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Microeconomic Issues in the Transition to a Market Economy

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Since most disintegrating socialist economies have experienced rising inflation, the establishment of macroeconomic stability has been a natural focus of the intellectual and policy debate about their reform. However, evidence from developing countries suggests that a one-sided preoccupation with macroeconomic issues may be unfortunate, as macro stabilization programs tend to unravel in the presence of an inadequate micro adjustment (for example, Kiguel and Liviatan, 1990). This finding is important because the socialist system introduced microeconomic distortions that probably transcend those observed in the third world. The recent developments in Poland, Yugoslavia and the Soviet Union also support the hypothesis that macro stabilization will be difficult to achieve in the transforming socialist economies in the absence of adequate micro adjustments.

In this paper I address what I consider to be the most important micro issues related to the transition from socialist to market economies. I first summarize the initial microeconomic conditions and then describe the main changes that have taken place in the early stages of the transition. Finally, I discuss the micro policy agenda that needs to be addressed if the transition is to be successful.

The Initial Microeconomic Conditions for Transition

The common initial conditions of the reforming socialist economies have been the limited extent of domestic markets and the isolation from the world

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markets; centrally fixed absolute prices and distorted relative prices; incentives that are unrelated to economic efficiency; policy imperatives like the maintenance of full employment; a lack of well-defined property rights; an absence of institutions for accounting, antitrust, audits, or taxation; and a relative absence of market transactions. These common conditions have led to similar outcomes: misallocation of resources, obsolete infrastructure and capital equipment, low productivity and income levels, insolvency and slow adjustment of many state-owned enterprises, and severe ecological problems. Yugoslavia's initial conditions have been in many respects different (see Estrin in this issue), but the outcome has been qualitatively similar. On the positive side, these countries do possess a relatively solid and broad human capital base (Gelb and Gray, 1991). In addition, they have potentially significant access to foreign assistance.

Input Markets: Labor, Capital, Energy

Throughout the communist era, the supply side of the labor market functioned relatively well in the sense that households were generally able to make their own decisions, albeit in the context of significantly distorted wage and price signals (Gregory and Kohlhase, 1988). However, the limited housing market impaired labor mobility. The demand side of the labor market was distorted by labor hoarding and generally rigid behavior of traditional socialist enterprises. Labor hoarding resulted from both the prohibition of economic layoffs (only disciplinary layoffs were permitted) and the implicit incentives that the system gave to managers to keep excess capacity to meet production targets.

The communist authorities also imposed a highly egalitarian distribution of earnings, with incomes of unskilled and semi-skilled workers frequently exceeding those of professional employees. Trade unions were political organizations whose primary task was to ensure that party policies were implemented at the level of enterprises (Windmuller, 1971). Unions did not engage in collective bargaining, although formally they did handle grievances and in the area of job security they at times sided with workers against the center (Granick, 1987). Strikes were explicitly or implicitly forbidden; disputes were handled by administrative fiat or arbitration.

Employees enjoyed virtually complete employment security. However, they were usually not assured of a specific job, but rather of employment within a specific firm or near their residence. The firms therefore did not have much flexibility to lay off workers, but they could induce significant intrafirm mobility. The Soviet Union was an exception here, in that workers reportedly enjoyed job-specific employment security (Granick, 1987). Quit rates were around 10 to 20 percent and thus comparable to the rates observed in the United States and some western European countries (Riveros, 1990). In view of the many company-provided and thus non-vested benefits such as housing, child care and health, the relatively high quit rate reflected the ease with which workers could find alternative jobs and the fact that above-average wage increases could be obtained through a job change and reclassification.

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The capital market has been characterized by underdeveloped financial institutions and a low volume of financial assets. There was no bond market and public sector deficits immediately translated into money creation. Interest rates on deposits were historically maintained at such low nominal levels that the real interest rate charged to firms was zero or negative. In most countries, the governments allocated investment funds centrally. Yugoslavia is an exception here, as the allocation of capital has been significantly influenced by local authorities and the borrowing enterprises (Estrin, this issue; Prasnikar and Svejnar, 1991). Governments usually provided subsidies to loss-making firms and taxed away (that is, confiscated) profits of profit-making firms. The entry of firms was limited and exit of firms was virtually nonexistent. International capital flows were severely regulated.

The allocation of most other inputs was historically also directed from the center, with prices often bearing little resemblance to the corresponding scarcity values. This led to very intensive use of some inputs, like energy, despite high world prices. The choice of investment projects was guided primarily by political considerations; only in the late 1980s did Yugoslav and to a lesser extent Hungarian and Polish banks start using the internal rate of return as an important criterion in project analysis.

The Product Market, Industrial Organization, and Trade

The socialist system generated an industrial structure that was highly concentrated with predominantly large state-owned enterprises. There were relatively few small- and medium-size firms. The system of incentives (linked to plan fulfillment) generated limited product variety and a rigid industrial production process.

The product market has also suffered from price and quantity distortions. As the country papers in this volume indicate, with the exception of Hungary and Poland, price controls were until very recently virtually ubiquitous, making it difficult to identify inefficient firms. Hare and Hughes (1991) suggest that in some areas, like food production, the inefficiency of socialist enterprises has been so extreme as to yield negative value-added even in world prices.[1]

The majority of foreign trade was historically carried out with other Soviet-bloc countries under a complicated system of bilateral trade (clearing) agreements based on nonconvertible currency. Trade with other countries was in convertible currencies. Virtually all trade was centralized, carried through state trading companies, and subject to quantitative restrictions.[2] The pattern of trade was significantly influenced by political decisions.

[1]These results must be treated with caution, however, because the calculations rely on (fixed proportion) input-output data from industrial branches, rather than individual establishments. The corresponding differentials between world and domestic prices are obtained by comparing the international and domestic values of goods sold as reported by enterprises to ministries and statistical offices and aggregated by these latter institutions to the industrial branch level. Only goods that were traded on the western markets were thus included in this relative price calculation.

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The Market for Land and Housing

While most socialist countries permitted limited leasing and *de facto* ownership of land, a market for land was basically nonexistent. A real estate market has emerged in recent years, although most housing is still rented at controlled prices that are significantly below market equilibrium. Housing costs have constituted a relatively small fraction of consumer expenditures for most households, although a significant group of urban residents pay substantial rents for deregulated housing, in some countries through a black market. The maintenance of houses was generally poor, and considerable excess demand for housing existed at the subsidized rental prices. On the other hand, the system succeeded in avoiding blatant urban poverty.

As for agricultural land, except for Poland, the socialist countries collectivized or nationalized most land. (More detail on agriculture is offered by Brooks, Guasch, Braverman, and Csaki in this issue.) Food shortages (at subsidized prices) were perennial and, as the fate of Gomulka and Gierek in Poland indicate, governments that increased food prices risked overthrow.

Recent Microeconomic Developments

The homogeneity of economic institutions and policies across socialist countries has diminished in recent years as countries have undertaken different reforms at different speeds. These changes are discussed in country-by-country detail elsewhere in this symposium. Here, I will summarize the main microeconomic reforms that have occurred.

Conceptually, it is useful to classify the reforms into two categories: those aiming at reallocation of resources and those concerned with increasing the efficiency of resources, given their allocation. Contrary to popular belief, it is not clear that resources ought to be reallocated to a massive extent in the short run. For instance, it is not clear how many workers would be employed in the Hungarian steel industry under perfectly competitive conditions. Steel workers' productivity may be low, but productivity is low elsewhere as well. It may not have made sense to develop the steel industry to begin with, but in the short run the relevant issue is how to use labor optimally, given the existing capital structure. Note also that the profitability of a firm may not be indicative of its efficiency unless evaluated at shadow prices and wages (Svejnar and Terrell, 1991).

With respect to the efficiency of the use of resources, given their allocation, it is useful to distinguish reforms within the firm (like improved incentives) from institutional reforms which are beyond the capabilities of the firm and which require a role of the government (like the introduction of competition or a legal system).

[2]Yugoslavia was again an exception. Its enterprises could trade directly, although in practice many firms relied on socially-owned trading firms to handle their export and import needs.

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With the exception of the Soviet Union, the transforming socialist countries have liberalized most producer and retail prices. Prices of basic commodities such as bread, apartment rentals, and utilities have remained partially under control, as have prices of some industrial commodities. As part of the stabilization policies, most countries have also imposed restrictions on excessive growth of wages or wage bills of state enterprises (Hungary and Poland already in the 1980s, Czechoslovakia, Bulgaria and Romania in the 1990s). The price liberalization measures have encouraged efficiency of resource use and efficient reallocation of virtually all resources except for labor. As for labor, while the wage controls (penalties) impaired efficiency, the major fall in real wages that they induced in Poland and Yugoslavia in 1990 and Czechoslovakia in 1991 slowed down the rise of unemployment.

The monopoly of foreign trade organizations has been diminished or eliminated, and enterprises have been encouraged to seek export markets. Policies aimed at establishing a relatively low and diminishing protection and transforming nontariff barriers into tariffs have been either adopted or are in process. However, with the exception of Hungary and Poland, competition from imports has been coming slowly and many state enterprises have not undertaken major steps to enter new markets.

All governments have adopted privatization programs for the state-owned (in Yugoslavia socially-owned) enterprises. While the schemes vary across countries, they all distinguish the privatization of small firms from the privatization of large enterprises. The privatization of small firms is carried out primarily through auctions and, after initial difficulties, it has proceeded quite smoothly in Czechoslovakia, Hungary and Poland. In Poland, more than 20,000 outlets have already been sold and the majority of retail trade is in private hands. Hungary plans to finish transfering about 10,000 small-scale establishments to private hands in 1991 and Czechoslovakia hopes to auction about 100,000 small businesses in 1991–92 (Gelb and Gray, 1991). This "small privatization" is observed to have positive effects on efficiency of resource use, but the impact on efficiency through reallocation of resources is at times intentionally limited; for example, in Czechoslovakia the privatized stores have to remain in the same line of business for at least two years.

The privatization schemes for large companies rely on a combination of regulated spontaneous privatization (where enterprise management prepares and carries out a privatization plan, possibly with a foreign partner), sale of the property or shares to domestic or foreign buyers (emphasized in Hungary), distribution of some enterprise shares to employees (envisioned in most countries), and distribution of shares (usually through vouchers or mutual fund shares) to the public at large (expected to be especially important in Czechoslovakia, Poland and Romania). The common problem has been the difficulty of privatizing many firms in a short time. As a result, most firms remain in state ownership and their commercialization has so far been more *pro forma* than real. Hungary, where the recently proclaimed five-year goal is to privatize

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about 50 percent of medium- and large-size firms, appears to have gone the furthest by successfully privatizing about 10 percent of these firms by early 1991 (see Hare and Wolf in this issue).

Trade unions have re-emerged as institutions representing worker interests, rather than government. They have engaged in industry-level bargaining, often within a tripartite government-labor-employer set-up. Notwithstanding the strikes in countries such as Poland, Romania and Yugoslavia, the unions have generally cooperated with (or at least tolerated) the transition policies. However, they could become formidable adversaries of the reform if the economic situation worsened. The tripartite set-up, while reflecting mainstream western European practice, has the important drawback that it limits the flexibility of individual enterprises to set incentives and can result in bankruptcies that might be avoidable if firms could set wages individually.

Following the Yugoslav example, Czechoslovakia, Hungary and Poland accorded workers participatory rights in management in the 1980s. With the disintegration of the communist regimes in the late 1980s, worker control of enterprises became significant in Hungary and Poland but it was greatly diminished in Czechoslovakia and somewhat diminished in Yugoslavia. As a result, a major policy issue revolves around the economic effects of strong insider power on enterprise performance in Hungary, Poland and Yugoslavia.

Since the foreign trade patterns of the countries of Eastern Europe had been centered on the Council of Mutual Economic Assistance, they have experienced a major external shock as their historical trade relationships disintegrated. First, when East Germany reunited with the west in 1990, it broke off many trade agreements. Second, the desire of the Soviet Union to improve the quality of its imports means that lower quality goods from Central and Eastern Europe may have a difficult time finding any markets, despite the frantic attempts of the Central and East European governments to preserve barter and other deliveries to the Soviet Union. For example, 1991 Czechoslovak exports to the Soviet Union are expected to be 50 percent below their 1989 level and the Soviets have demanded that two-thirds of these reduced exports be accompanied by export credits.

The terms of trade also shifted against Eastern Europe when, on January 1, 1991, much of the trade with the Soviet Union was switched from the clearing (barter) system to one based on hard currency payments. The collapse of the complicated CMEA system was inevitable. However, the speed of the disintegration and the lack of an alternative arrangement also reflects the instinctive, post-revolutionary desire in Eastern Europe to dismantle the old system without a careful consideration of the ultimate economic consequences.

The reduction in government subsidies and the severe reduction in trade among these countries has forced many enterprises to discontinue nonviable production and reduce employment. Estimates of labor redundancy in state enterprises prior to the recent crisis commonly ran at 20 to 30 percent, but these estimates seem to be based on private rather than social (shadow price)

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criteria. Recent labor force reductions have been considerably below the 20–30 percent level, although as Wellisz indicates in this volume, by reducing employment by 18 percent in the 1989–90 period, Poland's public sector has in fact carried out exceptionally sizable reductions. Schaffer (1991) reports that in 1990, output in Poland's state enterprise sector declined abruptly by 25 percent while employment declined more gradually by 15 percent. Enterprises have hence displayed labor hoarding, which is consistent with both expected utility maximization by worker-insiders and with a socially optimal employment policy guided by the falling shadow wage in the economy.

Since mass layoffs cannot account for the rapid rise in Poland's unemployment from virtually zero in January 1990 to 7.1 percent in March 1991, Blanchard (1991) attributes it to individual layoffs, quits and the lack of hiring of new labor force entrants. My own research on Czechoslovakia suggests that, as the unemployment rate rose from virtually zero in mid-1990 to 3 percent in April 1991, it was first attributable primarily to a virtual hiring freeze, termination of fixed term employees, and quits. However, as industrial production fell by 20 percent in the first quarter of 1991 and unemployment jumped from 1 percent to 3 percent, layoffs became more significant. Overall, the early phases of the transition seem to have a strong negative impact on labor force entrants, while in the later stages the effect is broader.

The firms are also experiencing considerable brain drain from the ranks of competent managers, technical personnel and skilled workers. Between their limited experience with labor markets and the severe wage or wage bill controls imposed upon them through the macro stabilization policies, they are not proving able to retain many of their top workers. To the extent that the enterprise capital stock has value, the depletion of important complementary inputs may result in substantial losses. I have not been able to find estimates of the extent to which the brain drain results in emigration or domestic private enterprise formation.

All the countries have undertaken initial steps to introduce personal income taxes as well as a social safety net of unemployment, retraining, and social security benefits. The budgetary allocations for the safety net have so far been adequate, but they would not withstand a major increase in unemployment. Retraining of workers has been relatively slow; government-sponsored retraining has been limited and enterprises have been slow to adjust to the changing environment.

Most countries have attempted to establish capital markets by turning the traditional "monobank" system into one based on an autonomous central bank and a large number of competitive commercial banks. Up to now, at least, this effort has generally failed. The few newly created commercial banks are undercapitalized, they lack trained loan officers and other professionals, and their (inherited) assets are frequently in the form of loans to loss-making enterprises. They have been unable to provide even rudimentary financial services, such as timely check clearing and wire transfers, and frequently they

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have been reluctant or logistically unable to provide credit for the creation of new firms or for the projects of already established private firms. Their loan activity has been oriented primarily towards their traditional state enterprise clients. As real interest rates have been raised in most of the transforming economies, the question has arisen as to whether enterprises have to pay the debt accumulated under the previous system. The issue is a serious one since, in the absence of a government write-off, either numerous enterprises or some banks are insolvent (Brainard, 1991).

So far, western banks entering these economies have focussed primarily on joint ventures involving western firms. Their contribution to the financing of new local firms has been minimal.

The decline in government subsidies, decrease in product demand and absence of a well-functioning banking system have led many enterprises to rely on inter-enterprise borrowing to reduce the shock and finance their economic activities. The practice, which is in principle similar to the problem of daylight overdraft in the U.S. financial markets, represents a serious threat to the entire transformation process. A widespread use of promissory notes usually culminates in the insolvency of a large number of loss-making enterprises. Moreover, the expectation of massive bailouts by the government induces even efficient firms to enter the inter-enterprise credit system, thus eventually forcing the government to abandon its restrictive macro policies and intervene. The Polish and Yugoslav situations in the mid-to-late 1980s were examples of this phenomenon developing and getting out of hand, thus contributing to the subsequent hyperinflations.

Institutions conducive to market activities have been slow to develop, as well. All the countries of Eastern Europe have aimed at streamlining public administration while establishing new public institutions such as the tax, privatization and antitrust agencies. However, the process is hampered by numerous bureaucrats, state enterprise managers and others who perceive themselves as the likely losers if the process continues. There is also growing discontent with the emergence of the visibly rich individuals, often from the ranks of the former communist nomenklatura. All these factors hold back the process of transformation.

Despite the twists and turns of policy and the factors holding back reform, many new firms have been established in some countries. Evidence from several countries indicates that small private enterprises develop rapidly once restrictions are lifted. Hungary has been liberalizing private sector activities since the early 1980s, with the result that it now has over 300,000 sole proprietors and several thousand private limited liability companies. Since the passage of Yugoslavia's Business Law in mid-1989, over 10,000 limited liability companies were created. In Poland, 980,000 sole proprietorships and over 30,000 incorporated companies were registered by November 30, 1990 (Dabrowski, 1991; Gelb and Gray, 1991). In Czechoslovakia, 15 months after a law was passed in April 1990, over 800,000 individuals registered for license as private entrepreneurs.

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Overwhelming statistics like these do disguise the problems encountered by the emerging private sector. Private entrepreneurs are often hampered by rules and regulations, high taxes, corrupt public officials, and barriers to entry (such as the malfunctioning real estate market and advantages still enjoyed by the state enterprises). The single most important hindrance to the outburst of new private activity is probably the limited availability of credit, which stems partly from the undeveloped financial sector, the limited collateral of the starting entrepreneurs and the high real interest rate that is a by-product of the stabilization plans. Most private firms are therefore very small. Many are individual or family firms and some are simply the (previously clandestine) overtime activities of individuals. Many are shell companies established by state enterprise managers to enrich themselves by carrying out enterprise trade at inflated transfer prices. The previous size distribution of firms, which was unimodal and highly rightward skewed, has hence been replaced by a bimodal distribution, with relatively few midsized enterprises. The overall extent of private activities is still limited but growing, with Hungary, in addition to the self-employed, reportedly having 10 percent of its workforce employed in the private sector. In terms of GDP share, private sector activities at present probably exceed 20 percent in both Poland and Hungary (see also Wolf in this issue) and according to Milanovic (1990, Table 3) the proportion may be much higher. In terms of ownership of productive assets, the CIA (1991) estimates that the state still owns 80 percent in Hungary and Poland and over 95 percent in Bulgaria and Czechoslovakia.

One of the most important findings of the transition period to date is that well-functioning markets, while rapidly appearing in some areas, do not automatically grow like weeds. Indeed, in many areas the successful introduction of well-functioning markets may be better likened to the nurturing of a greenhouse plant, rather than being a natural outcome of the liberalization of market activities. Retail markets in consumer goods (especially food and imports) emerged relatively fast in all countries after price liberalization, thanks to their relatively low capital and managerial requirements, but even here one observed important differences between the fast emergence of markets (including street vendors) in Poland and the slow process in Czechoslovakia.

While it is too early to make definitive statements, areas where significant liberalization occurred without a quick and substantial (as opposed to thin) market response include export activities, foreign investment, financial markets, real estate markets, and industrial production. While the aforementioned statistics on the rise in the number of private sector firms are impressive, observers have been surprised by the slow entry of potential western investors, the low penetration of imports in some countries and exports in most of them, the continued limited product diversity, the slow development of informal and formal financial markets, and the emergence of private firms only in special niches of industrial production. This limited development of markets in the face of seemingly thorough laissez-faire policies is notable, and deserves the serious attention of policy-makers.

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The Microeconomic Policy Agenda

The microeconomic reforms have so far been well-meant, but incomplete. When combined with fiscal and monetary restraint aimed at macroeconomic stabilization, the short-term outcome has been declining production in the formal (statistically recorded) sector,[3] slow restructuring and reorientation of the large state enterprises, and only limited entry of sizable new firms. Of course, the hope is that the disappointing microeconomic developments are transitory. In this section, I discuss the main microeconomic policies that should be pursued to assist the realization of this aspiration.

Functioning and Competitive Markets

Perhaps the most important phenomenon that requires policy attention is the slow development of well-functioning markets in many areas. The problem appears to be brought about by several factors: the inability of governments to create a complete and consistent legal framework to guide economic activity; inadequate emphasis on the creation of competitive market institutions, infrastructure and supporting practices in the areas of financial services, real estate, domestic trade, transportation, and telecommunication; the slow creation of accounting, auditing and other information systems; and the lack of strong market-oriented managerial and worker incentives in state enterprises. In some instances, government institutions also continue to exert direct control and influence, rather than moving to indirect regulatory influence, thus stifling market activities. Finally, the experience of Hungary, Poland and Yugoslavia, which started introducing markets before others, suggests that many economic agents go through a learning period before successfully switching from the socialist to a market framework. Some of these factors deserve a few words of discussion.

It is generally agreed that a clear and simple legal framework is essential for the functioning of a market economy (see Litwack's discussion in this issue). One notable aspect is that, while all the countries of Eastern Europe strive to join the European Community as soon as possible, none of them decided to adopt a (presumably consistent) legal framework from one of the western European countries or from the 1992 European Community framework. The result of the *de novo* creation of an entire legal system has resulted in an incomplete and at times inconsistent set of economic laws.

The new Czechoslovakian tax system provides a good example: while the system introduced in 1990 strives to replace the turnover tax by a value-added tax, the tax system remains unfinished and the value-added tax is scheduled to be introduced only in 1992 or 1993. To add to the confusion, the profit tax is

[3]World Bank estimates, reported by Gelb and Gray (1991), indicate that in 1990 real GDP declined by 10.2 percent in Bulgaria, 3.5 percent in Czechoslovakia, 6.5 percent in Hungary, 14.0 percent in Poland, 10.2 percent in Romania, and 3.2 percent in Yugoslavia. Some observers argue that the extent of economic decline is exaggerated as the newly emerging private activities are only partially recorded in official data.

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applied very selectively as foreign firms (but not domestic producers) routinely obtain various degrees of tax relief. Finally, the Tax Office is still one of the least developed and hence ineffectual government agencies. The legal uncertainty, coupled with the risk of political changes, has had a negative effect on investment and entry of new firms, especially in areas where the sunk cost associated with entry is high. A key focus in most countries ought to be the establishment of a consistent commercial code as well as tax and bankruptcy laws.

The success of the transformation hinges on a rapid expansion of the small- and medium-sized firm sector that can ensure output growth, generate new employment, provide a tax base, and generally augment the flexibility and dynamism of these economies. However, as noted earlier, neither domestic nor foreign banks seem willing to supply a sizable amount of capital to such firms. The financial sector continues to be regulated and underdeveloped in all the economies and the number of domestic and foreign banks with significant operations remains small. Domestic banks frequently continue to focus on their state enterprise clients, while the inflow of western financial capital has been both cautious and hampered by inability or unwillingness of government officials to negotiate or approve deals, the aforementioned uncertainty about the evolution of the legal and tax framework, and a number of seemingly trivial but actually serious problems, like the difficulties associated with finding office space. Perhaps most importantly, banks show a limited willingness to lend to new entrepreneurs with no reputation and limited collateral, which is of course understandable. In this situation, there is strong economic justification for government to step in and provide credit insurance or other measures to stimulate bank lending to this sector. The justification is all the more persuasive since the previous regime deprived enterpreneurs of assets and prevented them from establishing reputations.

The slow development of the real estate market as well as the slow demonopolization of domestic trade and transport have limited the process of entry of new firms and demonopolization of other economic activities. Similarly, the lack of standard accounting and auditing procedures has slowed down the transformation process. It has also permitted corruption and illegal transfers of property, which may pose a longer-term threat to the perceived legitimacy of the reforms.

In the labor market, the system of industrial relations has up to now not imposed major constraints. In the short term, the important distortion comes from the across-the-board restrictions on the growth of wages or wage bills imposed on the state-owned enterprises for macroeconomic stabilization. Clearly, strict control over state-owned enterprises with powerful worker insiders is needed to prevent indiscriminate wage increases and a run-down of the capital stock. However, it would be preferable to avoid distorting the labor market and instead to impose the hard budget constraint by permitting discretionary wage increases only if the enterprise operates without subsidies and pays the state a reasonable rate of return on its capital.

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The Achilles heel of the transition and one of the reasons for the relatively slow emergence of new products and markets is the lack of a well-established system of property rights, accountability and well-designed incentives in state enterprises. The system of state ownership provides few incentives for the management to respond to market demand. While recent reductions in state subsidies have forced firms to respond more to market demand, the reaction has come primarily in the form of discontinuation of loss-making activities (like those associated with earlier exports to the Soviet Union); reorientation toward new production has so far been limited. As I discuss in a moment, this outcome is in large part brought about by the fact that managerial compensation still contains only limited incentives for the efficient operation of the firms. In addition, since there are thousands of state enterprises in each country, enterprise supervisory boards are naturally composed of individuals that have little experience with enterprise operation in the market system. Moreover, the boards have been given only limited incentives and primarily advisory powers. As a result, state firms in all countries have been subject to only limited supervision. They have been permitted to engage in a variety of potentially dangerous activities, including the sizable accumulation of inter-enterprise credit and debt.

A bona fide commercialization of state enterprises is clearly needed and large-scale privatization is the generally favored solution to the problem. However, as discussed earlier, privatization of the large state enterprises has proceeded very slowly. The widely shared disappointment with this outcome poses the danger that hastily designed large-scale privatization may result in massive failures and possibly require renationalization as was the case in Chile in the early 1980s (Luders, 1990). There is also the danger that privatization may create a situation where the population, faced with falling living standards, revolts against the rapid and seemingly unjust enrichment of a relatively small number of individuals who happen to be advantageously poised, often largely as a result of their advancement under the previous regime (the Rakowski government in Poland, Husak regime in Czechoslovakia, and so on). Thus, the policy challenge is how to design the property transfer in a way that is both fair and economically efficient.

A major economic justification of private property is that the private owner, being the residual claimant, will ensure that resources are allocated efficiently, that employees are motivated and performing, and that the enterprise moves into the most profitable areas of business. Of course, the problem with privatizing the large state-owned companies is that very few local individuals have the assets to purchase a controlling number of shares in any given enterprise. The choice is hence to permit large-scale foreign ownership (a concept somewhat resisted in all countries except Hungary) or to establish diluted share ownership by local individuals. In the latter scenario one faces the standard problem of separation of ownership and control. In the most recent Polish plan this problem is to be partially handled by distributing to all adult Polish citizens a majority of the shares of 400 large enterprises (out of a total of

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about 5,000 large- and medium-sized firms) through shares in 20 or so mutual funds that would hold enterprise shares, exert control over enterprise management and be administered by western experts. Czechoslovakia is currently heading toward an intermediate path that allows individual share ownership in most large- and medium-sized firms both directly and through mutual funds. It remains to be seen if these schemes result in a major gain in enterprise efficiency.

As the above discussion indicates, the establishment of strong incentives for key employees—including corporate managers and directors—is a difficult problem and in the short term most enterprises remain in state hands. The employment contracts of managers of state-owned enterprises are frequently dominated by fixed salary elements and bonuses based on the fulfillment of specific tasks (like investment completion); they are not strongly linked to improvements in enterprise efficiency. As prices are being liberalized and foreign competition opened up, it would be desirable to link managerial renumeration (outside of natural monopolies) to short- and long-term profitability of the firm, perhaps through profit-sharing and compensation through so-called "blocked" shares of the firm that cannot be sold for a certain time.

Similarly, commission-based contracts for salesmen in state enterprises are still rare and their search for new markets is correspondingly lukewarm. In addition, while employee stock ownership is being seriously contemplated in several countries as a strategic move to make privatization popular, its role as an incentive scheme, a factor that exposes employees to a greater risk by reducing their portfolio diversification, or a means to concentrate control over enterprises has not been seriously considered. Direct profit-sharing for employees has received only limited attention despite evidence that it may have positive effects on enterprise productivity (Weitzman and Kruse, 1990).

In this context it is important to note that, with the exception of the Soviet Union, the reforming socialist economies are not rich in natural resources and have to rely on labor and human capital as key domestic inputs in the transition. The design of proper incentives is hence vitally important. Moreover, the emphasis of the communist regime on egalitarianism, employment security and the special political status of the working class has severely undermined the work ethic, inducing shirking and diminishing individual initiative. The creation of a strong performance-pay link is therefore likely to have an especially powerful effect, accentuated by the popular belief that the extreme income differentials vis-a-vis the neighboring western economies should be viewed as a temporary abberation. Hence, while the potential effect of incentives has so far been underestimated, imaginative public policy in this area could have a great payoff. As Wellisz points out in this volume, the highly publicized dynamism of the Polish private sector reflects the 200–300 percent wage differential between comparable jobs in the private and public sector.

Finally, a major policy preoccupation in Hungary, Poland and to a lesser extent Yugoslavia centers on the efficiency effects of worker participation in management. While powerful insiders may negatively affect resource allocation

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across firms, they may also increase productivity within firms. An analysis of the Yugoslav experience suggests that the negative aspects of economic performance were to a large extent due to social ownership of capital and a variety of government interventions in the economy (Prasnikar and Svejnar, 1991). The participatory system (codetermination) has worked well in Austria and West Germany and econometric estimates from western Europe indicate that participation may indeed have a positive effect on enterprise productivity (Estrin, Jones and Svejnar, 1987).

New East-West Economic Order

The fact that the western market economies that ideologically and intellectually spearheaded the transformation toward free markets maintain import restrictions on many potential East European exports—food, textiles, steel, and so on—has come as a shock to the new democratic governments in central and East Europe. There are strong arguments in favor of lifting these restrictions. The size of these economies is small compared to their western counterparts and the impact on producers in the West would not be substantial. Yet, providing the East European economies with access to western markets is the best way to strengthen their market economies. There is also a strong case for the advanced economies to provide additional technical and financial assistance to support the transformation process.

Social Problems

The imminent increase in apartment rents and the establishment of a housing market will equilibrate the housing system, improve maintenance, and probably also bring about social dislocations and problems. Indeed, homelessness, unemployment, open poverty, and rising crime rate are new phenomena to most of Eastern Europe.[4] Such problems have not yet reached critical proportions. However, if the decline in production and national income continues and budget cuts increase in severity, the momentum and support for economic reform could dissipate. The communist and other parties, as well as the trade unions, could provide a major challenge to the new governments. Since the transition to markets, unlike the introduction of central planning, is undertaken in a democratic system, the social aspects need to be given particular attention if the transition is to succeed.

While government officials and external technical assistants have put considerable effort into the construction of safety nets, the unemployment benefit and social security schemes are generally not set up to withstand a major inflow of unemployed and poor. The government-sponsored retraining programs are reportedly reaching only limited numbers of individuals and their effectiveness

[4] Yugoslavia has always had a significant unemployment rate but the problem has become especially acute as the rate rose from below 12 percent to about 15 percent in recent years.

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in imparting marketable skills is unknown. This is clearly an area that deserves special attention.

Infrastructure and Ecology

Communist regimes often delayed costly maintenance and construction of infrastructure and put off the introduction of effective environmental protection equipment. The new governments are facing the dilemma that infrastructure development and ecological amelioration both have considerable short-term costs, although many of the benefits are in the long term. There is a danger that the long-term benefits will be discounted too heavily by the present governments as numerous immediate problems command their attention. However, since sound infrastructure and environment policies confer positive externalities on neighboring countries, western assistance is a natural means to address these problems. Some steps have already been taken in this direction, but much more is needed.

Conclusions

The countries of Eastern Europe have been experiencing major disruptions associated with the disintegration of the planning system, the introduction of market institutions and rules, and the major external shocks brought about by the collapse of the Soviet-bloc trade arrangements. National income has fallen across the board, new social problems such as unemployment and inequality have emerged, and old problems like the degradation of the environment and infrastructure demand increased attention. If a major deterioration of economic and social well-being occurs, it may endanger the course of the transition.

The need to improve efficiency and find new markets is hence acute. One set of policies should focus on removing the remaining obstacles and undertaking necessary interventions to stimulate the creation of well-functioning markets in critical areas such as finance, foreign trade and manufacturing. Another set of policies needs to raise economic efficiency of firms, primarily by providing strong incentives for managers and workers of state enterprises and carrying out well designed privatization programs. Finally, since political sustainability is indispensable, the reform has to focus on social and labor market issues. Short-run measures include the provision of unemployment compensation and labor market information to facilitate labor mobility. Long-run oriented policies need to focus on inter-regional migration, training and inflow of capital.

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