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Sequencing The Transition

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The inefficiency of Soviet-type economies results from its monopolized production structure which makes soft budget constraints almost inevitable, as enterprises have bargaining power and must face expropriative tax rates for macroeconomic stability. Systematic reform aims to improve incentives, and if this is to be achieved with macro-stability, enterprises must be demonopolized. Most sequencing issues resolve into three key concerns: ensuring or restoring macroeconomic stability, not ruling out options for subsequent reforms, specifically those intended to increase competition, and maintaining support for completing the reform process.

NON-TECHNICAL SUMMARY

It makes little sense to discuss the sequencing and speed of transformation independently of the initial conditions of the economy and the preferred destination. Hungary, Poland, Czechoslovakia, and the Soviet Union were in very different positions at the beginning of 1989. There are more fundamental criticisms of the notion that there is an ideal sequence of actions which a transforming economy must take. One view is that everything must be done (or at least started) at once, and the actual sequencing will merely reflect the differing speeds with which different parts of the transformation programme inevitably proceed. Another view is that the programme is largely out of the control of policy makers, and has a momentum of its own.

There is force to both criticisms, and the paper argues that instead of setting out a detailed route map, it is more useful to consider how best to take the choices which become available during the transformation process. Is the available choice readily reversible or irreversible? Clearly the latter are more important. Of those, some will lock the subsequent path of the economy into one pattern of evolution rather than another, while others may have little long-run effect on the end state of the economy. The choice of exchange rate may have little long-run effect on the economy (and one can certainly argue that case for the former GDR). Trade Union organisation and wage bargaining procedures may be hard to change and have significant and lasting impacts on labour market flexibility The type of financial institutions (universal banks, or specialised banks and stock markets) may greatly affect the ease of merger and takeover, and thus the performance of the corporate sector. To the extent that subsequent economic evolution and options are history dependent, early choices may have profound long-run consequences.

Granted this, there are a number of fairly obvious guiding principles to apply. The first is that where possible choices should be so taken to keep open desirable options and to foreclose undesirable options. Thus it is easier to change specialised financial institutions into universal banks than vice versa. If universal banking faces potentially worrying problems of capture, information opacity, and instability, then it may be safer to choose the alternative initially. If, as is argued in the paper, market power reduces the incentives for efficient performance, then splitting up enterprises before they are privatised keeps open options for subsequent merger where there are genuine synergies, while it will be much harder to break up monopolies after they have been privatised.

The second principle is that it may be desirable to precommit to further supportive future actions and so rule out the risk that the current choice will be nullified in the near future. Sustained economic improvement requires costly current choices about the use of resources and the design of institutions whose benefits occur in the future. Decentralised agents will be reluctant to undertake these costs unless they are reasonably assured of receiving a sufficient fraction of the future benefits. For that they need confidence that property rights will be durable, well-defined and enforceable in law, that taxes will be stable and non-expropriatory, and that the macro-economic environment will not alter unpredictably and/or adversely. Perhaps the main task of policy makers during the early stages of transformation is to entrench reforms which ensure and underwrite such expectations. Privatisation can be seen very much in this light. Democratic governments find it notoriously hard to precommit to future policies, and their inability to precommit may weaken the incentives for costly but desirable changes. One way round this problem is to create decentralised autonomous institutions will well-defined mandates for action which it would be politically difficult to reverse. Independent central banks are one example popular with those who wish to see commitments to low inflation rates. Mandating holding companies to continue the process of restructuring industry for eventual sale to the private sector may entrench the privatisation programme in the face of adverse employment outcomes, and this seems to be the logic of the Polish privatisation programme for large enterprises.

Most of the sequencing issues then resolve into three key concerns: ensuring or restoring macroeconomic stability, not ruling out options for subsequent reforms, specifically those intended to increase competition, and maintaining support for completing the reform process.

The central argument of the paper is that the inefficiencies and stagnation of Soviet-type economies are intimately linked to its monopolised production structure which in turn makes soft budget constraints almost inevitable. Given the bargaining power of the resulting monopoly enterprises, macroeconomic stability in such economies required very low-powered regulatory incentive schemes, with low incentives for efficiency. The economic objective of systemic reform is to improve incentives for efficiency, innovation and growth. If this is to be achieved without macroeconomic instability, the enterprises must be demonopolised, otherwise firms will retain the power and incentive to devote the now higher fraction of their profits under their control to increases in wages, investment and consumption. This will rapidly lead either to excess demand and inflation, or incentive-sapping controls and taxes (such as the excess wages taxes). Small firms without market power are disciplined by the credible threat of bankruptcy, which will compel them to hold down wages and choose investment prudently, and this should suffice to restrict create excess demand.

Liberalising foreign trade is a swift way of importing sensible prices and putting the traded sector under competitive pressure, but runs the risk that it does little to undermine the political power of the enterprises, who may force the government to reimpose quotas, tariffs, or further devaluations which underwrite inflation. The major reform issue is how to mobilise forces for breaking up large state enterprises into smaller, privately owned firms, while maintaining macroeconomic stability and the necessary social infrastructure, both of which require considerable fiscal discipline. The answer is to retain low powered regulatory schemes for enterprises which remain in the state sector, providing incentives to bud off plants and divisions which can move into the private sector to be subject to market rather than fiscal discipline. Rapid privatisation of existing monopolies may lead to the worst of all possible outcomes: stagnation associated with inequality and social tension.

Sequencing the Transition

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The inefficiency of Soviet-type economies results from its monopolised production structure which makes soft budget constraints almost inevitable, as enterprises have bargaining power and must face expropriative tax rates for macroeconomic stability. Systemic reform aims to improve incentives, and if this is to be achieved with macro-stability, enterprises must be demonopolised. Most sequencing issues resolve into three key concerns: ensuring or restoring macroeconomic stability, not ruling out options for subsequent reforms, specifically those intended to increase competition, and maintaining support for completing the reform process.

Sequencing and the logic of choice

It makes little sense to discuss the sequencing and speed of transformation without identifying the initial conditions of the economy and the preferred destination. Clearly, Hungary, Poland, Czechoslovakia, and the Soviet Union were in very different positions at the beginning of 1989. The degree of macroeconomic imbalance, the size of the external debt, the rate of inflation, the size of the fiscal deficit, and the degree of internal and external convertibility were all different. Hence, the urgency with which counter- inflationary and stabilisation policies were required differed, while the domestic political situation presented very different priorities and constraints in each country.

In many ways, the debate over rapid or gradual transformation presents the choice in an ahistorical form. One can argue that there are many desirable steps to establish the pre-conditions for successful transformation that are probably difficult to undertake rapidly. If the whole process of transformation is under rational central direction (which, arguably, is almost a self-contradiction) then the entire process will be gradual, though certain steps may be taken very rapidly. If, as is more likely, different elements in the transformation proceed prematurely, then macro-stability may be so threatened that swift and wide-ranging action - a Big Bang - may be essential to rescue the economy and the transformation process. Poland had few choices available at the start of 1989, and was in any case subject to tight external conditionality from creditor nations and the IMF. Czechoslovakia emerged from the

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Velvet Revolution of November 1989 with a relatively small external debt, moderate levels of repressed demand, mild inflation, and a relatively minor problem of monetary overhang (Begg, 1991). Hungary has been gradually transforming its economy since 1968, in a sequence of so-called 'failed revolutions', and had begun many of the critical steps required for a transformation to a market economy during the 1980s. Thus private enterprise was tacitly allowed, if not actively encouraged, especially in the small-scale production of food, its distribution and sale to the towns, and in the services and retail sector. External pressures from the IMF and the World Bank which followed the large increase in external debt and which were the inevitable price to pay for access to Western capital markets, meant that many of the key institutional reforms were at least under discussion and in some cases had already been implemented by 1988. Specifically, the tax system had been reformed by January 1st 1988, the law on bankruptcy, though in an unsatisfactory state of execution, was nevertheless recognised as a key component of dealing with the fiscal deficit, and the economy was liberalising foreign trade in a planned but reasonably rapid manner.

The view expressed above is that the sequencing and speed will depend on the initial conditions and the preferred destination, but the concept of sequencing still suggests that some actions should be taken before others, and that to do the reverse will be less satisfactory. There are more fundamental criticisms of the notion that there is an ideal sequence of actions which a transforming economy must take. One view is that everything must be done (or at least started) at once, and the actual sequencing will merely reflect the differing speeds with which different parts of the transformation programme inevitably proceed. Another view, widely expressed by those caught up in the politics of policy reform, is that the programme is largely out of their control, and has an internal logic or momentum of its own. It is therefore naive or unrealistic to imagine that there are choices between well-defined alternatives open to the policy maker.

There is some force to both criticisms, and it seems useful to consider how best to take the choices which become available during the transformation process. The first issue is whether the available choice is readily reversible or whether it is irreversible. Clearly the latter are more important. Of those, some will lock the subsequent path of the economy into one pattern of evolution rather than another, while others may have little long-run effect on the end state of the economy. The choice of exchange rate may have little long-run effect on the economy (and one can certainly argue that case for the former GDR). Trade Union organisation and wage bargaining procedures may be hard to change and have significant impacts on labour market flexibility and the subsequent trade-off between unemployment and inflation. The choice of type of financial institutions (universal banks, or specialised banks and stock markets) may greatly affect the ease of merger and takeover, and in turn affect the equilibrium rate of return in the corporate sector. To the extent that subsequent economic evolution and options are history dependent, early choices may have profound long-run consequences. Given this, it makes more sense to consider the future consequences of available choices, rather than drawing up schedule for the order in which choices are to be made.

Once this is appreciated, there are a number of fairly obvious guiding principles to apply. The first is that where possible choices should be so taken to keep open desirable options and to foreclose undesirable options. Thus it is easier to change specialised financial institutions into universal banks than vice versa. If universal banking faces potentially worrying problems of capture, information opacity, and instability, then it may be safer to choose the alternative initially. If, as will be argued here, market power reduces the incentives for efficient performance, then splitting up enterprises before they are privatised keeps open options for subsequent merger where there are genuine synergies, while it will be much harder to break up monopolies after they have been privatised.

The second principle is that current choices may require future actions for their full effect, or may be prone to future choices which offset their effect, and it may be desirable to precommit to these future actions and so rule out the risk that the current choice will be nullified in the near future. Sustained economic improvement requires costly current choices about the use of resources and the design of institutions whose benefits occur in the future. Decentralised agents will be reluctant to undertake these costs unless they are reasonably assured of receiving a sufficient fraction of the future benefits. For that they need confidence that property rights will be durable, well-defined and enforceable in law, that taxes will be stable and non-expropriatory, and that the macro-economic environment will not alter unpredictably and/or adversely. Perhaps the main task of policy makers during the early stages of transformation is to entrench reforms which ensure and underwrite such expectations. Privatisation can be seen very much in this light. The most compelling argument for rapid privatisation is that the government may lose popular support for the privatisation once unemployment and inequality start to rise. Democratic governments find it notoriously hard to precommit to future policies, and their inability to precommit may weaken the incentives for costly but desirable changes. One way round this problem is to create decentralised autonomous institutions will well-defined mandates for action which it would be politically difficult to reverse. Independent central banks are one example popular with those who wish to see commitments to low inflation rates. Mandating holding companies to continue the process of restructuring industry for eventual sale to the private sector may entrench the privatisation programme in the face of adverse employment outcomes, and this seems to be the logic of the Polish privatisation programme for large enterprises. Reforms of this kind are likely to require institutional reform, and institutional choice will almost certainly create path dependence. Such choices are therefore critical. The optimistic view is that many of the institutions imposed on the defeated countries after World War II seem to have had very desirable long-run consequences, and that the opportunity to make institutional changes rarely arises and should be seized as presenting unique opportunities.

The transformation problem

The essence of the transformation problem is to transform a Soviet-type economy and turn it into a market economy. While it is not difficult to describe the key features of a Soviet-type economy, the concept of a market economy encompasses a wide range of possible models. Nevertheless, they have some key features in common, and their differences raise policy choices as to the preferred destination which are best laid out at an early stage. Some destinations may not be feasible, either economically or politically, while others may be unsatisfactory, if more likely.

I take the following to be distinguishing features of the Soviet-type economy. There is little or no private ownership outside small-scale agriculture and services. Production units are large, and form monopolies either by product or by region or both, if not at the enterprise level, then by explicit cartelization (as in the GDR) or through the system of tutelage from the responsible ministry. Enterprises are confined to certain defined lines of production (their profile), though they may be compelled by difficulties of securing intermediate inputs into increasing degrees of vertical integration of the production process. The planners, or the guiding ministries, have reasonably well-defined targets for the outputs of different sectors, and the negotiated pattern of Comecon trade has first priority as it has the status of a treaty obligation. Finance is allocated from the centre, through the mono-bank, or by a mechanism of subsidies and allocations specified from retained profits, and all surplus profits are channelled back to the centre. The system of taxes on inputs and outputs is designed to support the plan or the centre's objectives[1] while managers are frequently appointed on the advice of the centre. These economies have limited trade exposure to the West, and such trade takes place at heavily distorted domestic prices influenced by a complex system of tariffs and turnover taxes. The same is true for trade within Comecon, where there is no uniform price for the same product between any pair of countries.

After-tax wages are determined by political criteria which reflect the objectives for the economy. Wage differentials are relatively narrow, and the degree of after-tax and transfer income inequality is much lower than in market economies (Newbery, 1991b). Much of the system of social security is devolved through the large enterprises in the form of subsidized housing, creches, kindergartens, health facilities and subsidized holidays as well as pensions. Typically labour and raw materials are under-priced, partly because of a reluctance to adjust market prices, which results in essential consumer goods being under-priced and rationed, thus lowering the reproduction cost of labour, and partly because taxes fall primarily on enterprises and profits and not on labour. Thus the costs of social services, education, health, pensions, etc. may be borne by the enterprises either directly or through taxes on profits or outputs, rather than income taxes and national insurance contributions. Many systemic features of the economy follow from these characteristics.

Cheap labour leads to excess labour demand, which reinforces the view that unemployment is inappropriate, and so organised labour exchanges are unnecessary, as is any system of unemployment insurance. The lack of an active labour market

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[1] Not all countries had formal central plans. For example, after 1968 Hungary abandoned formal central planning, but the enterprises were under indirect but nevertheless tight central management implemented through a complex system of taxes and subsidies as well as investment allocations.

increases the option value of hoarded labour, which reinforces the excess labour demand. Cheap raw materials and energy lead to and support an excessive reliance on energy intensive and inefficient heavy engineering industries. Planned Comecon trade at artificial prices further supports the emphasis on heavy industry, transport equipment, and capital goods. The highly concentrated structure of industry reduces or eliminates the ability of enterprises to find competing sources of supply, and leads to bargaining rather than market-mediated transactions, excessive stock-piling, excessive vertical integration, and reduces the rationality of the price system. The same concentration reduces the quality of information flowing to the centre, and forces the pattern of relationships between the centre and enterprise into one of bilateral bargaining under asymmetric information, a situation which as Farrell (1987) shows is likely to lead to inefficient outcomes. More to the point, as each decision must be subject to bargaining, it is not possible to credibly commit to adhering to any agreement reached today in the future, as all future transactions are subject to re-negotiation. This in turn greatly reduces the incentives for efficient investment and management, especially for innovation, and creates the whole syndrome of the 'soft budget constraint' (Kornai, 1986).

If we turn to a characterisation of market economies it is harder to find uniformities, especially in the system of and market for ownership and control over large corporations. Stock exchanges and dispersed equity ownership are characteristic of the US and UK, while bank finance and more concentrated control are characteristic of Germany and Japan. The extent of state ownership in the productive sector varies widely, as does the choice between regulation and public ownership for natural monopolies. Some countries have very liberal trade regimes and no restrictions on capital mobility, others are almost at the other extreme. Nevertheless, one can make some broad generalisations.

Industrial concentration, entry the size distribution of firms

The most striking difference between the centrally planned and market economies of Europe lies not so much in the industrial structure, or even the relative sizes of industry, services and agriculture (shown in Fig. 1), but in the size of firms and the degree of industrial concentration within each industry. Fig. 2 shows the average size of establishment in the US and the U.K. (typical of developed market economies) for the manufacturing sector as a whole, and for three 3 digit industries within manufacturing, and the average size of establishment in the USSR and Hungary. Czechoslovakia and the former GDR had even larger enterprises, while those shown here are between 15-20 times the average size of enterprises in developed market economies.

This in turn is a reflection of the relative absence of small and medium sized firms, which is illustrated in more detail in Fig. 3. This shows the proportion of firms of different size (measured by employment) in various planned and market economies. The differences are striking and systematic. Market economies tend to have a log-normal size distribution of firms, and this can be explained by a model in which the proportional rate of growth each year of any firm is a random variable drawn from a

-6-

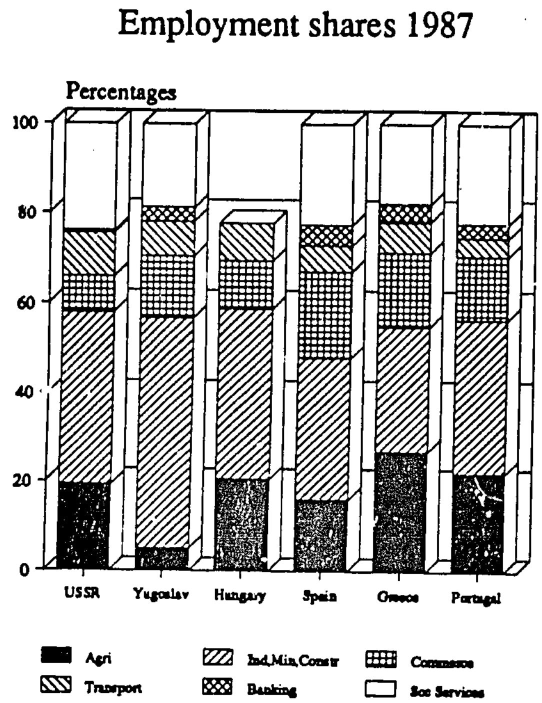


Fig. 1

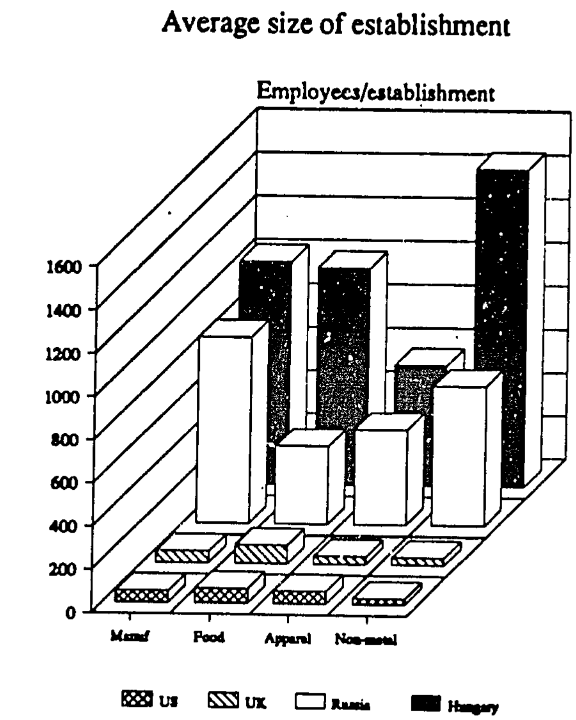
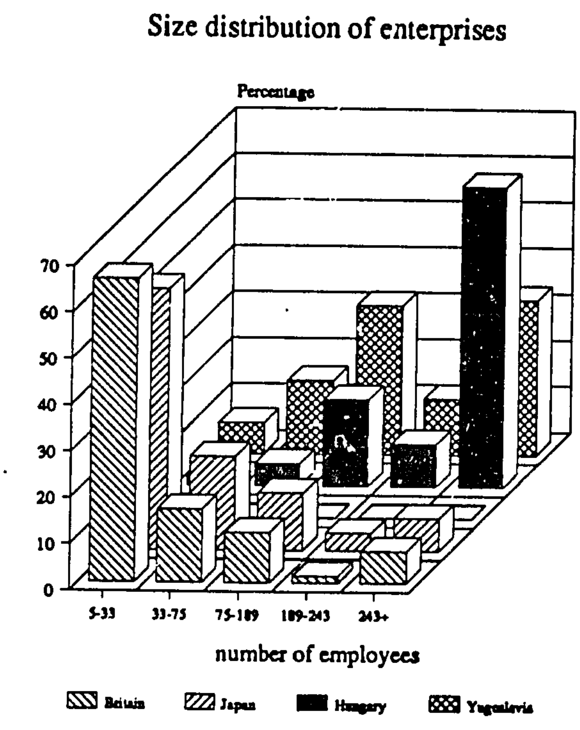


Fig. 2



Source: Table 2

Fig. 3

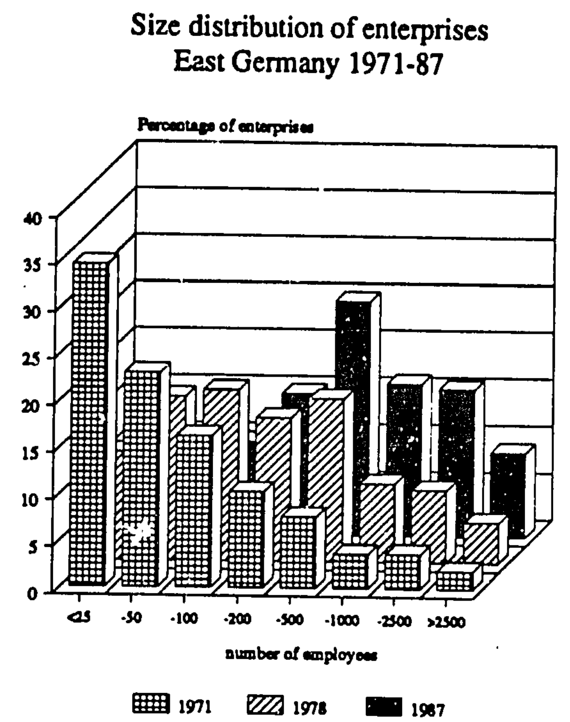


Fig. 4

normal distribution, independent of the size of the firm. Such a process, repeated enough times, will produce the size distribution typically observed - a phenomenon known as Gibrat's law. Of course, like all laws in economics, it is not strictly true, and the shape of the size distribution of firms needs qualification at the lower end (to account for entry barriers, difficulties of finance etc.) and at the upper end (where market size may limit growth, at least without diversification).

Nevertheless, the remarkable consistency of the observed size distribution over industries, over time, and between market countries, suggests that there are powerful market forces at work to generate and reproduce this pattern. Why, then, does it not happen in the Soviet-type economies? One plausible reason is that planning requires the centre to receive information from and to send instructions to the individual enterprises. This, to be manageable, requires limiting the number of enterprises within each industry - and firms are typically restricted in the range of activities they can engage in to remain conformable with the particular part of the bureaucracy concerned with planning their sector of the economy. Ideologically, the resulting concentration can be defended as enabling the state to reap the economies of scale that justify planning in the first place, for the market is least likely to operate efficiently when economies of scale are dominant and firms behave monopolistically.

Concentration in Soviet-type economies is preserved and enhanced in a variety of ways that thwart the natural tendencies of size dispersion in the market economies. Entry is impossible if there are no independent sources of finance, such as commercial banks, and if it is illegal to employ wage labour (as opposed to cooperative labour). The state-owned enterprises themselves have no incentive to fragment themselves into competing units, even if this were permissible, for competition in the same product market might reveal that one at least of the enterprises was not producing efficiently. If each firm dominates its product line, then the planer has no independent sources of information on which to judge the performance of the enterprise, and the enterprise can control the flow of information to its own advantage. This in turn leads to sluggish performance, poor levels of productivity, and a reluctance to exploit profitable but new opportunities - lest a precedent be established that might be hard to live up to in the future.

The more fundamental question is why this industrial concentration has been allowed and even encouraged, given the unsatisfactory performance which results. Here one can appeal to the Public Choice theory of regulation, as set out by Stigler (1971). At the purely theoretical level, we have the elegant theory that efficient bilateral bargaining between large numbers of agents leads (definitionally) to core allocations, and as the size of each agent shrinks relative to the economy, so also the core shrinks to the set of competitive allocations. This misleading theorem tends to suggest that out of anarchy will emerge the atomistic competitive market of Adam Smith. The theorem on the core as the outcome of the bargaining process sensitively depends on the assumption of full information, as Farrell (1987) points out, but more fundamentally, the claim that bargaining outcomes will tend to competitive outcomes as numbers increase requires costless bargaining. If transaction costs are positive, then transactions which create small gains for the participants will be filtered out, leaving those which create large gains. Producers monopolising the market exemplify the latter, while consumers, each small and gaining little from any one transaction (except that involving their labour power) exemplify the former. One could conclude that it requires active pressure to create and defend the competitive market, though entry by new firms (rather than bargains with consumers) will tend to erode existing cartel agreements. The log-normal size distribution of firms in market economies is preserved only by the entry of new firms, and the death of old firms, both of which are rare events in Soviet-type economies.

A more plausible alternative to the myth of the natural emergence of atomistic markets is that the pursuit of economic and more general power is fundamental, and the extraction of surplus provides the means for maintaining that power. As pillage and conquest give way to more established forms of surplus extraction, so the state emerges and uses its coercive powers to maintain and extract that surplus. Taxation is the most obvious form, but not the only one. Legal monopolies have the considerable advantage over other forms of monopoly, as Stigler is at pains to point out, that they are not subject to the competitive threat of entry which threatens the ability to generate profit and the other advantages of monopoly incumbency (including the quiet life). Trading enclaves (Amsterdam, Venice, the Hansa League) and trading nations (Britain, Japan), heavily dependent on international trade and hence freer of domestic political control have to varying extents escaped this limitation on entry and enjoyed the more competitive conditions that have resulted. Other, more inward-looking countries, have frequently failed to limit this quest for monopolisation. The Soviet-type economies exhibit the end result of this natural quest for monopolisation to an extreme degree.

The worry is that if one accepts that the natural state of (political) affairs is a tendency to monopolisation, which creates the support and financial power to keep it in being, then the system is stable (if inefficient) and may be incapable of reforming itself. It may take external pressure (international trade, debt, the collapse of Comecon trade) or domestic political change to precipitate the start of systemic reform, but that reform process may find it peculiarly difficult to reduce the concentration of economic/political power. Fig. 4 shows the striking tendency to increased monopolisation over time in the former GDR, and similar trends (though occurring earlier) are also visible in Czechoslovakia.

The key elements in the transformation

The advantages of the market economy to which the reforming socialist economies aspire have many dimensions, of which the freedom from a coercive and all-powerful central government may be politically the most important. Nevertheless, dissatisfaction with recent economic performance, and the serious economic plight into which the former governments lead their countries in the end-game to preserve political power both put improved economic performance high on the agenda. The main qualification is that the reform process must be entrenched and made irreversible. Reform sequences which might be ideal if implemented by an all-powerful benevolent dictator may not be politically feasible, and sequences which build support for continued reform may involve compromises and poorer performance when measured against this unattainable ideal. As usual in public economics, the best feasible is 'second best'.

The economic advantages of the market economy are its flexibility, adaptability to change, ability to innovate, and its efficiency in resource use, both static and dynamic. These result from the coincidence of private gain and public good under competitive conditions, but this coincidence appears to require strong competitive pressure, which rewards success, penalises failure, and reallocates resources from the unsuccessful to the successful. Private property is a key element in providing the incentive for efficiency, but for other than small scale enterprise there is an inevitable separation of ownership and control which creates principal-agent problems. The evidence from recent privatisations and de-regulation in the West is that transferring assets from state into private ownership by itself may do little for efficiency if the enterprise remains a monopoly protected from serious competition. What appears to be more effective is liberalisation which increases competitive pressure (Vickers and Yarrow, 1988). This argument, which is convincing in a mixed but predominantly market economy, needs to be qualified for a Soviet-type economy during the period of transformation. It is then arguable that a change of ownership without a consequent change in the size distribution of enterprises would have a considerable impact on performance. The reason is simple. In a predominantly market economy prices provide considerable information about efficiency and allow state-owned enterprises to be monitored more effectively than in a Soviet-type economy. Their efficiency before privatisation is therefore likely to be higher, and closer to that likely to be required of a natural monopoly under diffuse ownership.

The argument here is not that privatisation is less important than market structure, but that to achieve the full benefits of privatisation, a competitive market structure is essential. Privatisation without deconcentration will preserve inefficient monopoly, as it will be very hard to break up firms after they have been privatised. On the principle of not foreclosing desirable reforms, deconcentration before privatisation is to be preferred. If this argument is accepted, it follows that a major objective of the transformation is to turn the large state-owned monopolies into competitive firms which are actively motivated to pursue profits without distorting or controlling the market. A key determinant of the likely success of any reform sequence is whether it leads to such an outcome in a reasonable time frame. A large number of necessary reforms can be viewed as enabling the economy to reach this destination. These include liberalising trade, financial reform, the creation of property rights and the necessary legal and institutional framework to clarify and enforce these rights. One of the central elements in the creation of the institutional environment to support the market economy is an Anti-Monopoly agency (or an equivalent institution, such as the Treuhandanstalt in Germany or the proposed holding companies in Poland), entrusted with breaking up and restructuring existing monopolies and enforcing a vigorous anti-monopoly or competition policy.

The main sources of sustained economic improvement lie in improved investment and innovation, which both require hazarding current resources for future gain, and which will be adversely affected by uncertainty and instability in the economic environment. Macro-stabilization is therefore a pre-requisite for these micro-economic gains, but without micro-economic reforms which create the necessary price-responsiveness, stabilization is likely to be painful and possibly even unsuccessful.

Most of the remaining elements of the transformation process have to do with protecting public finances and balancing claims of equity against efficiency in the distribution of income. Let us consider these briefly first, as they appear largely uncontentious in formulating the reform strategy (though not necessarily commanding adequate support within the countries).

Public finance and the management of state enterprises during transition

Fig. 5 shows the sources of government tax revenue for various East European economies and for the OECD for 1986 as percentages of GDP. The most striking difference between East Europe and the OECD lies in the relative importance of profits tax (shown in black), compared to income taxes (immediately above the profits tax on the bars).[2] Fig. 6 shows the share of GDP allocated to consumer and producer subsidies in four East European countries in the same year, as well as the provisional data for 1989 and the budgeted amounts for 1990. Note that enterprise subsidies are large and in the case of Hungary and Poland in 1986 would reduce net taxes on enterprises to very low levels.

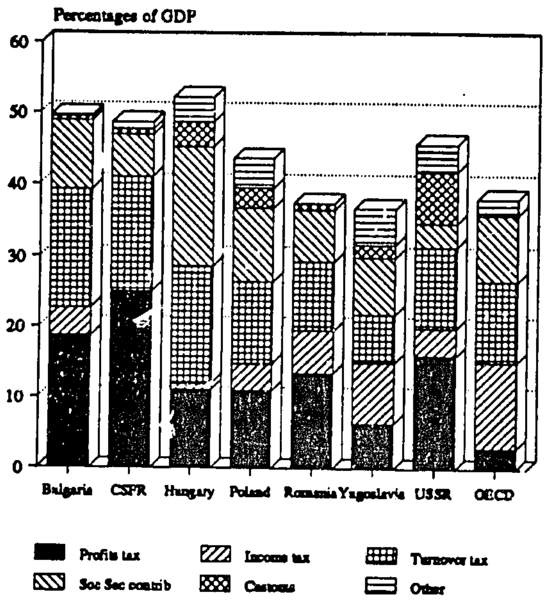
Tax reform at the enterprise level is a critical step in replacing the system of bilateral bargaining (prone to renegotiation and thus lacking in credibility) with a uniformly applied and predictable set of rules which permits the government to establish credibility and hence hard budget constraints in its financial relations with enterprises.[3] Tax reform by itself is not enough to break this system of bilateral bargaining, for this can reassert itself through the system of subsidies, which, as Fig. 6 shows, are large by comparison with profits tax revenue.

From a macroeconomic point of view one of the major elements of the tax reform is to move from a system in which enterprise profits are taxed at almost 100 per cent, and investible resources were made available to enterprises on a bilateral basis, to a system of profits tax at rates comparable to market economies. In Hungary this was done on January 1, 1989 with the Entrepreneurs' Profit Tax. The rate for 1990 was 40% on profits exceeding Ft 3 million (about $50,000), and 35% on profits

[2] The data for Czechoslovakia does not distinguish income and profits taxes and they have been arbitrarily allocated to profits.

[3] It can be argued that countries like the US and the UK are forever adjusting the corporate tax system, but they do so on a uniform basis, not to meet the special needs of individual enterprises, and as part of a programme of improving the efficiency of the tax system and/or removing loopholes and anomalies.

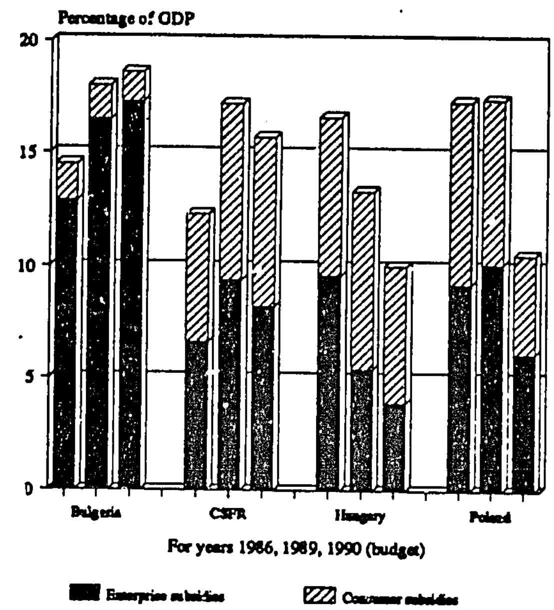
General Government Tax Revenue
East Europe 1986



Tanzi (1991)

Fig. 5

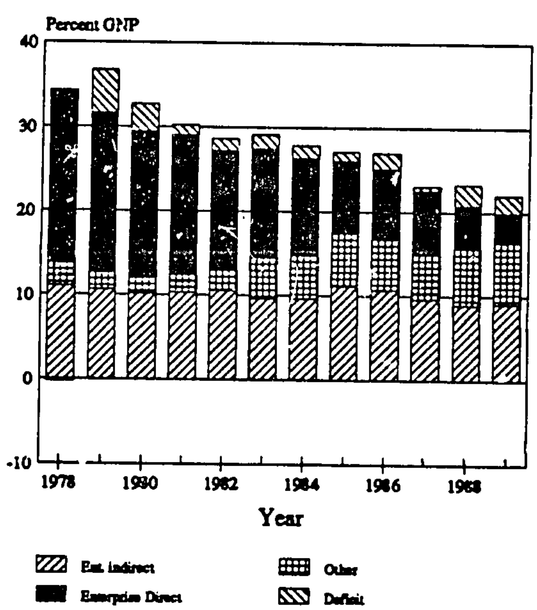
Budgetary Subsidies
East Europe 1986-90



Holzmann (1991)

Fig. 6

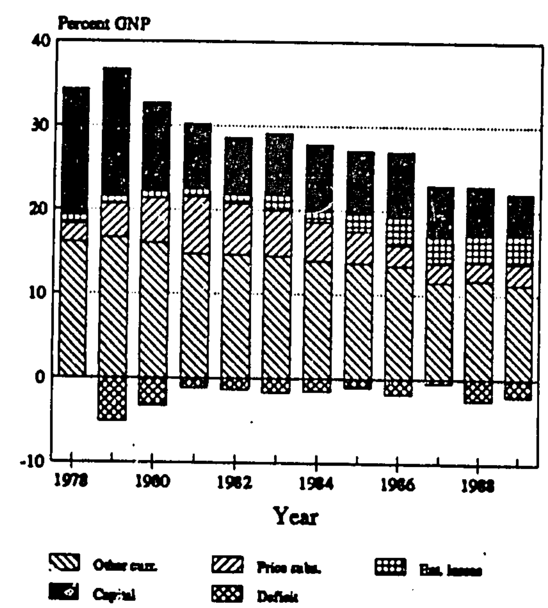
China
Composition of Government Revenue



Source: Hussain and Stern (1991)

Fig. 7

China
Composition of Government Expenditure



Source: Hussain and Stern (1991)

Fig. 8

below this limit.[4] Enterprises are allowed to retain profits and borrow to finance investment. Such a change potentially puts the budget under greater pressure, as enterprises now have more autonomy and control over their investment, and more incentive to raise prices and increase profits and possibly also wages. It is instructive to look at the experience of China during the reform period which decentralised greater control to enterprises. This experience is described by Hussain and Stern (1991) and Fig. 7, taken from their data, shows the dramatic fall in tax revenue from enterprises over the past decade. Fig. 8 shows that if anything enterprise losses borne by the budget increased, so the net fall in revenue was even greater. Part of the response was a cut in central government financed investment, as the responsibility was shifted to the enterprises, but the overall effect was inflationary and led to persistent deficits on the budget and trade account. Aven (1991) descibes the same fiscal consequences of enterprise decentralisation in the Soviet Union, though it appears that the need to reduce government expenditure was even less appreciated and has led to more serious problems.

As part of the budget rebalancing exercise, and also as part of a move towards greater uniformity of treatment, it is therefore important to reduce subsidies both to enterprises and to individuals, and either to replace lost profits tax revenue by other taxes or cut other components of government expenditure (such as defence). Fig. 8 shows that China reduced price subsidies, while Fig. 6 shows that Hungary was also quite successful in cutting subsidies in the period 1986-90, under strong pressure from the IMF and World Bank. Bulgaria and Czechoslovakia had clearly not started this stage of the reform process by 1990. Hungary introduced a Personal Income Tax which enterprises were instructed to collect, and also to increase before-tax wages so that the after-tax wage remained unchanged. In effect part of the former profits tax was now collected as a tax on labour, making the relative cost of employing labour higher and helping to reduce excess demand for labour. Hungary also retained in a modified form the wage (earnings) regulation, which was changed in 1989 to tax wage increases which exceed twice the proportional increase in value added at the profits tax rate (which, in 1989 was 50%).[5] The reason for retaining one of the distinctive taxes of the former system of enterprise control is instructive. Hungary, which is the most advanced in terms of tax reform, has found that the main problem in shifting away from the detailed enterprise-level setting of taxes, wages (via wage regulation), access to funds, and prices (via the Price Office) is that the economy has not been adequately transformed into the competitive system for which Western tax systems are well suited. Firms remain large, monopolised, often with explicit market sharing agreements with

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[4] *Public Finance in Hungary* (1989) No 59 'Acts on a) Entrepreneurs' Profits Tax (Revised Act) and b) The Participation in the Process of the State Property'. See Newbery (1991c) for details.

[5] *Public Finance in Hungary*, (1989), No 48, 'New rules affecting enterprise incomes'.

similar firms, and have considerable bargaining power in their dealings with the newly created commercial banks. Their objectives in many cases are to advance the interests of their workers, rather than maximising profits, as they retain Enterprise Councils as apparent owners. The combination of the soft budget constraints which survive through the weakness of the banking system and through the ability of large enterprises to force their suppliers to advance trade credit, and their market power, means that there is a danger that a reduction of central control and the increased decentralisation implied by the new form of enterprise taxation will lead to excessive wage increases, and hence excess demand for the economy. Wage regulation (ie taxes on excess wage increases) has therefore been kept in place as part of the necessary system of regulation of state-owned enterprise once they have greater freedom to operate in a more decentralised way. Aven (1991) shows that the Soviet Union placed great emphasis on enterprises not exceeding their planned wages fund after the Hungarian-style decentralisation reforms of 1987. The equivalent wage regulation in Poland has attracted considerable criticism, even though it only applies to the state-owned sector. It thus has the desirable property of encouraging privatisation while reducing tendencies to excess demand in the state sector.

Monopoly power thus emerges again as a constraint on the reform process, and will be discussed further below. For the moment we continue to ask how enterprises are to be managed from a fiscal and macroeconomic point of view. Small-scale industry which is successfully privatised and held by single or concentrated ownership creates no great problems, as the owners will pursue profits, have an incentive to hold down wages, and will have little market power to exercise.[6] Public utilities which are expected to remain in the public sector (postal services, railways, possibly but not necessarily, telecommunications and electricity) will continue to require tight budgetary control, though there are good reasons for delegating oversight to independent agencies to reduce political interference and the suspicion of political taint. Corporatisation may be desirable, and an institution similar to the British Public Audit Commission, with the power to choose to audit, publish its findings, and report to parliament would appear to be highly desirable.[7]

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[6] unless they are allowed to form local monopolies or effective, licensed trade associations restricting entry (funeral parlours in some market economies being a good example; car dealer franchises another). Clearly such attempts should be resisted.

[7] Auditors in the private sector are normally chosen by the company, and though the auditors should be selected by the representatives of the owners to provide the owners with the information needed to monitor performance, they are frequently chosen by the managers with the implicit understanding that damaging information will not be revealed to the public (by the effective threat that auditors who do not cooperate will not be reappointed). There are few less informative documents than published company accounts, at least in the UK and the US.

The main fiscal (and economic) problems have to do with large enterprises which should eventually be destined for privatisation, but which it is infeasible to privatise in the near future. At present rates of progress outside the former GDR this is likely to account for the bulk of manufacturing industry over the next five years. The problem here is that in some countries their legal status remains unclear as they were transferred to the control of enterprise councils, though Czechoslovakia has taken the logical first step of renationalising them. Even if their ownership status can be clarified, there is the more serious problem of monitoring their performance and ensuring that they act in the public interest, rather than in the narrowly sectional interests of their current management and labour force. Under tightly held private ownership, managers would be compelled to act in the owners' interest. Under state ownership the machinery (in the form of the confiscatory tax system) existed to limit the extent to which the management could divert resources to their own use, though the incentives to perform efficiently may have been weak. Under dispersed private ownership the capital market provides a market for corporate control though takeovers, though in some countries (Japan, Germany), where takeovers are difficult, effective management control appears to be exercised by the major commercial banks. Weak state ownership combined with a tax system designed for a market economy with effective methods of management control is likely to achieve the worst outcomes of both systems - little incentive for efficiency, and low returns to the owner (the state). Transferring the enterprises to the private sector under dispersed ownership without a vigorous market for corporate control would probably encounter many of the same difficulties, though it would at least provide the pressure to develop the capital market.

Tirole (1991) has argued persuasively that public enterprises (and private monopolies) require regulation if they are to be persuaded to act in the public interest, and that a key choice concerns the power of the regulatory incentive scheme placed upon the management. Regulatory incentive schemes attempt to extract rent while providing adequate performance incentives for the manager, and a high powered scheme gives management a larger share of incremental returns. High powered schemes have good incentive effects for innovation, cost reduction, etc, but yield low marginal rents. The problem is that the state needs high quality information to capture the rents on the intra-marginal returns. This information is open to manipulation by the enterprise, or, even worse, the regulator risks capture. If the state fails to obtain good information, it will have to recoup the lost rents by means of more distortionary taxes elsewhere (such as sales taxes on the enterprise's output).

Tirole concludes from this that high powered schemes are inadvisable where information is poor and noisy, and where the threat of regulatory capture is high, and both circumstances are likely in the early stages of the transition. Market prices are not very informative, past inefficiencies make cost calculations difficult, and the legacy of former management with its links to the bureaucracy makes capture especially likely. Consequently low powered regulation (akin to cost-plus contracts or rate of return regulation) are advisable. If, for good reasons, the enterprise tax system should be non-discriminatory between different sectors and between the public and private sector, then the state should set required dividend payments to make up the shortfall.

In Britain, nationalized industries had to set prices to earn a required rate of return on (written down replacement cost) capital, and faced external financial limits which restricted the amount of borrowing permitted. (These were sometimes negative, implying that the enterprise was required to repay past loans.) Wage regulation or excess wage taxes (as in Hungary and Poland) can be seen as a key element of the required low powered regulatory system for enterprises which remain in the state sector and which are not subject to strong competitive pressure and hard buudget constraints.

If one takes the view that deconcentration is a prime long-run objective, then there is a tension in the financial control of enterprises which remain in the state sector. Ideally, managers should be given incentives to restructure the enterprise and break it up into smaller single-plant firms, with a lean management structure (following the example of such corporate raiders in the West as Lord Hanson). One such incentive is that viable and smaller units are easier to privatise, either by a leveraged management buy-out, or private placings with development banks, pension funds, or investment trusts. Managers who are successful in restructuring and dismantling the former enterprise would be retained as the managers of the units to be privatised, those who were not successful might even lose their post in the residual state-owned rump. Once privatised, the new smaller firms would no longer be subject to low powered state regulation, but would face the normal financial constraints imposed by banks, and this freedom should appeal to managers and provide the required incentive to restructure.

The disadvantage of this approach is that the entire loss of the loss-making sections of the enterprise would continue to be a burden on the state, but only 40% of the profits of the profitable parts would accrue to the state. There is the further danger that the least competent managers would be left with the most difficult problem - that of deciding whether and how to salvage the loss-making divisions. In such cases rough justice is likely, and potentially viable firms may be lost. This may have to be treated as the inevitable cost of the shortage of good market-oriented management.

To some extent this process is already under way, under the label of 'wild privatisation'. It has aroused considerable popular opposition, and attempts have been made to prevent it. Obviously, it is important to develop and retain respect for the rule of law, but it is also desirable to legitimise a satisfactory (or the least unsatisfactory) move towards a viable private and competitive economy. One possibility is for the state to retain residual ownership rights in fixed assets, especially land, so that if these are sold for the personal profit of the managers (and workers), then a large fraction of the proceeds are returned to the government. Such mechanisms were introduced by the British Government after some flagrant examples of property sales, whose valuation in the management buyout (as assets of a continuing industrial enterprise) was a tiny fraction of their free market value (sold for commercial development of a quite different nature). A capital gains tax on real capital gains would also reduce the arbitrariness in the allocation of the gains from deconcentration and restructuring, though the administrative costs of this should not be underestimated.

Perhaps a neater solution is to load enterprises with debt secured on those fixed assets which can readily be sold (especially land).

To conclude this section, the severity of the fiscal consequences of shifting to a western system of profits taxation will depend on several factors:

- the extent to which subsidies can be reduced in line with the fall in profits tax;
- the extent to which managers of enterprises which remain in the state sector can be induced to behave prudently (not paying out excessive wages, nor investing in unprofitable ventures) by imposing low powered regulatory incentive schemes (e.g. specified dividends and/or interest on the state equity and debt);
- the speed with which loss-making divisions can be dealt with (by restructuring or closing them down).

How serious the fiscal problem is will vary from country to country.

Equity, efficiency, safety nets and fiscal reform

The governments of most transforming economies face a heavy burden in financing infrastructure, debt repayments, and the restructuring of industries, even before considering claims of equity. The former GDR illustrates this in a dramatic form, as the costs are falling on West Germany in a highly visible form, though the aim is the more ambitious one of bringing living standards up to a level at which massive out-migration no longer poses a threat to West Germany. Hungary and Poland have large foreign debts, and all require considerable investment in telecommunications. Unless former levels of Comecon trade demand can be restored (essentially by some kind of move to internal convertibility in the Soviet Union), the investment required to re-employ the workers of industries heavily dependent on these markets will be considerable. Czechoslovakia is in the fortunate position of having a low enough foreign debt to be credit-worthy, and will therefore be eligible for EBRD funds for infrastructural investment, but the other countries are less favourably placed to incur increased foreign debts, and creditors will be naturally cautious about advancing further loans, at least unless some form of debt forgiveness or restructuring takes place.

This means that Eastern Europe faces similar problems to heavily indebted developing countries attempting to restructure their economies, or, indeed, to the economies of Western Europe at the end of the second world war. As the transformation process is as much a political as an economic process, and as most of these countries have elected democratic governments, changes in the distribution of income are likely to be resisted. The governments thus face a further constraint, for if public revenue is required to provide safety nets, or to redistribute income, then less will be available for investment, debt service and restructuring. Newbery (1991b) demonstrates that in Hungary the previous system of transfers and provision of social services appears to have been very effective at maintaining a remarkably egalitarian income distribution. As such, there is little scope for improved targeting in order to reduce the fiscal cost of redistribution, and any fall in social expenditure will therefore be at the expense of the poor. Putting it starkly, the old degree of redistribution is unlikely to be sustainable for countries at their current level of development under a market economy, where incentives and efficiency bulk larger, even without the additional strains of structural adjustment. These additional strains confront the government with an unpalatable choice: either to cut investment and use the declining budget revenues to provide as much redistribution as possible, thereby risking stagnation; or to invest, and face the unpopularity of substantial falls in real income of the more vulnerable sections of the population. Barnett (1986) has argued that Britain's poor post-war performance compared with that of West Germany reflected a choice for equity rather than investment, while West Germany deferred the arrival of the welfare state until the economy was strong enough to support its heavy claims.

A pessimistic view is that these economies have increasingly put the considerable power of state ownership to extract surplus towards short-term attempts to preserve an equitable income distribution and hence political support, and this support will now be threatened by the reform process. The main hope is that the costs of restructuring will be perceived as inevitable, given the collapse of the Soviet market and the revealed inefficiency of much of the industrial structure.

Legal reforms and the clarification of property rights

There is widespread agreement that a viable market economy requires the rule of law to uphold and enforce contracts. This in turn means a code of law and a set of institutions to enforce the code. There is also agreement that this should proceed as quickly as possible, consistent with clarity and lack of ambiguity, widespread understanding and support among the population. There is less agreement whether this means adopting the legal code of some model country, such as Germany, or attempting to draft an indigenous code, derived perhaps from pre-war models. The argument against the first approach is that existing legal codes in many countries have unsatisfactory features which represent political compromises, and which are best avoided unless inevitable. The argument against the second is that inventing laws is almost bound to lead to ambiguities and inconsistencies, as they will not have enjoyed the long scrutiny and testing that existing statutes in other countries have survived. There is little further an economist can usefully say, except to note the attractions of mimicking EC practice as far as possible to encourage future cooperation, and to observe that Japan and Germany had extensive legal reforms forced upon them by the occupying powers, which appear to have been remarkably successful. This argues in favour of the desirability of foreign transplants.

Clarifying the status of private (and public) property rights is of the first priority, and the uncertainty and confusion created by restitution will impose a high cost on economic transformation. Privatization will have to await this clarification, though leasing may be a viable transitional solution.

Macro-stabilization

Many of the Eastern European economies began the transition with repressed or actual inflation, wide disparities between the official and black market exchange rate, and a monetary overhang - that is, excessive money holdings relative to the current level of output and money price level. Edwards (1991) argues that most economies experienced both *stock* and *flow* disequilibrium. The stock disequilibrium is reflected in the monetary overhang, while the flow disequilibrium derives from the fiscal deficits which are immediately monetised under the mono-bank system of public finance. Both need to be addressed in stabilizing the economy.

The stock disequilibrium can be dealt with by bringing real money balances into equality with desired balances. This can be done either by raising the price level or reducing the stock of liquid assets by monetary reform. The obvious solution to the twin problems of excessive money and inadequate savings (for purchasing shares in private companies, liquidating mortgages and/or buying houses) is to create a new currency in the appropriate amount, available for exchange at par with old money, the excess being repaid in (partially?) indexed bonds, which in turn can be used to liquidate mortgages, and can be placed in pension funds, or exchanged for shares or real property currently owned by the state. Given the urgency of treating the stock disequilibrium, Edwards and others express scepticism at the feasibility of the monetary reform route. They note that Poland and Yugoslavia opted for the former route, which involved massive devaluation and a step change in the price level. The problem is that the step change in price level appears as rapid inflation, which is hard to stop. In both cases the policy was to follow the massive devaluation by a statement that the nominal exchange rate would be held and would provide the nominal anchor for the price level. In neither case was this sustainable.

Eliminating stock disequilibrium by itself will not eliminate inflationary pressures if the flow disequilibrium remains, and here the urgent need is to reduce the budget deficit. This problem is compounded by the fall in tax revenues from profits tax reform, and the probable increase in enterprise losses borne by the state, as Figs 7 and 8 show for China. If the government has resorted to the price-change approach coupled with trade liberalisation to eliminate the monetary overhang, then it may be even more difficult to deal with the budget deficit. One reason is that enterprises are likely to confront a hard budget constraint from the banks under the kind of tight monetary policy which will almost inevitably accompany the anti-inflationary policy. A devaluation sufficient to change the price level by the appropriate amount is likely to be excessive from the trade view point, so that initially enterprises will not need to borrow as their profits will be high. They will be able to pay higher money wages and to increase domestic prices as domestic demand rises with the money wage rate. After some time (about 12 months in the case of Poland) the bank budget constraint will begin to bite, inflationary expectations and consequent wage demands will have been firmly established, and the natural response of the enterprise will be to delay payments to other firms, creating an interfirm credit expansion. The final step is to delay tax payments. The former tax system in most countries was highly efficient at channelling funds to the central authorities on a monthly basis, and this will now be placed under great pressure. Corporatization and privatisation have the feature that profits tax payments are payable in arrears, once accounts are closed, and in the transition it will therefore be important to ensure that monthly tax payments on account (as with PAYE) are retained.

Cutting subsidies thus has high priority, though it will be hard to stop underwriting losses in loss-making enterprises before carefully assessing whether the enterprises are making losses because of distorted prices, because they are comparatively disadvantageous with structural reform, or whether they are unviable even with plausible restructuring. Cutting consumer subsidies may further fuel wage inflation, though this will be dampened eventually by rising unemployment. It thus becomes important not to fully index wages if such fiscal problems are to be avoided.

Edwards (1991) finds that Chile's 1973 economic reform has the closest similarity to the Big Bang in Poland. Prices were completely freed, the exchange rate was devalued by 90% and partial convertibility for commercial transactions was introduced. Prices rose in October 1973 by almost 90%. Eliminating the black market improved tax collections, as did the major tax reform of 1975 (which included the introduction of a 20% VAT, full indexation, and integration of personal and corporation taxes, described in Edwards and Edwards, 1991). The fiscal deficit which was 23% of GDP in 1973 was further reduced by a reduction in government expenditure, and by 1977 the fiscal deficit had been eliminated. A key element in expenditure reduction was a reduction in public sector employment, which reinforced the policy of reducing public sector real wages. Reprivatising nationalised firms by returning them to former owners was obviously a simpler option than that facing Eastern Europe, and further reduced the size of the public sector. Despite such fiscal rectitude, it took eight years to lower the inflation rate into single figures. In a country familiar with price controls, price liberalisation lead firms to expect further inflation, and the reimposition of price controls, which encouraged the firms to increase prices by more than currently justified. Such expectations may be particularly difficult to reverse, and such was the case in Chile. Edwards concludes that monetary reform might have proved a less costly alternative, and this might yet be a useful lesson for the USSR.

Sequencing liberalisation and demonopolisation[8]

If productive enterprises are to be compelled to behave more efficiently, both in the current use of resources, and in their choice of investment, then they must face competitive pressure in markets with rational prices, and hard budget constraints. The obvious source of rational prices is the international market, which, if combined with competitive factor markets, competitive markets for non-traded goods, and market clearing, would lead to an efficient set of market prices in the absence of market failures. The concentrated structure of industry in these countries reduces the competitive pressure for cost-minimisation and the associated market power allows firms to set prices at distorted levels.

This raises the obvious question of sequencing. What is the desirable sequencing of demonopolisation, liberalising domestic markets, and liberalising trade? One could argue that if trade liberalisation occurs first, then demonopolisation of the traded goods sector is less urgent, and could be delayed. On the other hand, if trade

[8] This section builds on Newbery (1991a).

liberalisation is to be delayed, then there is an important choice in the sequencing of demonopolisation and domestic price liberalisation. Kaser (1990, p610) poses the choice as '. . . whether domestic pricing and foreign trading (which in practice requires sharp devaluation and internal convertibility) should precede or follow demonopolisation.' He observes that the Polish reform programme started in January 1990 with market liberalisation and will be followed by demonopolisation, whereas the present Hungarian and Czechoslovak programmes start with demonopolisation.

To some extent the Polish (and also Yugoslav) governments had little choice—macro stabilisation was so important given the pre-existing state of hyperinflation that market liberalisation and trade liberalisation in particular were likely to act far more quickly than demonopolisation, which, with the best will in the world will take many years. Kaser also remarks that the earlier 1968 Czechoslovak reform had already been seriously compromised by monopolistic profits even before the Soviet invasion. This, together with the lack of acute macro-economic disequilibrium, must have influenced the present government's priorities.

Hare (1990b, p593) argues that for Hungary, domestic liberalisation should precede trade liberalisation, even if monopolies remain (though major public utilities should be regulated). His argument is that higher prices relative to wages (achieved by shifting market power from labour to the monopoly firms) should reduce excess demand, and higher profits will allow investment to be restructured in line with market demand, rather than bureaucratic preference. If imports were liberalised first and firms were to be exposed to strong competition, they might fail before they were satisfactorily restructured.

The problem is more complicated than this simple choice might suggest. The key elements in the reform are the removal of excess demand, the hardening of the budget constraint, and moving to a less concentrated and more competitive industrial structure facing a rational set of prices. In Hungary's case the trade surplus will need to rise if the foreign debt is to be serviced, and investment should increase if the economy is to be restructured. Unless output rises dramatically (and it fell by nearly 10% in 1990), it follows that consumption must fall if these objectives are to be met. This can either be done by reducing real wages while keeping moderately full employment, or by reducing employment, preferably while maintaining output, and paying the unemployed less than the employed (or by some combination). The strategy of liberalising domestic but not foreign markets makes the former solution more likely, while liberalising imports makes the second more likely.

The second strategy has similarities with that followed by Mrs Thatcher in 1979/80. Unemployment rose sharply as the exchange rate appreciated, and the costs of adjustment were borne largely by the unemployed, for real wages of those employed increased steadily in line with productivity. It is an interesting question which strategy is likely to be politically more sustainable. The British Conservatives discovered that the unemployed (most of whom would have probably voted for the opposition anyway) had relatively few votes, while the employed workers enjoying the rapid rise in real wages may even have switched to supporting the government. A more egalitarian country, or one in which the party in power is more representative of the workers, might prefer the alternative.

The danger with liberalising domestic markets but not imports, and delaying demonopolisation, is that it does little to force managers to reduce costs and improve efficiency, and it provides little incentive to banks to assess the credit-worthiness of borrowing firms. If firms can always cover costs by raising prices, and if banks know this, why undertake painful restructuring? Only if import liberalisation were credibly promised for some near future date would firms be under such pressures. The central argument of this paper is that demonopolisation is an essential element in transformation to a dynamic market economy. The sooner the process is started, the sooner will it lead to an increase in domestic competition, and in providing standards against which firms can measure their performance. Breaking large enterprises into smaller firms gives banks a choice as to which firm to lend, and their least risky strategy would be to lend to the most successful firm, reinforcing the Darwinian element of competition.

Let us consider the alternative of liberalising imports more rapidly. If the trade balance is not to be jeopardised, this will require a larger devaluation than if imports are not liberalised. This in turn will reduce real wages, and increase cost-push inflation. It is likely that the exchange rate will need to overshoot its long-run equilibrium level to achieve the real devaluation needed for short run stabilisation. Real wages will therefore also be lower than their long-run level. In the short run, the opportunity cost of most capital in firms will be low, or almost zero. Firms facing bankruptcy which are overmanned will have the option of either partially or completely reducing their labour force, unless they can borrow from banks or the government. The banks and government could reason that if the firms are not viable with zero opportunity cost of capital, lower than equilibrium real wages and an optimally adjusted labour force, then they will never be viable and should indeed be closed down. If they are able to cover their running costs, but not repay past debts, then they are technically bankrupt, and need at least capital restructuring. It should be in the interests of banks to allow this to happen, as the least costly alternative. Whether they would be willing to lend for further investment can be judged in the light of a moderately rational set of prices (though allowing for future rises in real wages if the structural adjustment succeeds). In short, on this set of arguments it is hard to see that firms which finally fail include any that should be kept alive, even though they may have survived for quite a long time under the alternative of domestic but not import liberalisation.

There are a number of qualifications which might modify these conclusions. The first is that if the government and the banks are intent on creating a reputation for imposing hard budget constraints, they may not believe that the enterprise can only survive if relieved of its debts. Clearly, all enterprises would like to claim this in order to relax their budget constraints, and to avoid the hard task of reducing the labour force. The banks may therefore choose to force some potentially viable enterprises into bankruptcy to create the correct incentives for other enterprises. Hard budget constraints require uniformity of treatment and adherence to established procedures if bilateral bargaining is to be avoided, and this will lead to rough justice in some cases. The correct approach is to design and/or evolve a set of procedures for dealing with bankruptcy. Franks and Torous (1991) contrast the US approach which allows troubled companies to file for chapter 11 protection from creditors, with the British system of receivership. The US approach places more emphasis on keeping firms running than honouring debt, while the British approach puts creditors first and is more likely to lead to the firm ceasing to trade. Mitchell (1990) argues that there are three aspects to a satisfactory bankruptcy law. The first, efficiency test is whether the institutions and procedures ensure that firms which should survive, do, and those which should not do not. The second, distributional requirement is that the distributional rights of claimants are clearly defined and appropriate. Finally, if the law is to have an effect on enterprise performance then it must be effectively enforced. The main problem in Soviet-type economies is the lack of procedures for closing enterprises which should not survive, and hence in the early stages of the reform process the emphasis will need to be on increasing the power of (non-governmental) creditors to bankrupt firms. At a later stage it may be necessary to worry about protecting the firms from premature liquidation - so there may be a sequencing aspect to the design of bankruptcy procedures, and their appropriate form will depend on the nature of the capital market that eventually emerges.

The second qualification to the view that trade liberalisation will not bankrupt potentially viable firms is that the main potential for future viability may lie in the human capital of the work force, but this may require investment in new machinery to realise its potential, and would be unviable with the existing assets. The management may be better placed to judge the profitability of the investment than the banks or the government, but under a regime of hard budget constraints may not be able to signal this information.

The only solution is to strengthen the investment appraisal skills of the development banks which would specialise in the restructuring of bankrupt enterprises. Fortunately, the EBRD is required to target lending to the private sector, and might usefully take on this activity (together with the creation of such development banks), acting as a politically independent agency.

If imports are liberalised, is there any urgency to demonopolise the economy? There are at least three arguments suggesting that it remains an important short to medium run objective. The first is that trade liberalisation will do little to impose competitive pressure on the non-traded sectors. Aside from public utilities, the main non-traded sectors are transport, distribution, construction, and services. None of these, with the exception of railways, which is a network utility, is a natural monopoly. They are therefore natural candidates for rapid demonopolisation, the more so as they are also natural candidates for privatisation, and we shall argue below that it is important to demonopolise before privatising where possible. The evidence from transport liberalisation in Britain and the US suggests that significant efficiency gains can be realised from increased competition. The same is likely to be the case in the other sectors. If foreign imports remain in the hands of monopoly distribution networks, then trade liberalisation will be seriously compromised. More generally, transport and many services are inputs into the traded goods sector, and if they are not forced to become more efficient by liberalisation and exposure to entry, then the traded goods sector will remain at a competitive disadvantage.

The second argument applies to both traded and non-traded sectors. Many of the large firms are conglomerates producing too wide a range of goods (often to ensure control over inputs by vertical integration). It may be hard to determine which lines of business are profitable if they remain integrated. and the signals for restructuring will be muted as internal cross subsidisation allows unviable units to survive. The same is true where firms have horizontally merged—the firm as a whole may be profitable at world prices, but parts of it may be unprofitable, and should be restructured or closed down. In addition there is a shortage of experienced managers. It seems sensible when the current and new managers are inexperienced to minimise their degree of control, and to allow as many of them as possible to produce a track record. Autonomous units with their own accounts will allow successful and unsuccessful managers to be identified more readily than the managers of divisions inside conglomerates.

The third argument is probably the most compelling, and has to do with resisting the inexorable pressure to provide protection to ailing producers in the future, once the drama of the early stages of transformation have subsided, and political compromises must be struck. Concentrated industries are better placed to capture the regulators or politicians and lobby for protection (though one should not underestimate the ability of representatives of the numerous sellers of well-defined single products (agriculture, labour) to lobby effectively on behalf of their interest group. The danger is that these interest groups will either lobby for protective tariffs and quotas, or for an attempt to sustain an undervalued exchange rate (ie keeping the real wage low) in order to protect inefficient production. If successful, this will lead to continued stagnation, if not, to inflationary pressures and possibly the 'stagflation' of Europe in the 1980s.

Finally, the network utilities like rail, electricity, gas, and water are likely to remain in the public sector, though there are powerful arguments for making them subject to regulation as quasi-autonomous corporations. It is conceivable that telecommunications could be privatised, but would certainly need to be regulated, as economies of scale and natural monopoly arguments argue for a very small number of suppliers, probably only one. Where competitive entry is feasible, such as in electricity generation, there is a strong case for encouraging it, but it seems unlikely that this will change the degree of monopoly much in the medium run. Where monopoly is unavoidable, regulation will be necessary.

Lessons of trade liberalisation

What are the lessons of import liberalisation to date? The experience of German economic unification suggests that the ability to use the exchange rate to change the real wage may be critical. East Germany has the singular difficulty that it cannot decrease real wages because of the ease of migration, as well as the fixity of the exchange rate, whereas most other East European countries may not face that problem.

Poland, on the other hand, has been unable to prevent rapid domestic inflation in the period after the sudden liberalisation, and, sixteen months after stating its firm adherence to a fixed nominal exchange rate, has been forced to devalue. In short, as the experience of market economies should warn us, there are considerable macro-economic problems in maintaining economic competitiveness, especially in economies with inflexible markets and poor supply responses.

This raises an interesting policy option. Should the product wage be kept down, if necessary by subsidies, to maintain competitiveness? One could argue that in the former GDR, regional wage subsidies would have been more cost-effective than paying unemployment pay, given that the ability to influence the real wage was lost by the labour mobility granted upon unification. The appropriate level of subsidy is the difference between the minimum feasible wage which does not induce excessive migration and the shadow wage. The shadow wage will be equal to the marginal product of labour at an optimal level of unemployment. This in turn will be determined by balancing the social costs of unemployment (including induced excessive migration) with the benefits of keeping wage demands low, encouraging the relocation of labour, and inducing the creation of small firms. Too high a level of subsidy will lead workers to successfully press for higher wages, though this may be countered to some extent by making unemployment pay a function of pre-reform real wage levels, and hence not manipulable by subsequent wage negotiations.

Wage subsidies thus make considerable sense in the former GDR, but are counter to the spirit of tax reform and making labour more expensive to enterprises in countries where real wages remain low. Given the fall in profits tax revenue, taxes on labour (either direct, or indirectly on consumer goods) will inevitably have to increase. The practical question is the extent to which wages are indexed in the transition phase.

The lessons from the Polish and Hungarian trade liberalisation offer two contrasts in the speed of liberalisation. Poland liberalised suddenly, with an over-devaluation relative to the equilibrium exchange rate. Hungary is making gradual progress towards complete convertibility, with the National Bank of Hungary still maintaining control over foreign exchange transactions (Abel and Bonin, 1991). Although other banks have been granted licences to engage in foreign exchange transactions, they are required to keep low working balances. In early 1991 the black market exchange rate was still 20% higher (in HUF/$) than the official rate, but the intention is to establish a domestic interbank foreign exchange market in the second half of 1991 which should eliminate the differential. Abel and Bonin find evidence that the Hungarian authorities have a real exchange rate target and are prepared to adjust tariffs to protect the balance of trade, as well as adjusting the exchange rate. Hungary has achieved an impressive switch of exports from Comecon to hard currency markets (as has Poland), arguably with a lower core rate of inflation. Both countries experienced a sharp drop in production, and a far less dramatic fall in employment, suggesting that much of the structural readjustment remains to be completed.

Trade liberalisation allowed the importation of a rational set of relative prices for traded goods, and is the least risky way of achieving domestic price liberalisation in economies with heavily monopolised domestic production and distribution systems. It provides incentives for entry and competition into distribution and ceilings on the prices domestic firms can charge. But if the exchange rate is to equilibrate the trade account, domestic production needs to become more price-responsive, and this will require far-reaching micro-economic reforms in management, in handling information on costs and margins (ie in the introduction of management accounting systems), in marketing, subcontracting, finance, labour markets, etc. The heavy burden of debt repayments denominated in hard currencies places an even greater weight on trade responsiveness to exchange rate changes and makes it even more necessary than in market economies that the government achieve macro balance to protect the balance of payments.

Liberalising capital flows

The case for liberalising foreign trade early in the reform sequence is powerful, and the worst fears of the possible adverse consequences have been allayed by the experiences of Poland and Hungary. Does it follow that the capital account should be liberalised at the same time? Foreign Direct Investment (FDI) is correctly perceived (at least, outside the USSR) as an attractive solution to the debt problem and to the lack of management and marketing skills. FDI is inhibited by fears that profits and capital might not be freely transferable at some future date. It could be argued that liberalising the capital account allays such fears, but exactly the opposite view could also be argued. There seem to be cogent practical reasons for not allowing residents the freedom to export capital, for a run on the currency (capital flight) can precipitate the devaluation and the imposition of exchange control which might prompt such capital flight. The problem is akin to bank runs, for which central banks stand ready to underwrite claims and so reduce the risk of illiquidity which might prompt the attempt to withdraw deposits. The difference is that without adequate reserves and/or agreements with foreign banks or the IMF, the central bank may not be able credibly to make foreign exchange available in adequate amounts in moments of crisis. Most Eastern European countries have large foreign debts, most of which trade at a discount, rather low reserves, and lack the interbank agreements characteristic of the G7 countries. Future full capital mobility is thus not fully credible, and it would require high (and therefore costly) current real interest rate differentials to persuade residents not to avoid exchange rate risk by moving their assets abroad. Even high differentials may not prevent sudden capital flight.

Hungary has had several episodes similar to capital flight in which domestic residents obtained foreign exchange for 'tourism' and promptly moved the funds to Vienna either to bank, or, more usually, to import consumer durables and cars (often for 'invalids', thus escaping import duty). Their adverse impact on the balance of payments did little to help economic management. Foreign investors who are offered the ability to repatriate an amount related to the initial foreign financed investment are more likely to believe in the future possibility of repatriation if they believe that the exchange rate regime will not be threatened by domestic capital flight. The model here is of Western Europe with its foreign exchange controls which survived most of the post-war period. (It is noteworthy that the UK liberalised during the period of oil surplus in part to encourage capital *export* and hence to lower the real exchange rate.) Although such controls enforced a closer match between investment and savings than might be efficient from the global point of view, they did so at lower real interest rates than has accompanied capital liberalisation. In any case, the ability of most of these economies to invest much more than they save is severely constrained by the size of their foreign debt. It is hardly plausible that prudent bankers would be willing to lend large sums to Hungary and Poland.

Indeed, for most countries (excepting the special case of the former GDR and the low-debt example of Czechoslovakia) DFI is likely to involve very little capital inflow for that reason, unless the investor is able to export a reasonable amount of value-added back to the parent company. Only then can the investor be reasonably secure about the prospects of repatriation until they have more confidence in the macroeconomic stability and degree of commitment to a liberal trading regime. Given the difficulty of achieving such credibility in the short to medium run, there seems little to be gained and much risked by a move to capital convertibility.

Privatisation

There is widespread agreement that concentrated private ownership of competitive unregulated firms is the best recipe for efficiency, flexibility and willingness to innovate. Diffuse ownership requires delegation to managers who have little direct stake in profits, but it also weakens the incentive to monitor the management. Monopoly or regulation reduce the pressures for efficiency and make it more difficult for external owners to assess reasonable levels of managerial performance. There is the additional cogent political argument that diffuse ownership of property constrains the expropriative and coercive powers of the state, and provides a defence against the erosion of political liberty. The problems are several - how to achieve concentrated ownership of individual firms with diffuse ownership of property as a whole, and how to move from the current concentrated state ownership of monopolised industries to this future private ownership economy. Owner management implies numerous small firms which are conducive to competition, and hence desirable for as large a fraction of the economy as possible, without foregoing significant scale economies. This in turn means that existing firms should be vertically disintegrated to encourage subcontracting and specialisation. Transport and distribution services should be divested forcibly to create the demand to match the potential supply of new small firms. Leasing assets and renting land are natural substitutes to sale which avoid the severe financial constraints created by the limited extent of private wealth and the underdeveloped state of the banking system.

The main impediment to rapid progress in those sectors where owner management is a practical proposition is the confusion created by restitution and the resulting insecurity of property rights. Unless this issue is rapidly resolved, small scale privatisation will be unnecessarily delayed. The cost will be high, as such privatisation has the greatest potential for revivifying the economy and creating the labour demand to absorb the unemployment inevitably created by any serious large scale industrial restructuring. Without a penumbra of small firms underwriting the ability of new firms to enter existing markets there will be no competitive pressure put on large firms, and the soft budget syndrome will continue, though now exacerbated by weaker fiscal control.

The questions surrounding the privatisation of large scale industry are whether the firms should first be restructured before or after privatisation, whether the process should be fast or slow, and whether the enterprises should be sold or given away. The questions are interlinked. Speed dictates a process closer to giving away unrestructured firms, while restructuring and/or sale at commercial prices will take time. The argument advanced here is that enterprises should be subdivided as far as possible before sale. In the former GDR, the 316 Kombinate were turned by the Treuhand into 8,000 legally independent firms, which comprised some 40,000 plants (Siebert, 1991). Ideally, the unit of sale would be the plant, but the value of a specialised subcontracting plant might depend on the unknown viability of the mother plant. Siebert argues that as the Treuhand does not have the information to judge which plants are viable and which not, the restructuring decisions must be left to the management or the new owner of the unreconstructed plant, though he recognises that plants should have the right to declare themselves legally independent. Presumably there is a strong incentive for plants which can survive (either with or without the mother plant) to so declare themselves independent, to avoid being accidentally liquidated if the enterprise as a whole is loss-making, or to avoid cross-subsidising other plants. On the whole this would seem to encourage the emergence of a vigorous small and medium firm economy with concentrated ownership but without concentrated wealth. The dangers are the usual ones of 'cream skimming' and leaving the state with the least valuable assets and least competent managers. It may be that there were genuine synergies which are lost in this process of voluntary fragmentation, though the evidence on the negligible gains from mergers in market economies suggests that these synergies are often exaggerated.

Siebert also supports the conclusion that firms wishing to be privatised should submit their firm to an open bidding process. This should do something to reduce the incentive to transfer valuable assets at low prices to owners who may not be those best placed to maximise their value. The main benefit may be the political one of creating the appearance of open-ness, honest dealing and equality of opportunity, as there may in practice be few potential owners able to bid in many cases. Nevertheless, if the process of privatisation is reasonably drawn out (as seems inevitable), and if it becomes widely known that bidding for such firms is a recipe for profitable investment, then foreign buyers are likely to be attracted by these sales. Even domestic savers may find institutions willing to pool their savings in mutual funds to bid for ownership of these management-initiated privatisations.

The initial enthusiasm for instant privatisation and the creation of active stock exchanges has given way to a recognition that this is impractical and in any case would not take the economy closer to that of a typical market economy. It is striking that by the end of 1988, pension-fund share holdings in both the US and the UK were equal at 30% of total listed share value. (*The Economist*, April 27, 1991, *Survey of*

International Finance, p8). Typically, rather few households own shares directly, and even fewer exercise any significant ownership/monitoring role over firms. Such oversight over large firms, to the extent that it exists, comes from pension funds, individually large share holdings (Hanson has terrified ICI by a holding of less than 3% of the voting shares), banks, and the threat of takeovers. Economies in which takeovers are unusual and share holding less widespread than the US and UK seem if anything to perform more successfully, casting further doubt on the need for an active stock exchange to promote efficient management.

It is also now more widely appreciated that the critical need in the coming decade is for an adequate banking system to finance and monitor private investment. The most obvious route to this is to encourage foreign banks to enter the economy and channel domestic savings to domestic investors. Such banks have the managerial expertise required, lack the 'old boy' ties to the *nomenklatura* which create suspicion if not outright incompetence, and provide the reassurance required by foreign investors. They are a potential lobby for appropriate infrastructural investment and legal reform. They would form the natural counterpart to the finance that the EBRD is required to channel to the private sector.

Conclusions

The main argument advanced here is that the inefficiencies and stagnation of Soviet-type economies are intimately linked to its monopolised production structure which in turn makes soft budget constraints almost inevitable. Given the potential bargaining power of the resulting monopoly enterprises, macroeconomic stability in such economies required expropriative tax rates on enterprises, or, in Tirole's (1990) terminology, very low-powered regulatory incentive schemes, with low incentives for efficiency. The economic objective of systemic reform is to improve incentives for efficiency, innovation and growth. If this is to be achieved without macroeconomic instability, the enterprises must be demonopolised, otherwise firms will retain the power and incentive to devote the now higher fraction of their profits under their control to increases in wages, investment and consumption. This will rapidly lead either to excess demand and inflation, or incentive-sapping controls and taxes (such as the excess wages taxes). Small firms without market power are disciplined by the credible threat of bankruptcy, which will compell them to hold down wages and choose investment prudently, and this should suffice to restrict create excess demand.

Liberalising foreign trade is a swift way of importing sensible prices and putting the traded sector under competitive pressure, but runs the risk that it does little to undermine the political power of the enterprises, who can effectively force the government to reimpose quotas, tariffs, or further devaluations which underwrite inflation. The major reform issue is how to mobilise forces for breaking up large state enterprises into smaller, privately owned firms, while maintaining macroeconomic stability and the necessary social infrastructure, both of which require considerable fiscal discipline. The need for fiscal discipline means maintaining low powered regulatory schemes for enterprises which remain in the state sector, and this has the added advantage of providing incentives to bud off plants and divisions which can move into the private sector to be subject to market rather than fiscal discipline. The main problem is to maintain momentum and commitment to the process of restructuring and privatising enterprises, to reassure those contemplating purchase and ownership of private firms, while not losing control over monopolies. Rapid privatisation of existing monopolies may lead to the worst of all possible outcomes: stagnation associated with inequality and social tension. Excessive caution may persuade investors that the government is not serious about moves to the market economy, and their incentives will then be for fast 'speculative' profits, exploiting ignorance and the confusions caused by instability, rather than for long term investments which make the creation of a reputation for honest dealing desirable.

Most of the sequencing issues resolve into three key concerns:

- ensuring or restoring macroeconomic stability,
- not ruling out options for subsequent reforms, and
- maintaining support for completing the reform process.

For example, macroeconomic stability requires demand management. Decentralisation tends to loosen fiscal control and needs to be sequenced carefully with reductions in subsidies or other government expenditure, and the imposition of wage controls and other means of monitoring and controlling enterprises. It may be that competitive markets, foreign trade and the monitoring of commercial banks are enough for smaller and privatised firms, but for the large state enterprises additional measures will be required.

Restructuring and splitting up large state enterprises before privatisations is essential to avoid continued monopoly power, as it is far more difficult to break up privately owned firms.

Creating decentralised and autonomous institutions (independent Central Banks, Anti-Monopoly Offices, Regulatory Agencies, etc) is a potentially good way of creating credible commitments to policy regimes, and hence entrenching the reform process.

These principles can shed light on some of the controversial sequencing issues. For example, should prices be liberalised before or after privatisation and enterprise reform? If the price reform increases competitive pressure (as with trade liberalisation) then it will harden budget constraints and may not prejudice macro-stability. Where it does not (for domestic prices set by monopolies) it will have adverse effects, and should be preceded by competition policy and other enterprise reforms, including possibly temporary low powered incentive regulation. Should large-scale privatisation be 'quick and dirty' or slower and more carefully planned? The argument for fast privatisation is that private property is seen as the key to incentives and the market economy, but without demonopolisation, which will take time, the effects may be hard to reverse and fail to achieve efficiency. The solution is to identify the sectors where firm structure is not an impediment to competitive pressure, and concentrate on these, while setting up devolved autonomous institutions which will remorselessly continue to restructure and privatise.

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