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PRIVATIZATION COMPLICATES THE FRESH START

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Putting Entrepreneurs First in the Eastern Bloc

Privatization Complicates the Fresh Start

by Peter Murrell

Quick privatization of state enterprises often is viewed as a necessary and sufficient condition for the success of economic reform in Eastern Europe. With private owners and market competition, it is assumed, large increases in the efficiency and output of the enterprises will ensue, and these increases will more than repay the political, social, and organizational costs incurred in the privatization process.

Yet restructuring old state-run organizations to enable them to function in a changed economic environment may prove even more expensive than the admittedly costly alternative of constructing new organizations. Thus, Poland's former finance minister, Leszek Balcerowicz, has emphasized that the costs of transition in Poland were much higher than had been expected.[1] And one of the reasons he cited was the slow pace of change in state-firm management.

The Trade-Off

Poland's experience confirms what one might expect for theoretical reasons, namely, that a trade-off exists between the privatization of the old state sector and the growth of a new private sector. Existing organizations have adapted in many ways to existing conditions: in everything from the behavior and language of their people, to the many commitments they have made to those people, to the very alignment of the organizational structure with the existing physical plant. Because of the difficulties of such adaptations, the restructuring of existing organizations involves costs that are not present in the construction of new organizations.

At the least, therefore, one cannot assume *a priori* that privatization is better than simply shutting down existing state enterprises in coordination with the gradual rise of new private enterprise. In the process of privatization, more capital may be used than would be required in the process of creating new firms, especially if "restructuring grants" (that is, government subsidies) are part of the privatization process.

[1] See "Bielecki, Balcerowicz Meet Press on Economy," Foreign Broadcast Information Service, *Daily Report: Eastern Europe*, May 14, 1991, from Warsaw PAP, May 13, 1991.

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Even in capitalist societies, large organizations are often unresponsive to new circumstances and thus new organizations are essential for change.[2] That is why new firms have proven themselves of enormous importance in creating new industries and in adapting existing industries to new technology.[3] The failure of existing computer firms to profit from the advent of personal computers, and the subsequent success of start-ups such as Apple and Microsoft, is but one example of this phenomenon. Surely the situation of newly privatized enterprises in Eastern Europe is every bit as demanding as that of an entrenched capitalist firm confronted by a new technology. Indeed, certain factors that give large established firms an advantage in market economies — economies of scale in science-based research and development and the benefits of accumulated learning-by-doing — will not be as relevant to the situation of large established enterprises in reforming economies.

The difficulties of reorganizing existing enterprises are especially great if restructuring requires fundamental changes in an enterprise's specialization, technology, or market orientation. As it happens, East European enterprises are likely to have to make changes of all three types. The first will be a change in specialization away from heavy industry. If one compares the size of the industrial sector in an average East European economy to that in the poorer West European countries, the over-production of industrial goods in the former is probably between 25 percent and 33 percent. Specialization in steel and in bulk chemicals, for example, will no longer be a feature of economic activity. Thus, large structural shifts will have to be made from industry to services; and, within industry, from heavy to light.

Secondly, changes in production technology will be needed because of the imposition of more stringent environmental policies, the higher quality demanded by new Western markets, and the reductions in the size of factories that are of an inefficient scale for a market economy. On this last point, East European economies would have to shut down half of the manufacturing capacity of their large plants (and create a similar amount of capacity in small plants) in order to obtain a distribution of plant size roughly comparable to that in Western Europe. In individual industries, such as textiles, the figure could be as large as 70 percent.

Lastly, large changes in market orientation will follow from the demise of the Council for Mutual Economic Assistance (CMEA — also known as COMECON) and from the East Europeans' attempts to make their economies more fully integrated with international markets. For example, light industry, such as food processing and apparel, will likely become a source of comparative advantage, given the low wage rates in Eastern Europe. But, if this is to occur, quality standards and attention to product design and marketing — ig-

[2] Kenneth J. Arrow, *The Limits of Organization* (New York: Norton, 1974), pp. 56-59.

[3] E. Mansfield et al., *The Production and Application of New Industrial Technologies* (New York: Norton, 1977), p. 16; P.B. Nelson, *Corporations in Crisis: Behavioral Observations for Bankruptcy Policy* (New York: Praeger, 1981), pp. 1051-2.

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nored within the CMEA — will have to play a major role in the decisions of firms.

The foregoing argument gains additional force when one focuses on the nature of entry and exit processes under capitalism. In a normal market economy, there is a substantial turnover of firms. For example, only 60 percent of large, new, single-plant firms survive their first five years of operation in the United States.[4] Given the status of East European enterprises — large organizations thrust into a new market environment — one expects their failure rate after privatization to be of the same order.

Too much effort is being invested in privatization, and too little in creating and fostering the development of new private firms.

In sum, then, it may be that too much effort is being invested in privatization, and too little in creating and fostering the development of new private firms. In many East European countries, policy toward the private firms can be characterized as one of benign neglect. Little attention is being paid to the question of generating the additional capital needed for investment in these private companies. To be sure, some authors, such as Jan Svejnar, have consistently emphasized the benefits that can come from new private firms rather than from privatized firms.[5] However, such emphases are not the major focus in the majority of discussions of the transition process. It is even common to see the terms "privatization" and "creating a private sector" used synonymously. Conversely, one rarely finds authors who emphasize the costliness of the privatization process and the need to slow down this process in order to channel resources to the private start-up businesses.

A trade-off does exist between efforts to create new private businesses and the speed of privatization. During the period of central planning, the state extracted surpluses from its enterprises and used these funds to reallocate investment across all sectors. During reform, the state can either surrender its claims on such revenue (through decentralization and privatization) or continue to use surpluses from state firms as a means to provide an adequate flow of finance for the growth of private business. Such state financing would not finance particular sectors or firms but could instead be chanelled through the banking system. Thus, an inverse relationship results between the degree of privatization and the rate of growth of private firms. Exactly this trade-off has appeared in the most dramatic way in Poland. The Huta Katowice steel plant is

[4] Timothy Dunne, Mark Roberts, and Larry Samuelson, "The Growth and Failure of U.S. Manufacturing Plants," *Quarterly Journal of Economics*, November 1989, p. 694.

[5] Jan Svejnar, "A Framework for the Economic Transformation of Czechoslovakia," *PlanEcon Report*, January 1990.

under consideration for privatization and commercialization, but the government is reluctant to begin the process because of the drop in tax revenue that will result.[6]

This inverse relationship also occurs because a significant part of the country's entrepreneurial talents and scarce financial infrastructure will be consumed in the process of privatization (for example, the creation of privatization voucher trading schemes and mutual funds, as in Czechoslovakia and Poland) rather than being freed to build up private firms. In addition, the desire to privatize ongoing operations, rather than to sell their assets by the piece, leads to a dearth of facilities, particularly buildings and land.

In conclusion, privatization appears to have gained too much prominence as an objective of reform policy. The appropriate goal is creation of private businesses. Privatization is only one route to that goal, and it might be a costly route, one whose implementation impedes the more effective route of creating private firms from scratch.

The Costs of Nonintervention in the State Sector

Organizations tend, not unnaturally, to continue behavior that has been successful in the past. Unfortunately, certain aspects of pre-reform enterprise behavior can be dysfunctional in a swift change to a market-regulated regime.

An interesting example of this phenomenon has been identified in capitalist economies in the period after deregulation of an industry. In such cases, for example in the U.S. trucking industry, it has been observed that firms continue cartelistic behavior, using the very instruments that were legal before the deregulation took place.[7]

In Eastern Europe, the old systems accommodated their arrangements to certain behaviors, such as the tendency of enterprises to disregard financial constraints when faced with more urgent demands. These arrangements were successful to the extent that they survived over a number of decades and kept large-scale economic imbalances from occurring in such areas as foreign trade and the government budget. In this way, the system accommodated the most immediate consequence of financial indiscipline among state firms, and imbalances did not threaten the short-term stability of the system. Of course, not all the negative effects of general economic imbalance on productivity, work effort, and quality were ameliorated. But policy and institutions under the old regime were matched to the behavior and expectations of enterprises.

With the destruction of old institutions, and a swift change to market-based stabilization policies, deep problems have arisen as the old patterns of behavior continue and the old expectations are still held. The essence of the

[6] *The Financial Times*, April 19, 1991.

[7] The trucking example is discussed in Robert D. Willig, "Anti-Monopoly Practices and Institutions," in Christopher Clague and Gordon C. Rausser, eds., *The Emergence of Market Economics in Eastern Europe* (Cambridge, Mass.: Basil Blackwell, 1992).

problem of economic stabilization — of ensuring that free markets are not accompanied by excessive levels of inflation — during reform lies in the incompatibility between the behavior of the old enterprises and the new market environment. One of the most important problems is the persistence of behavior that was learned under a regime of soft-budget constraints. As Janos Kornai has emphasized, soft-budget constraints for firms almost inevitably give rise to excess demand in the economy as a whole — loosely speaking, to spending more than the economy can afford.[8] When reforms are implemented, organizational behavior that led to excess demand in the past is likely to continue as an important factor in the economy. Thus, until large-scale restructuring has taken place, and the entry and exit of firms has been greatly facilitated, East European economies will have a strong tendency to generate excess demand, and thus will have a tendency toward high inflation plus low growth.

In Eastern Europe, during transition, direct controls on state enterprises may promote overall economic stability, and thus be preferable to market-based measures alone.

This prediction has been borne out in the reform experience of Hungary and Poland. Enterprises in those countries have used their previously learned behavior to ward off adversity in the new environment. In both countries, failing enterprises have been able to stall payments for inputs bought from successful firms, relying on the continuation of previous relationships. As a consequence, a very large growth of inter-enterprise credit has occurred in these two countries during the post-reform period, after the reforming governments tightened banking system credit. This growth of inter-enterprise credit can be viewed as a simple continuation of the passive monetary system of central planning, where creditors were largely unconcerned about the risks of non-payment. One East European banker, Lajos Bokros, a director of Hungary's Central Bank, explained the extending of inter-enterprise credit by saying "If only our managers had just once seen a company not paying its debt! But this is not part of our corporate culture." Hence, market-based stabilization policies will be much more costly for reforming economies during their period of transition than are such policies in economies with a tradition of markets and private enterprise.

Thus, the main policy conclusion for East European governments is that, during transition, direct controls on state enterprises may promote overall economic stability, and thus be preferable to market-based measures alone. At the least, since one is dealing with state firms, the usual presumption of non-interference in markets cannot be accepted without question. For state firms,

[8] Janos Kornai, *Economics of Shortage* (New York: North-Holland Publishing Co., 1980).

price and wage controls, direct credit restrictions, and exchange controls must be considered as potential candidates for use by national policy makers. Kornai writes: "Precisely because I am a proponent of liberalization of the economy . . . I would like to see tight control over the ways in which taxpayers' money is spent. In this respect I classify the manager of a state-owned firm among the state officers."[9]

There are also lessons here on the way stabilization programs should be implemented. Within the mix of old enterprises and new market institutions, people will have little knowledge of how their system functions. The early period of reform will be their major source of learning. While that learning is taking place, caution in reform is advisable, as is delay in taking any irreversible actions. Such irreversible acts include decentralization of state enterprises and loss of the government's political capital through a failure to keep commitments. Of course, such caution has a cost — half-way reform might not teach people the proper lessons. But these costs are small compared to the dangers of large, ill-informed, changes in public policy.[10]

When stabilization is considered within the context of the reform process as a whole, the creation of an economy based on private firms becomes the *sine qua non* of success. The essence of market-based stabilization policies is to contain the expansionary impulses of enterprises and firms, usually by imposing very tight monetary policies and high real interest rates. If state firms and private firms are treated equally, these policies will greatly constrain the growth of the new private firms, just at a time when the economy needs them most. In the Polish stabilization, tight credit applied both to the private and state firms, as did the draconian wage control policies. Thus, despite all the exaggerated claims for the growth of private business in Poland in 1990, investment in private business actually went down from 1989 to 1990.[11] This is another reason for questioning whether only market-type stabilization measures are to be used or whether more *dirigiste* policies might be countenanced in the state industrial sector.

Do Existing Institutions Have Any Value?

To some reformers, a market economy is synonymous with the decentralization of decision making, and thus the destruction of central planning is sufficient to create a viable market economy. This view was expressed by one top official of a reforming regime who proudly boasted of the "liquidation" of the central planning apparatus, at a time when no market economy institutions had been created.[12] That notion, together with a justifiable resentment against the center, probably contributed in no small degree to the destruction of the old

[9] Janos Kornai, *The Road to a Free Economy* (New York: Norton, 1990), p. 62.

[10] For further exploration of this issue, see Peter Murrell, "Conservative Political Philosophy and the Strategy of Economic Transition," *East European Politics and Society*, forthcoming, 1992.

[11] *Rzeczpospolita*, February 2, 1991.

[12] Private conversation with the author.

system of planning and control in many countries in the latter half of the 1980s, a destruction that took place before any market institutions had been created. But that same destruction, together with an accompanying decentralization of decision making, resulted in the loss of overall economic control that was evident in a majority of East European countries in the late 1980s.

This view of the market, as no more than decentralization, overlooks the role that institutions play in modern capitalist systems, and the way in which they contribute at the concrete level to general stability. First and foremost is the institution of private property, which gives the individual responsibility, most especially the responsibility for obeying budget constraints. Second are those institutions whose function it is to ensure that responsibility is certain and enforceable — for example, commercial codes, civil law procedures, collateral, and bankruptcy. Third are the institutions that monitor and control the behavior of people who hold the property of others in trust. The court system is chief among these, but accounting practices and associations, banking practices and regulators, stock markets, and so forth, also contribute. Lastly, one must not forget a whole set of expectations about the way other economic agents will behave, and these expectations apply most importantly to the actions (and nonactions) of government itself. In the foregoing, emphasis has been placed on the control functions of the institutions of capitalism rather than their incentive properties. There is no implication here that those incentive properties are less important in the long run. Rather it is the control functions that need to be emphasized in the present discussion.

Such institutions will take many years to create. For example, it takes five years to train a bank examiner in the United States.[13] Additionally, the privatization process is inherently a slow one. Thus, a decision must be made at the beginning of the reform process: How is society to exert that control over economic agents needed to preserve budgetary, financial, and monetary stability during the early stages of reform? Should these societies rely upon the disciplining force of the free market? Or should they use some of the existing state institutions — on a selective and temporary basis — to exert control over state enterprises in the period before market institutions are in place. (It should be emphasized that the nascent private firms should not be subject to the same control.) Although the decision to rely on the existing institutions is not politically attractive, certain economic arguments favor it.

The information and skills that people possess are attuned to existing institutions, and lose much of their value when those institutions are destroyed. Yet the creation of new institutions and organizations is a lengthy process requiring much trial and error. During the period of destruction and creation, uncertainty increases, and the value of information increases.[14] For this reason,

[13] Stanley Fischer and Alan Gelb, "Issues in Socialist Economic Reform" (World Bank, Washington, D.C., June 1990, Mimeographed), p. 17.

[14] James Hess, "Risk and the Gain from Information," *Journal of Economic Theory*, June 1982, pp. 231-38.

some economic value might lie in maintaining existing institutions, even though they are not the best from a long-run point of view, and even though there are firm intentions to scrap those institutions later in the transition process. This argument — that old institutions might be useful for temporarily carrying out the tasks for which they were designed — is the obverse of the argument that privatized firms might not be able to fit the requirements of the new capitalist market. Inefficient institutions may be better than ones that are expected to materialize, but that do not yet exist.

What possible job could the old institutions do in the early stages of reform? One capacity of traditional central planning was an ability to produce a semblance of general economic balance in foreign trade and in the credit allocated to the state industrial sector. If inclined to question the veracity of this statement, the reader should keep in mind the exact time periods when traditional central planning was operating. For example, Poland had essentially given up economy-wide balancing in the mid-1970s.[15] Until then, however, the traditional central planning systems had a passably good record on budgetary, financial, and monetary stability (though at a high cost in terms of economic efficiency). There is thus a *prima facie* case for keeping some elements of traditional central control in the state sector in the early stages of reform. In particular, it would seem that there is an argument for keeping some central control over the use of credit, access to foreign exchange, and payment of wages by state enterprises. This case is strengthened by the failure of all the decentralized socialist economies to achieve general economic balance and stability. (Privatization takes long enough that reforming economies are still dominantly socialist ones in the first few years of reform.)

Given the differing histories of the East European countries during the period of central planning, and given that each country is now at a different stage of reform, few general points can be made about them. Seemingly analogous institutions functioned with varying degrees of effectiveness in different countries. For example, the failure of central planners to exert their influence in Poland stands in contrast to the macroeconomic control achieved by the planners in Czechoslovakia through 1990. Reform and change might have already irreversibly destroyed many institutions of the old systems, as in the case of Polish central planning in the 1980s. Nevertheless, where the reform process is still beginning, policy makers should take stock of the effectiveness of existing institutions and ask whether some would be useful in the early stages of reform; for example, in the allocation of foreign exchange to state enterprises during the early phases of transition.

To sum up: a trade-off exists between reform of the old state economic institutions and the creation of new private economic institutions. This trade-off appears in two ways.

[15] J. Michael Montias, "Poland: Roots of the Economic Crisis," *The ACES Bulletin*, Winter 1982, pp. 1-20.

First, if old institutions are immediately scrapped, there is a correspondingly immediate need to create market institutions that control state enterprises. Assuming a scarcity of talented personnel, some of it must be used by the state institutions and firms, when it might be employed more advantageously in creating the private institutions that are most needed. For example, the creation of a commercial code is probably less important to state firms with their traditional ties than to new entrepreneurs who are building new commercial relationships and do not have the backing of the state. Hence, creation and enforcement of an authoritative commercial code at the outset of reform is essential if the emphasis is on the creation of a capitalist economy. But this element of the legal infrastructure will probably receive lower priority if the new free markets are still dominated by state firms.

Secondly, when the reforming government is not willing to use the old control mechanisms to constrain the activities of the state enterprises, the effects of state-enterprise actions are much more likely to impinge on the nascent private businesses. For example, if the state eschews all non-market means of controlling its own enterprises, monetary policy might need to be more stringent and foreign currency less available for private businessmen. The growth of the new private companies would thereby be slowed.

Reform Policy: A Fresh Start

When one acknowledges the competition for scarce resources between state enterprises and budding private enterprise, one weakens the case for a reform policy that focuses on privatization. Rapid privatization of state firms might actually impede the ease with which private firms can enter and exit the market. Since this entry-exit mechanism is vital for imparting dynamism to the reform process, the overall speed of change in the economy might be adversely affected by the effort spent on reforming state presence in the economy.

In general, actual reforms in Eastern Europe have proceeded at a much slower pace than Western economists first expected. In some countries, there have been significant reversals — for example, price controls have been reimposed on the state sector in Ukraine, Lithuania, and Bulgaria. Moreover, the need for non-market constraints on existing state enterprises has been recognized even in the policies of the fastest reforming countries: wages are still subject to very severe controls; full convertibility of currency has still not arrived; and domestic credit is still rationed. These constraints are consistent with the desire to create market capitalism as quickly as possible. However, if such policies of restraint on state firms are not to be a mere hindrance, they must be set within a consistent program that promotes the growth of capitalism.

One factor not considered here is the political dimension of reform policy, which is important given the linkage of democratic and economic transitions. The politics of each country will play a significant role in defining the exact implications of the foregoing arguments, for at least two reasons. First, the efficacy of the old economic institutions during the transition will reflect the extent to which these institutions were dependent on the structures of the old political system. The lesser this dependence, the more use the old institutions will have during reform. Secondly, it is possible that some reformers might see a non-economic, political need to destroy the old system. The structure and rhythm of the economic transition must certainly be attuned to the needs of the democratic transition from the old political structures.

How the West Can Help

At the moment, the conditions for Western aid center on a common theme. These conditions begin with an orthodox International Monetary Fund stabilization and liberalization package. Then, further aid from individual countries and from multilateral institutions is often conditioned on a commitment to rapid privatization. The basic premise underlying these conditions is that the state industrial sector is simply a set of repressed economic agents waiting for decision-making freedom and capitalist owners. But this premise ignores the history of these firms, which is now embodied in their very modes of behavior and organizational structure.

These conditions for aid programs may not be ones conducive to the fastest transition to capitalism. Problems of macroeconomic stability will be endemic in a system that treats the old state-owned firms as normal market participants. If control of those firms is limited to the indirect instruments of the market, the growth of the new private sector will be hindered enormously.

Western aid, and the conditions under which it is given, must focus on the extent to which the reforming countries promote the growth of the nascent private sector. Instead of help on complicated and risky privatization schemes, aid should be given for the creation of a legal structure facilitating the development of capitalist markets. Instead of insisting that state industrial enterprises be allowed to participate in free markets, multilateral institutions should focus on ensuring that new private sector firms are not squeezed out of credit markets by the old ties of the state enterprises and the implicit backing that these enterprises receive from the government.

Direct help for individual private sector firms is not needed in this process. As long as there is access to credit, to legal protection for private property, and to all markets, the new private sector will become predominant solely because of its faster relative growth based on its greater efficiency. (Even under far from ideal conditions, the non-state sector in China vanquished the state sector in under a decade.) But this process cannot occur if all the reform efforts of the society are geared to the process of liberalization and privatization of the state industrial sector. That is why the thrust of Western aid programs must now be focused on building a legal, institutional, and political framework for creating the new, rather than on changing the behavior of the old.

- 10