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Fiscal impact of privatization revisited: The role of tax revenues in transition economies

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ABSTRACT

In contrast to earlier literature, this paper finds empirical evidence that privatization has deteriorated fiscal balances in transition economies. The investigation focuses on the role of tax revenues in explaining the fiscal impact of privatization, as it appears that tax revenue in many transition countries remained lackluster even after the adoption of several tax reforms in the last two decades, and no formal econometric assessment has been conducted of the extent to which privatization has affected tax revenues. Using panel data for 29 Eastern European and former Soviet Union countries, the analysis finds robust signs of a strong negative impact of privatization on different tax revenue sources. The paper also provides some empirical evidence favoring the early adoption of value-added taxes that appear to have contributed to government revenue recovery.

1. Introduction

There is little doubt that privatization of state-owned enterprises generates major effects on the government's fiscal position[1] (Davis et al., 2000; Barnett, 2000). A significant concern for many countries as they contemplate further privatization is its potential impact on the budget balance and, thereby, on the overall macroeconomic stability. The standard prescription for doing so has been that

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[1] Besides fiscal consolidation, privatization schemes have been adopted, among others, for achieving gains in economic efficiency, attracting investment, improving corporate efficiency, and liberalizing key sectors such as telecommunications and energy (Katsoulakos and Likoyanni, 2002). For excellent surveys on the several effects of privatization, see also Svejnar (2002) and Estrin et al. (2009).

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privatization of state-owned enterprises would imply less transfers to these enterprises and thus less expenditure responsibilities. However, not much attention has been given to the revenue side, in particular tax revenue collection, which may deteriorate considerably following privatization, as tax bases may shrink and special tax treatments for some economic sectors are usually provided, contributing to a worsening of the budget outcomes. This paper aims at empirically analyzing the impact of privatization on the budget balance of transition countries in Eastern Europe and the Former Soviet Union, with particular focus on the tax revenue side.

Despite subsequent reforms to their tax systems in the last two decades, including among others the adoption of value-added taxes, tax revenue collection has remained lackluster in many transition countries following the significant drop in tax revenue in the first years after transition early in the 1990s. The most prominent exception is, perhaps, the experience of some Eastern European countries that implemented successful tax reforms very early in the transition process and were able to modernize – to some extent – their revenue administrations, to a great extent motivated by the run-up to enter the European Union.

Tax revenue was particularly affected in transition economies in the early stages of implementation of liberalization, privatization, and stabilization reforms (Ebrill and Havrylyshyn, 1999; Martinez-Vazquez and McNab, 2000). Before the transition, the main sources of tax revenue came from taxes levied almost only on state-owned enterprises; the tax on profits and the turnover tax being by large the most important revenue sources. The tax on profits was collected mostly on the basis of negotiations between large enterprises and government officials, effectively a business withholding tax (Buiter, 1997), with tax rates adjusted frequently, and the tax burden usually being different depending on the industry. Turnover taxes were levied mainly on goods, collected at wholesale or retail level, and often used as a mechanism to regulate prices and support allocation of resources set in the plan. The tax base was usually the difference between the retail price (fixed by the government) and the production cost.

As a result of the structure of the tax system in the pre-transition period, privatization resulted in a significant decline in tax revenue collections that can be attributed to three major reasons: (i) decline in the traditional tax bases, (ii) deterioration in the capacity of the tax administration, and (iii) widespread adoption of tax exemptions and other tax incentives to attract investments. Privatization caused a significant negative impact on previously reliable tax bases, as a result of a decline in production, in state enterprise profitability, and in real wages. The capacity of the tax administration was severely weakened for different reasons (Tanzi and Tsibouris, 2000). Privatization eliminated most of the information on quantities produced and prices at which the output was sold, the number of taxpayers increased dramatically, and previous restrictions on the methods of payments among taxpayers, by which tax payments were transferred to the government, were removed. It is clear that the unsophisticated nature of the pre-transition tax administration, dealing with a few large state-owned enterprises, was not prepared to face this completely new environment and, therefore, prospects for tax evasion rose. Privatization may also have had an impact on tax revenues to the extent that governments aiming at attracting investors have provided a number of incentives, including tax rate reductions, tax holidays, establishment of special economic zones, and other tax exemptions (Cass, 2007). Clearly, the impact on different tax sources may have differed too, as their tax bases narrowed to different extents. For instance, taxes on international trade were not a major source of revenue, and some countries even extended protection of national industries through the adoption of higher tariffs after transition.

The impact of privatization on tax revenue collection in transition economies remains a highly relevant issue. While some economies have already gone far in the privatization process with accumulated privatization proceeds above 30 percent of GDP (EBRD), for some others, particularly in the group of Former Soviet Union countries, privatization is still in a relatively early stage. Most importantly, the majority of the transition countries still face challenges in the adoption of sound tax policy reforms and in strengthening revenue administrations, to a great extent associated to the pre-transition structure of the tax system.

Surprisingly, the question of how privatization has affected budget balances in transition economies and the extent to which tax revenue has contributed to that (and which taxes most) has received little empirical attention. Also, no empirical attention has been given to the type of tax