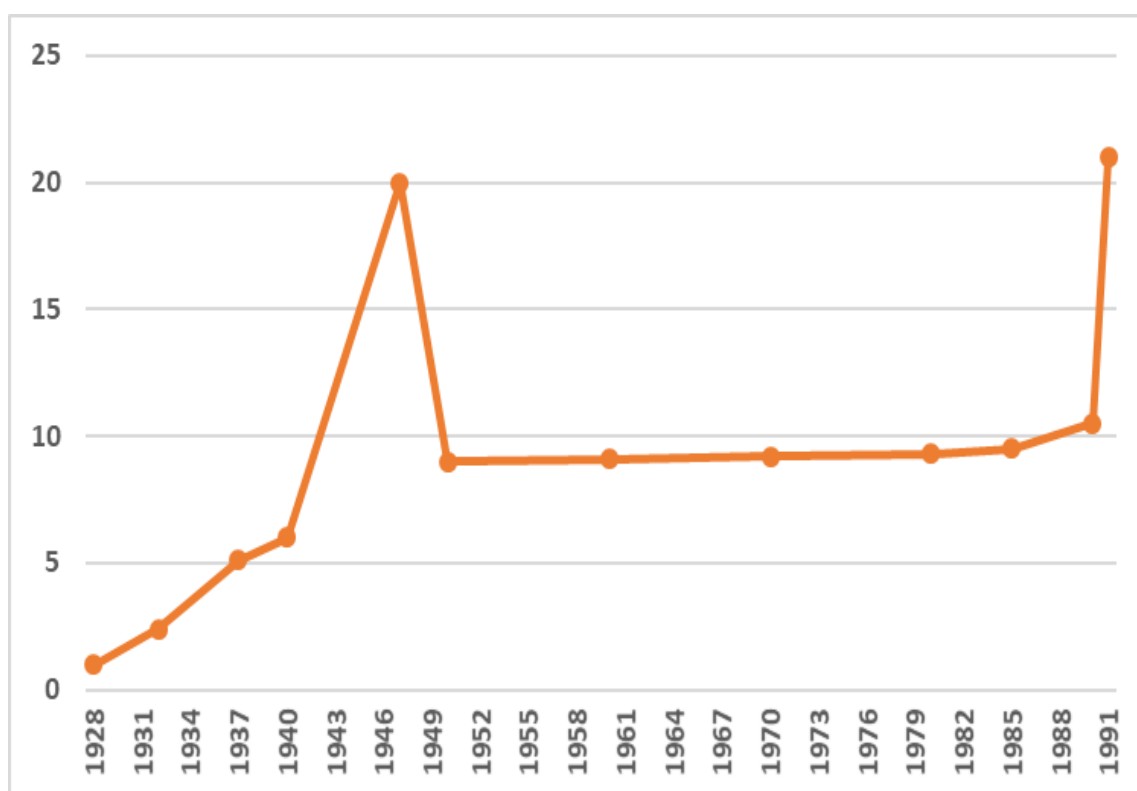
Source: Stabilization, Liberalization and Devolution: Assessment of the Economic Situation and Reform Process in the Soviet Union. EC, December 1990, p. 163.

The inflation rate is difficult to estimate, price indices were not calculated properly in the USSR. The only price index that was computed in the 1930-40s was the retail trade price index (fig. 5), and it is known to understate actual inflation because the new goods were excluded from comparison (Shmelev, Popov, 1989), whereas in the conditions of pervasive price controls the creeping inflation was happening exactly via the introduction of new goods (without major quality improvements, but a few new bells and whistles, and considerably higher price). This index can be trusted only to indicate the general picture of price increases – prices increased considerably (20 times even according to the index) in 1928-47³, during the period of industrialization and war, fell by a good half in 1947 after the confiscatory monetary reform of 1947, and were relatively stable for the next 4 decades (1947-87).

³ 20 times increase in 1928-47 is equivalent only to 17% annual inflation.

But it is quite obvious that inflation was running in the 1980s in the lower single digits: national income and retail sales in current prices in the 1980s were growing annually at 2 to 8% only (fig. 3), so with real growth at about 2% a year (this is the estimate of alternative statistics, not official), inflation could hardly have been higher than 5%.

Fig. 5. Retail trade price index in the USSR, 1928 = 1



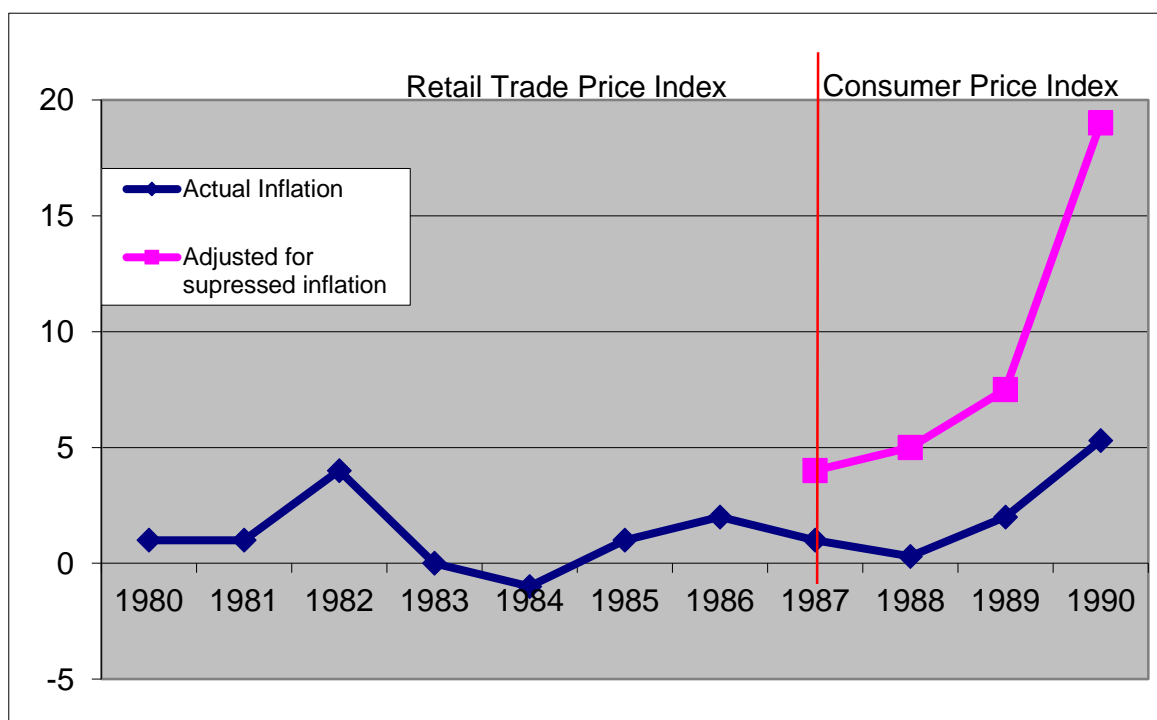
Source: Goskomstat.

Total inflation, including hidden (suppressed) inflation – the increase in the gap between demand and supply due to price controls – was estimated at below 5% until 1987, but increased to 20% in 1990 (fig. 6).

Another estimate of the suppressed inflation – increase in the ratio of collective farm market prices (reflecting supply and demand) to controlled prices of state retail trade. This ratio increased in 1950-1985 2.4 times (fig. 7), which is equivalent to the annual growth of 2.5% only. So even assuming that all the growth of the collective farm

market prices reflected inflation⁴, inflation in the Soviet Union in 1947-87 seem to be no higher than several percent a year, which is a better record than in most of the countries of the world at that time. The belief that soft budget constraints were “pervasive” simply does not square up with virtual absence of budget deficits, low growth rates of money supply and single digit inflation.

Fig. 6. Inflation in the consumer market, %



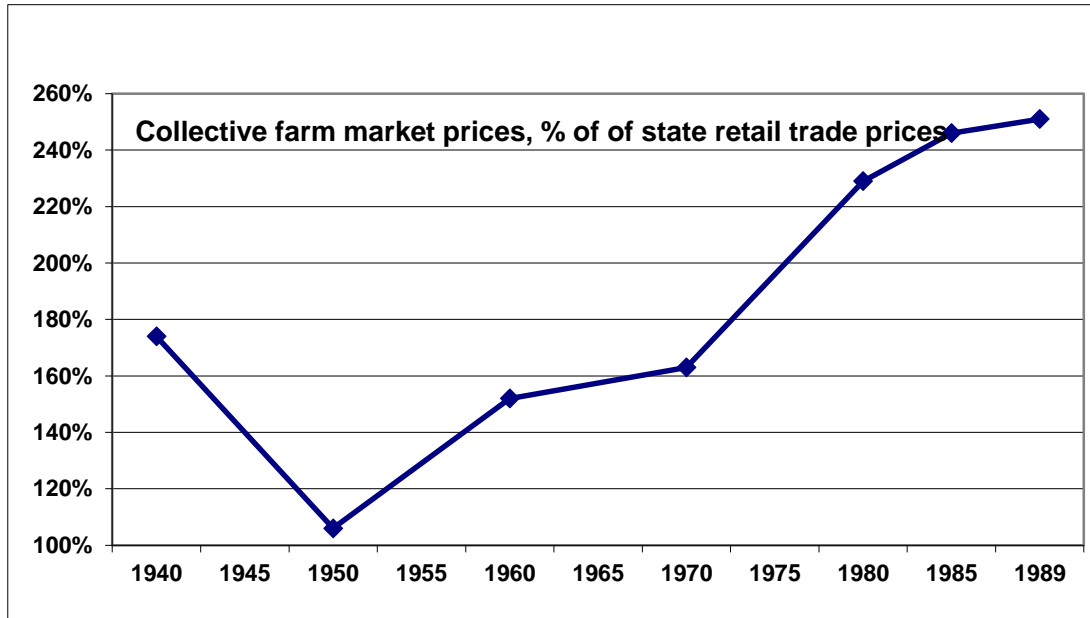
Source: Goskomstat.

Inflation in the USSR was caused not by SBC, but by the physical inability of the planners to control prices in industries with large and rapidly changing nomenclature of output (secondary manufacturing, construction, services) – every new product in these industries was a way to get a price increase, and it was virtually impossible for the planners to check millions of cost calculations and to stop creeping inflation. In resource industries and agriculture with fewer products and slowly changing nomenclature, price controls were much more efficient, so these industries experienced constant declines in profitability (fig. 8) due to growing costs of machinery and supplies and wages; periodically – once in 5 to 10 years – prices for

⁴ Part of the increase in prices of the collective farm market as compared to prices of state trade most probably reflected the increase in the quality gap between goods sold in state retail trade and at the collective farm market.

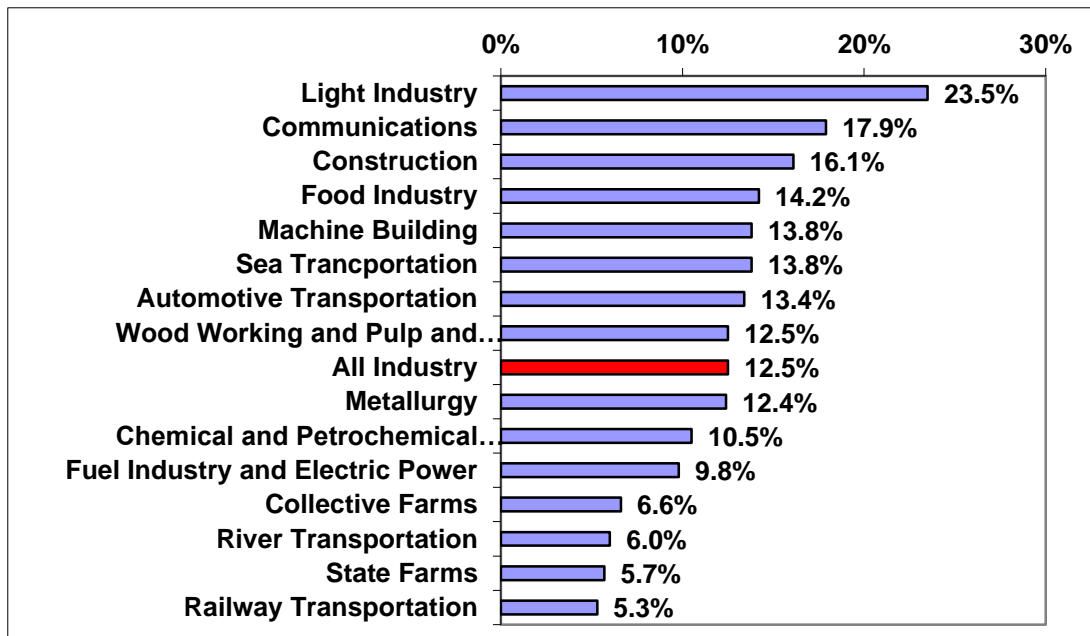
these goods were increased in a one-time hike, so that these industries could become profitable again (Shmelev, Popov, 1989).

Fig. 7. Prices of state trade and collective farm market



Source: Goskomstat.

Fig. 8. Profitability of key economic sectors in the USSR in 1986, %



Source: Goskomstat.

Socialist economies in this respect were not so much different from low inflation market economies, especially developing countries, where single digit inflation is of cost-push nature – prices and wages in these countries are rigid and increase due to market imperfections (adverse supply shocks), so the monetary authorities have to allow the money supply to expand to make sure that there is no recession. If inflation is running at a low level, the relationship between growth and inflation is positive (normal Phillips curve: negative relationship between inflation and unemployment, i.e. positive relationship between inflation and growth). Negative relationship between inflation and growth is in effect only when inflation exceeds several dozen percent a year. These non-linear links were studied extensively in the literature since Bruno and Easterly (1996) paper in developing countries and in transition economies.⁵

Soft budget constraints and industrial policy

SBC did not “permeate all organizations” in socialist countries, as Kornai, Maskin, Roland, (2003) suggest, but were very selective, i.e. subsidies were provided to some enterprises/industries/regions at the expense of the other.

All centrally planned economies had extensive explicit and implicit subsidies. In most EE and FSU countries on the eve of transition, in 1989-92 only direct subsidies from the government budget amounted to 10-15% of GDP (World Bank, 1996, p. 116; EBRD, 1997, p. 83). In addition to direct subsidies that went mostly to cover the cost of housing, public utilities and food (see table 1), there were hidden subsidies, in particular, low prices for fuel, energy and raw materials, not associated with any transfers to/from government budget, but efficiently redistributing rent from resource industries to secondary manufacturing and to all energy consumers.

The impact of subsidies on growth may be different (Popov, 2019). On the one hand, there is an example of East Asian countries which were subsidizing strong and competitive export-oriented sectors and were relying on export as a locomotive of economic growth: in China, for instance, the share of export in GDP increased from 5% in 1978 to 35% in 2006 (later fell to 20% in 2018), while the GDP itself was

⁵ For a survey of this literature see: Polterovich, 2006; Popov, 2011 a, b.

growing at an average rate of about 10%. On the other hand, there are much less appealing examples of import-substitution industrialization (ISI) that involved subsidization of weak, non-competitive industries.

Table 1. Subsidies to producers and consumers, 1989

Item	Billion rubles	As a % of GNP
Total subsidies	126.5	13.7
Budget subsidies to domestic producers and consumers	103.0	11.1
-Agro-industrial complex	91.1	9.9
-Food production	55.6	6.0
-meat & milk products	39.8	4.3
-other	15.8	1.7
-Farmers	32.0	3.5
-Subsidies for fodder, seeds, fertilizers, tractors, etc.	3.5	0.4
-Other subsidies to consumers (housing, utilities, theatres, etc.)	4.4	0.5
-Subsidies to heavy industry (coal, thermal energy, etc.)	7.5	0.8
Agricultural price support fund	9.3	1.0
Subsidies for foreign economic activity (trade subsidies)	11.7	1.3
Subsidies financed by tax offsets or outside the budget (construction of farmers markets, children's clothing, Ministry of non-ferrous metals)	2.5	0.3

Source: A Study of the Soviet Economy. IMF, World Bank, OECD, EBRD, 1991.

Vol. 1, p. 290-291.

Soviet industrialization of the 1930s and beyond became a major isolationist import substitution experiment: from that time on the share of export in Soviet GDP did not increase until large scale fuel sales abroad started in the 1970s. The huge perverted

industrial structure created without any regard to costs and prices of the world market proved to be stillborn and nonviable in 1992, when it finally faced foreign competition after half a century of artificial isolation. One can also cite the examples of “the champion of isolationism” – North Korea – and other socialist countries, of many developing countries of socialist orientation, which were creating their own heavy industries following advises and using assistance of the Soviet Union, of India (where the share of export in GDP remained frozen at a level of 6% from the 1950s to the 1980s) and many Latin American countries.

Theoretically, industrial policy in the USSR could have been better than the actual import substitution type that was never replaced by export orientation. It is inevitable that a country in need of industrialization starts with the import substitution policies (because the creation of new industries that were absent before results in crowding out foreign goods from domestic market), but there is a need to switch to export orientation at an appropriate point. If enterprises eventually do not become competitive in the international market, they evolve into grandiose, but useless “industrial dinosaurs” and “Egyptian pyramids” that can exist only behind a protectionist wall and that go bankrupt as soon as they are exposed to the winds of international competition. But there are examples of export orientation within the framework of the CPE: China started to increase its exports at double digit rates from the early 1970s, well before the market type reforms.

There is a certain irony in that some authors, denouncing SBC, point out to China of the 1980s – one of the most successful cases of catch up development in history. “Indeed, – writes one of them, – the concept is also highly relevant for China during the period of economic transition after 1980 – with large volumes of “soft”, in fact often non-performing, loans by state banks to state firms” (Lindbeck, 2007).

By the mid-1990s direct subsidies in most of East European and FSU countries declined to about several percent of GDP (0-4%)⁶ and relative prices largely started to approach world market ratios. But with democratization small and well organized interest groups, such as resource companies and military industrial complex, found

⁶ World Bank, 1996, p. 116; EBRD, 1997, p. 83.

themselves in a position to exercise greater lobbying power than numerous, dispersed and unorganized consumers (Olson, 1971). The weak state was unable to resist the pressure of these strong interest groups, and in addition to the inefficient industrial policy there emerged an array of SBC that contributed to macroeconomic instability that had not existed in the socialist period.

Macroeconomics of populism

SBC is just one type of populist macroeconomic policy that was rare in socialist countries, but is found in abundance in many developing countries (especially Latin America and Sub-Saharan Africa) and transition economies (especially FSU states). Most of them experienced macroeconomic instability – budget deficits, inflation, increased domestic and foreign indebtedness, overvalued exchange rates leading to currency crises – more than once in their recent history, after the transition to the market and democracy.

Inflation surged in the CIS and some Balkan states after the transition to the market and remained rather high for a number of years (since the late 1980s in Yugoslavia and in 1992-94/5 in Bulgaria, Romania, and CIS) – table 2, and re-materialized a couple of years later, after the currency crises (Bulgaria and Romania – in 1996-97; Belarus – in 1997-98; Russia – in 1998) – (Popov, 1995; 1996).

Budget deficits and their financing through money printing and/or debt accumulation were common in the post-Soviet space in the 1990s. In Russia government budget deficit increased to 20% of GDP in 1992 and remained in the range of 10% of GDP until the currency crisis of 1998 (fig.9).

Prices distortions in transition economies were also very pronounced. In all resource rich post-communist countries domestic prices for fuel were kept below the world market level (usually below 50%) through export taxes (on exports of fuel) and direct restrictions on exports (export quotas, access to the pipeline). In 1997, for example, effective electricity tariffs in most EE and FSU countries were 1 to 4 US cents per kWh (only in Poland, Latvia, Hungary and Slovenia it was 6 cents and higher) as

compared to 8 cents in the US and 14-15 cents in 15 European Union countries at that time on average (EBRD, 1998, p. 43).

Table 2. Inflation in East European and former Soviet Union countries in the 1990s, % a year (retail trade or consumer price index)

Countries/Years	1990	1991	1992	1993	1994	1995	1996*
Eastern Europe and Baltic countries**	116	148	516	223	51	26	15
Albania	0	36	226	85	28	8	6
Bulgaria	22	334	82	73	89	62	30
Croatia	136	250	938	1516	98	4	5
Czech Republic	11	57	11	21	10	9	7
Estonia	23	211	1069	89	48	29	22
Hungary	29	34	23	22	19	28	22
Latvia	10	124	951	109	36	25	20
Lithuania	8	225	1020	290	72	35	30
FYR Macedonia	120	230	1925	248	65	50	6
Poland	586	70	43	35	32	28	19
Romania	5	174	211	256	131	32	20
Slovak Republic	11	61	10	23	14	10	7
Slovenia	550	118	201	32	20	13	6
CIS states**	5	94	994	2008	2874	397	114
Armenia	10	100	825	3732	5458	175	20
Azerbaijan	8	106	616	833	1500	412	30
Belarus	4	84	969	1188	2200	800	80
Georgia	3	78	913	3126	18000	160	20
Kazakhstan	4	91	1610	1760	1980	180	30
Kyrgyzstan	3	85	855	1209	280	45	25
Moldova	4	98	1276	789	327	30	16
Russia	6	93	1353	896	303	190	45
Tajikistan	4	112	1157	2195	452	635	500
Turkmenistan	5	102	493	3102	2400	1800	500
Ukraine	4	91	1210	4735	842	375	60
Uzbekistan	3	82	645	534	746	315	40
China	2	3	5	13	22	17	-
Mongolia	0	209	321	183	145	75	-
Vietnam	68	68	18	5	8	17	-

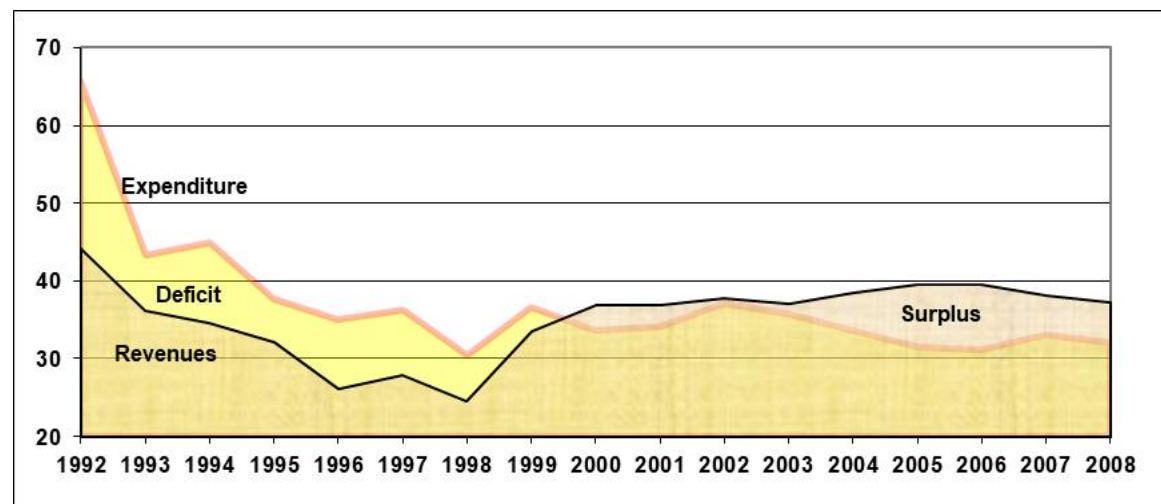
*Forecast

**Non-weighted average

Source: For 1990-5 World Bank (World Development Report *From Plan to Market*, 1996:174), annual inflation. For 1996 EBRD (*Transition Report Update*, April 1996:23), December to December inflation.

If subsidization is carried out through price controls, price distortions worsen the allocation of resources⁷. In all countries, where energy is cheap, the energy intensity of GDP is high: in FSU electricity consumption per \$1 PPP GDP in the 1990s was nearly 2 times higher than in EE countries, whereas in EE countries it was 2 times higher than in Western Europe (EBRD, 1998, p. 47). Only in 1996-98, when domestic energy prices in these countries started to approach the world level, energy intensity showed some signs of decline, but not for long. The new drop in relative domestic energy prices after 1998-99 devaluations in the CIS states staged conditions for another round of increase in energy intensity (Polterovich, Popov, Tonis, 2008).

Fig. 9. Consolidated government revenues and expenditure, % of GDP



Source: EBRD Transition Report, various years.

Why transition economies developed these SBC, even though there was a clear understanding that such policies are sub-optimal? Why there were persistent (and not cyclical) budget deficits, accumulation of debts beyond the ability to pay, debt and currency crises, high inflation, price and exchange rate mismanagements? Why Russia and other resource abundant CIS states had to struggle with budget deficits, high inflation and currency crises in the 1990s and are still choosing to keep fuel,

⁷ Consumer subsidies have similar effect – they favor consumption over savings and lead to inefficient use of subsidized goods (housing, energy, etc.). In addition, consumer subsidies are generally socially unfair, since more subsidies go to households that consume more (which are usually the richest).

energy, and resource prices low and thus are relying once again on import substitution, which seem to have lost in recent decades all the supporters among economists and policy makers?

Transition economies could be quite similar in this respect to developing countries, where the political economy of subsidies and macro instability were thoroughly analyzed⁸. Three decades ago the research on the macroeconomics of populism in Latin America raised similar questions (see Castanheira and Popov, 2000 for a summary) and suggested two answers: (1) sharp asset and income inequalities (as compared to Asian countries) and (2) sharp division between primary products export sector controlled by the traditional oligarchy and employers and workers in industry and services (Kaufman and Stallings, 1991). It was argued that upper income groups are generally in a good position to resist taxation and this placed a limit on the capacity of Latin American governments to deal with distributive pressures within the context of the growth-oriented export models.

In small open European economies, the expansion of the welfare state allowing to adjust painlessly to costs of internationalization, was an important political concomitant of liberal trade policies. In East Asian countries political weight of urban popular groups (pressing for redistribution of export revenues in their favor) was counterbalanced by the presence of the large class of independent farmers or small export-oriented manufacturing firms. In contrast, in Latin America the state had a much more limited capacity to tax income and assets directly, and the export-oriented oligarchy was not willing to share its revenues, but at the same time not able to resist the pressure for redistribution because of political isolation.

The heritage of the CPE put the transition economies into a situation, somewhat similar to Latin American countries. In the very beginning of transition, after the deregulation of prices, they experienced a dramatic and quick increase in personal income inequalities and sectoral inequalities in the profitability of enterprises.

⁸ To be sure, political influence is one of the major reasons. Among different explanations of SBC, there are references to political influence, creditor's lack of information and commitment, and insider control, but there is no evidence that these factors decrease in response to financial losses (Li and Liang, 1998).

Previously, under authoritarian regimes, the government was strong enough to impose substantial burden of transfers on the producers (the government revenues in most former socialist countries were way above 50% of GDP). Newly emerged weak governments, however, were not only in a position to maintain large scale open subsidization, but also experienced falling budget revenues.

The shadow economy expanded dramatically in the 1990s. Estimates based on electricity consumption suggest that in Eastern European countries the share of shadow economy in 1989-94 increased on average from 18 to 22%, whereas in the former Soviet republics it increased from 12 to 37%⁹. As a result, the government was unable to raise tax revenues. In Russia government revenues plummeted after the CPE was dismantled, falling below 30% of GDP (including off-budget funds) in 1997. This was still more than in East Asian countries and other economies with similar GDP per capita on average, but much less than in Central European countries and much less than needed to finance government commitments - still very large agricultural and housing subsidies, mostly free education and health care, and universal pay-as-you-go system of social insurance.

Deprived of the much needed revenues and not being able to renege on its obligations, the government had to resort to alternative ways of financing its commitments – inflationary financing, building up domestic and foreign debt, maintaining the overvalued exchange rate, driving foreign borrowing up and/or foreign exchange reserves down.

Inflation, in fact, resulted from the weakness of post-communist governments caused by the lack of consensus on the issue of financing the costs of economic reforms. The Chinese government was able to impose such a consensus “from above” using authoritarian methods, and in Central European countries this consensus was built “from below” leading to the emergence of relatively strong democratic governments. In contrast, the CIS and South East Europe societies have been more divided than in Central European countries and Baltic states, where a greater consensus on how to proceed with economic reforms existed.

⁹ World Bank, 1996, p.27.

In Russia, for instance, there were clear and deep contradictions between major industrial groups (namely, agriculture, defense and machine building, and fuel and resource sector) on the issue of financing economic reforms. Its weak democratic government was not able to withstand the pressure of these interest groups (“complexes”, as they are called in Russia – fuel and energy complex, military industrial complex, and agro-industrial complex¹⁰), political opposition, and regions, and, as a result, did not have the power to bring its expenditure in line with the revenues. The lack of political consensus at three levels – between the central government and the regions, between the parliament and the government, and within the government itself – may have been the main reason for the failure of macroeconomic stabilization attempts in 1992-94.

Inflationary financing under these circumstances was a sort of a “safety valve” – a device allowing to finance the reforms (with the inflation tax) without forcing the conflicting parties to come to the explicit agreement. It turned out to be a symptom of the tensions and contradictions between the interest groups and allowed the government to function under the conditions of disagreement between major parties. The alternative would have been the open conflict between the confronting sides, which could have been associated even with greater costs than the highly inflationary environment. In a sense, the rate of inflation was a pretty accurate measure of the degree of social consensus on financing the burden of reforms. As the popular sayings go, “inflation is better than civil war”, and “nobody yet died from inflation”.

Once there is a need, whether mythical or real, to redistribute income in favor of poorest social groups and weakest enterprises, coupled with the inability of the governments to raise enough taxes for this redistribution activity and to withstand the pressure of interest groups, the story unfolds pretty much in line with Latin American type macroeconomic populism (Dornbusch and Edwards, 1989; Sachs, 1989) and leaves a strong sense of *deja vu*. Constraint by inability to raise tax receipts and by the simultaneous need to maintain redistribution in favor of particular interest groups,

¹⁰ Fuel and energy industries were the donors that subsidized agriculture and secondary manufacturing not only by being the major source of tax revenues for the government budget, but also by supplying all domestic producers with energy at prices below world market level.

the governments are left basically with only four options for indirect financing of subsidies.

The first one is to maintain control over particular prices. Controls over prices of non-resource goods do not solve the problem completely, since they require explicit subsidies from the budget to cover the losses of companies producing those goods. In contrast, price control for fuel, energy and other resource commodities effectively takes away rent of resource sector and redistributes it to consumers. This option is available to resource rich countries, which may give additional explanation to the resource curse story – it may contribute to economic growth of manufacturing industries, but only at the expense of losses in energy intensity (Polterovich, Popov, Tonis, 2008).

The second alternative way to continue subsidization, when funds are not available, is to resort to trivial inflationary financing of the government budget. The government in this case compensates for the shortfall of tax revenues by imposing the ruinous for growth inflation tax on everyone.

The third way is certainly debt financing – either domestic or external borrowing. Debt financing makes sense, when it buys some time for maintaining subsidies while conflicting parties are negotiating the way to get rid of them. If it continues for too long, however, it only makes things worse, since debt service payments impose an additional burden on the government budget.

Finally, the fourth way to continue redistribution with no funds in the budget is to maintain the overvalued exchange rate that favors consumers over producers, exporters over importers and leads to increase in consumption at the expense of savings. Consumption increases in this case due to increase in imports financed through external borrowing or foreign exchange reserves, and obviously provides only a temporary solution, leading to the balance of payments crisis in the longer term. It was shown for developing countries that overvaluation of the exchange rate is detrimental for economic growth (Dollar, 1992; Easterly, 1999; Montes, Popov, 1999; Polterovich, Popov, 2004).

Overvaluation of the exchange rate is usually supported by the governments (that collect their taxes in domestic currency, but service the international debt in foreign currency) and, of course, by the importers, whose political influence may exceed that of exporters. A number of transition economies that maintained the overvalued exchange rates in the 1990s, and in 1998-99 experienced the currency crises (Popov, 2001).

This is another reason why exchange rate based stabilization and currency board arrangements are quite risky for transition economies (Montes and Popov, 1999). Opening the possibility for the appreciation of real exchange rate (and ensuring equilibrium only through balance of payments crisis) these arrangements allow also for the continuation of populist policies – redistribution of income from producers to consumers. At the end of the day, however, exchange rate management as a weapon to fight inflation can play only a limited role because the balance of payments deficit cannot continue indefinitely.

Different countries in different periods resorted to one or more of the described above mechanisms of implicit redistribution. In Russia, for instance, the government was initially (1992-94 relying on controlling resource prices and inflationary financing. Since 1995, when exchange rate based stabilization was carried out and the ruble reached 70% of its purchasing power parity value (i.e. Russian prices, including resource prices approached 70% of the US prices, which was the apparent overvaluation of the ruble), the government relied mostly on debt (domestic and foreign) financing and redistribution via overvalued exchange rate. Since 1998 financial crisis, however, leading to the collapse of the overvalued rate and to the cessation of international and domestic debt financing, the government has to rely largely on price control (via export taxes and export restrictions) on major tradable goods (oil, gas metals).

There seems to be two logical ways to deal with the populist redistribution and to ensure stable macroeconomic environment. First, to eliminate the need for redistribution itself, i.e. to alleviate social and sectoral income inequalities, which is of course the task for the long run. Second, to strengthen the government, so that it can redistribute income explicitly (direct subsidies) rather than indirectly, or cut the magnitude of redistribution altogether. The research on Latin American and other

countries has proven that the “transitional democracies” are less efficient than either authoritarian regimes or well established democratic regimes in resisting macroeconomic populism. It was also shown that countries, where one or two multiclass parties have provided the government elites with stable electoral majorities, are less prone to demands of populist coalitions (Kaufman and Stallings, 1991). And it was shown that illiberal democracies (countries with relatively free elections, but poor rule of law) have the worst record in ensuring prudent macroeconomic policy (balanced government budget, low government debt, low inflation and non-overvaluation of the exchange rate) as compared to liberal democracies and liberal and illiberal autocracies (Polterovich, Popov, 2007).

Conclusions

Most of the time the budget constraints in the socialist economies were harder than in developing countries and no less hard than in developed countries. The soft budget constraints (SBC) in socialist economies were not pervasive, as most authors believe, but selective, i.e. involved subsidization of some enterprises/industries at the expense of the other. This type of selective subsidization is a classic case of industrial policy: it may be good or bad, leading to success (China, Vietnam) or failure (USSR, Eastern Europe), but cannot be regarded as an intrinsic feature of the socialist centrally planned economy and an example of pervasive SBC.

When soft budget constraints exist in the form of subsidization of export oriented manufacturing and high tech industries, it may be a necessary component of export oriented industrial strategy that was a *sine qua non* of every single case of economic miracle – successful catch up growth of developing countries.

The problem with soft budget constraints in the former USSR and Eastern Europe was not the subsidization per se, and even not the subsidization of manufacturing industries at the expense of resource industries, trade and financial services, but the way this subsidization was carried out – through maintaining higher domestic prices for manufactured goods. This was basically an import substitution industrial strategy that led to the creation of inefficient industrial dinosaurs and mastodons that proved to be uncompetitive once the protection was removed in the 1990s.

Pervasive SBC should be associated with permanent government budget deficit, debt accumulation, high inflation and other forms of macroeconomic populism. In the Soviet Union in the post-war period (after the monetary reform of 1947 and until the Gorbachev financial and monetary expansion that started in 1987) budget deficit and debt were very low, open and hidden inflation was less than several percent a year – a better record than in most Western countries.

On the contrary, after the transition to the market in the 1990s the previously hard budget constraints weakened dramatically in many EE and FSU countries. This resulted in growing budget deficits and high inflation. Most economists agree this kind of policy is sub-optimal, but there are political economy factors that make populist macroeconomic choices inevitable. The combination of weak state and powerful interest groups that cannot agree on how to divide a national pie, forces the government to “kick the can down the road” by accumulating deficits and debts, printing money (inflationary financing), keeping domestic fuel and energy prices below the world level and maintaining an overvalued exchange rate. SBC is just one type of this populist macroeconomic policy that was rare in socialist countries, but is found in abundance in many developing countries (especially Latin America and Sub-Saharan Africa) and transition economies (especially FSU states).

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