precipitated and it will not be carried out in such a way that it could hurt the prospects for greater economic and political integration.

On the other hand, in the end there was no question of negating the prospect of enlargement, were it only for clear political reasons. The European Agreements can be seen as an elegant way of balancing these somewhat divergent concerns. And just as a reminder, referring to countries that did not have such a vast structural adjustment agenda ahead of them, one shouldn't forget the time it took Great Britain and Spain to enter the EC.

5. Conclusion

The move from a centrally planned economy to a market economy involves a number of radical changes in the name of economic efficiency. Firms which used to be price setters have to get accustomed to becoming price takers, in line with the revolution that has turned a sellers' market – for what the term "market" was worth in the previous context – into a buyers' market. A demand driven economy has replaced a supply driven one. The most painful change of all will no doubt be the recognition that you cannot have full employment and stable prices in a market economy with a fiat currency. Despite the wastage of human resources that unemployment implies, it is a fact, a sad fact from a moral and social point of view, that the unemployment associated with a market economy is not as wasteful as the full employment associated with a planned economy.

Economic Inertia in the Transitional Economies of Eastern Europe[1]

DOMENICO MARIO NUTI

"No-one said it was going to be easy... and no-one was right...".
(President George Bush, after Yogi Berra).

1. Transition and economic recession

The restoration of capitalism, opened by the 1989 revolutions in Central and Eastern Europe and by the August 1991 coup/countercoup/revolution in the former Soviet Union, was expected to put those countries back onto the road to greater efficiency, technical progress, and prosperity. A "shock therapy" of price liberalisation, monetary and fiscal austerity, the opening of the economy to unrestricted free trade, and internal convertibility for residents, was understood to require initial sacrifices; however, thanks to stabilisation, privatisation and other economic and political reforms, these side effects would be short lived. In Poland, for instance, the government expected the Balcerowicz Programme to bring about a decline national income of 5% in 1990, with a positive supply response already six months after the beginning of the Programme (Lipton and Sachs, 1990). Western advisors and international organisations encouraged this expectation, in Poland and elsewhere (see Kolodko, 1992a, section 2, who reports their optimistic projections).

On the contrary, in all countries without exception, in the first two years from the beginning of stabilisation programmes – and so far in the first year in the former Soviet Union – the therapy has led to a drastic deterioration of symptoms and of general economic conditions, instead of the anticipated improvements. National income and especially industrial output, already falling in 1989, have accelerated their fall and then continued to decline at a lower rate, cumulatively by about 15% to 20% in GDP and by 25% to 30% in industrial output. Employment has fallen

1 Acknowledgements for useful comments are due to Conference participants (in particular to discussants Marie Lavigne and Vladimir Shemiatenkov, to Stuart Holland, Miroslav Hrncir, Dariusz Rosati and Robert Waldmann) and to Joly Dixon. The views expressed in this paper do not necessarily reflect those of the Commission of European Communities.

much more slowly, with an elasticity of 1/3 to 1/2 with respect to output,[2] though fast enough to create mass unemployment of the order of 8% to 12% of active population or more (13.8% in Poland in September 1992; in the former Soviet Union the rise of unemployment in 1992 has lagged behind output falls, but has been steady and will accelerate in 1993; see Standing, 1992a and 1992b). Initial inflation, often hyperinflation, has been brought down but has not been defeated (with the exception of the CSFR, however thanks to draconian taxation of excess wages, reminiscent of former wage controls).

By the end of 1992 the first signs of a turnaround have appeared in Poland, with sustained industrial growth on a month to month basis since April 1992, with September 1992 industrial output being 9% higher than in September 1991, and industrial output in December 1992 expected to be 13% higher than in December 1991. In October 1992 modest industrial growth has resumed in Hungary. In November 1992 Keith Crane presented a Conference paper entitled "The end of the recession in Central and Eastern Europe", noting the Polish and Hungarian signs of recovery (though yet insufficient to reverse GDP decline for 1992 as a whole) and forecast the resumption of growth also in Bulgaria and in the Czech republic (though the CSFR split will delay and slow down recovery; Crane, 1992). The UN-ECE (1992) takes a much more pessimistic view of 1993 prospects for the whole area except for Poland. Romania, not to speak of the former Soviet Union and Albania, are still in the grips of deep recession, expected to continue well into 1993. The restructuring of productive capacity, inappropriate with respect to world and domestic demand, to technical choice and environmental protection, has hardly begun and is being delayed by drastic investment cuts (see Kolodko, 1991a and 1992a; Nuti, 1992a). In 1988-91 gross fixed investment fell on average by about 37%, and in 1992 it continued to fall albeit at a much slower rate in Poland and the CSFR, while it fell precipitously in the former Soviet Union through 1992 (UN-ECE, 1992). Such investment trends encourage a sober view of medium run sustainability of incipient recovery (Kolodko, 1992b).

Production activities characterised by negative value added at current international prices, reputed to be of the order of as much as 20% to 25% of manufacturing in Poland, Hungary and the CSFR (Hughes and

2 This may suggest greater employment flexibility than in advanced market economies – as emphasised by Robert Waldmann – but the comparison is misleading in view of the depth of Central-Eastern European recession, which makes employment preservation there a different phenomenon from the temporary and modest labour hoarding by enterprises in market economies, facing cyclical drops in demand.

Hare, 1991 and 1992) and presumably accounting for an even higher proportion in the other economies,[3] have been cut but not eliminated and continue to destroy resources, with financial losses covered no longer by subsidies but by the accumulation of tax arrears and of bad debts towards viable enterprises and the banking system. Private activities have grown fast but from too low a level to compensate for the decline recorded in the state sector, still predominant due to delays in privatisation. Changes in relative prices, including drastic falls in real wages, have created incentives for technical substitution and profitable expansion but the system has not responded to such incentives with the expected speed. Instead of the desired *supply response, supply inertia* has been the standard predicament of transitional economies.

2. Three reactions: incredulity, complacency, gradualism

The deep recession observed in all transitional economies has given rise to three kinds of reactions on the part of observers: incredulity (things are not as bad as they look), complacency (things are nearly as bad as they look but this is exactly how they should be), advocacy of gradualism (the course is correct but its speed is excessive).

The first reaction is exemplified by Andrew Berg (1992) and Berg and Sachs (1992): private sector growth is underrecorded, quality improvements of products are unrecorded, the living standards improvements due to the end of shortages and queues are totally excluded from national income accounting; dollar incomes – for instance in Poland where an initially over-devalued currency gradually appreciated up to overvalued levels – have actually grown.

This optimism is totally unwarranted. In order to significantly offset public sector decline the growth of the relatively small private sector would have to be massively under-recorded. On the contrary, although the *level* of private sector output may still be under-recorded, certainly it is significantly *less under-recorded now* than it was before it was legalised and encouraged, therefore the *growth* of the private sector must necessarily be, if anything, *over-recorded*, as previously illegal or unrecorded activities surface to be observed and are better counted. Moreover, the economists employed by new governments are better than their predecessors; they are also better at statistical cosmoses and index

3 This is a consequence of the inefficiency of the system as a whole, due to inappropriate pricing, and not necessarily an indication of non-economic behaviour on the part of state enterprises, which had access to inputs – especially energy – priced well below world market levels relative to the price of their output.

number manipulation.[4] The consumer surplus resulting from better access to markets is never recorded in national income accounting and there is no reason why it should be on this occasion, especially in view of the parallel unrecorded welfare losses due to unemployment and generalised insecurity. The growth of dollar incomes is no consolation to wage earners whose domestic purchasing power is reduced by domestic inflation being much faster than dollar inflation, and who in any case make purchases almost entirely in domestic currencies.

The second kind of reaction is exemplified by Stanislaw Gomulka (1991a and 1991b): the recession is a disappointment and a "surprise" but what we are observing is a Schumpeterian process of "creative destruction", which is necessary to promote restructuring and subsequent growth. This argument may hold for some of the decline, namely for that due to reducing the large share of negative value added activities. But many of these activities have survived, and the observed output decline is greater than attributable to their reduction. There has been some overshooting, for instance of credit squeeze targets, with effects predictable to the point of not warranting surprises; some of the unemployment has often been Keynesian – i.e. generalised excess capacity without either excessive wages or an overvalued exchange rate. Most important, Schumpeterian "creative destruction" is the result of innovation, investment and competition, all phenomena which are scarcely present, if at all, in the transformation of post-communist economies. Destruction of the state sector has often been the result of a deliberate political design, in order to weaken the political strength of its managers as an organised interest group; "red barons" – for instance in Russia in 1992 – might restrain and slow down stabilisation and systemic transformation, but this is a typical ex-Soviet phenomenon not a general problem, and in any case there is no need to dress up this political strategy, costlier than more effective traditional political processes, with dubious euphemisms reminiscent of old-style propaganda.

The third reaction – advocacy of gradualism – is exemplified by Valtr Komarek in the CFSR (1992), and by the founding leader of the Russian Union of Industrialists and Entrepreneurs, Arkady Volsky (1992). In an article entitled "Economic shock therapy endangers the patients", Komarek writes "The issue is one of time, not intent. East European

4 See for instance the treatment of the Polish 1991 budget deficit, over half of which was made invisible only to reappear at the beginning of 1992; or the prompt correction of the November 1991 Polish industrial production index to allow for the difference in working days with respect to November 1990 (both on a monthly and yearly basis) – a correction which for the construction sector reversed the direction of change, but which was not made on other occasions.

economists agree on the need to establish market economies. The question is whether it should be done over two years or ten". Like many representatives of the opposition, he advocates gradualism instead; a similar position is taken in Russia by Volsky (1992), who argues for the resumption of price controls, exchange rate controls and forced surrender of export earnings, and continued though more selective ad-hoc subsidies to state enterprises: "The fundamental word is 'gradual', not 'landslide' transformation".

The range of available alternatives between gradualism and shock-therapy is significantly narrower than it is believed to be. On the one hand, a number of steps in stabilisation and reform can and must be nearly instantaneous: there is no conceivable justification for the postponement, by one single day, of the achievement of market clearing prices, a uniform exchange rate, decentralised foreign trade, the legalisation of private property and enterprise, and the beginning of privatisation. At the same time product subsidies, inflationary budget deficits, automatic credits to loss makers, and perfunctory interest rates, should come to an end as soon as possible. The dilution over time of these measures can only prolong the indignity and humiliation of queuing and shortages, inefficiency in foreign trade, the attenuation of incentives, and transform a price hike into an inflationary if not hyper-inflationary spiral; *a fortiori*, after painful measures of stabilisation, like those introduced in Russia in 1992, the reintroduction of subsidies, price and exchange rate controls (as advocated by Volsky), is a pointless and costly waste of sacrifices and time. In principle product price subsidies could be phased out gradually, in order to soften the blow of absolute and relative price changes on both producers and consumers. However for this to be a viable alternative it is necessary that: i) the goods should be available in the quantities demanded at the subsidised prices; ii) the budget should be in a position to finance those subsidies without higher inflationary strain due to monetisation of the budget deficit; iii) the subsidies should not prevent at least the beginning of efficient substitution of subsidised goods in consumption and production; iv) the unavoidable subsequent price increases gradually introduced should not trigger off an inflationary spiral prices/wages/prices. These considerations make a gradualist approach to the removal of subsidies somewhat problematic. Concern about the distribution effects of price increases should lead not to the preservation of product subsidies but to the introduction of more efficient income subsidies.

On the other hand, institution building can only be, and therefore must be, gradual, not out of choice but out of necessity: the process is time

consuming. The counterproof of this proposition is the sheer uniqueness of the East German case, and the exceptional circumstances which have allowed East Germany to adopt at a stroke the legislation, jurisprudence, factor markets, currency, financial and monetary institutions, tax system and tax collection, government administrators and government credibility – taking them from another country which happened to be nationally, linguistically and ethnically homogeneous, and to which it could surrender its sovereignty to reconstitute a previous existing national entity. The price was high[5] but reunification was regarded as a priceless good in itself (see Siebert, 1990a and 1990b; Jackson, 1991a and 1991b; Bryson, 1992). If we seek a parallel with enterprise restructuring, the German case resembles the restructuring of a weak enterprise not through internal reorganisation and rationalisation but through merger with or rather takeover by a stronger enterprise. Such instantaneous process is not repeatable except, perhaps not even in too distant a future, in the case of the two Koreas.[6] Everywhere else systemic change – no matter how fast – must necessarily be gradual: institution building – and above all the building of habits, reputations and trust – invariably takes time. Even mass privatisation, i.e. the instantaneous, free of charge transfer of state assets to the population, does not and cannot lead to instantaneous capitalism, as the change in property titles has no effect on efficiency without the building of more complex and time-consuming institutions such as stock exchanges, bankruptcy procedures, competitive commercial banking, and the "primitive accumulation" of financial capital (see Nuti, 1990).

In practice the only area where a significant choice between instantaneous or gradual transition is open to policy-makers is in the degree of protection to be granted to domestic producers. Trade decentralisation, trade opening and currency convertibility are enhanced by unrestricted free trade, but do not require it as an absolute precondition: they are achievable also with significant degrees of tariff protection. Unlike quotas and other non-tariff barriers, tariffs – like prices – are parametric instruments which do not suppress market response to changes in international demand and prices.[7] Temporary, uniform, non-discriminatory,

5 Transfers from West Germany amounted to $ 79 billion in 1991 and some $ 105 billion in 1992, more than double the amounts made available to the whole of Central-Eastern Europe and the Soviet Union (UN-ECE, 1992). These large transfers were partly due to the need to rapidly bring real wages close to the West German level, in view of unrestricted labour mobility.

6 China is a less likely occurrence, due to the marked asymmetry in the relative size of its two parts.

7 Even quotas, however, could be made parametric by auctioning import and export trade licences to the highest bidders.

relatively low tariffs have the advantage of raising revenue, alleviating the fiscal crisis that usually accompanies the transition. They also protect the output and employment of those enterprises which although unprofitable still produce a positive value added: many such enterprises do not cover their combined wage bill, amortisation and interest, and therefore are loss-making, but still make a positive contribution to national income and employment. Thus instant free trade, "the most liberal trade regime in the world" such as could be boasted at the inception of their programmes by Leszek Balcerowicz and Vaclav Klaus, respectively Finance Ministers of Poland and the CSFR, has a significant cost. Its main benefits are guidance in the search for new equilibrium prices in the chaotic move from macroeconomic and microeconomic disequilibrium to market clearing, and a stricter competition discipline of domestic producers, which can be important given the monopolistic and oligopolistic structure of state production and trade typical of the old system (see below, section 5); but even tariffs allow some competitive discipline, together with the reference function of the world price system. At a time of systemic transition and capacity restructuring the net effect of unrestricted free trade, at least in the short-medium run, is not necessarily positive. Indeed there is now an increasing consensus, among academics (e.g. McKinnon, 1992; Williamson, 1992; Portes, 1992) and international organisations including the World Bank and even the IMF (see IMF, 1992; Blejer and Gelb, 1992), that some of the recession was the direct consequence of premature free trade. It is significant that Poland soon reintroduced some tariffs in order to be able to negotiate their reduction in its association agreement with the EC (November 1991), while in October 1992 the Polish government decided to introduce a temporary 6% import surcharge, not only with IMF blessing but apparently at IMF instigation, so as to raise additional revenue of almost 1% of GDP in order to reduce its budget deficit.

If premature free trade may have caused some of the recession, its impact has been amplified and prolonged by these economies' inability to respond quickly enough to the economic incentives and disincentives provided by greater trade opportunities, i.e. by supply inelasticity –which we have called inertia. The same inertia must account for these economies' inability to bounce back after absorbing the effects of external shocks (such as adverse terms of trade changes, reciprocal trade multiplier effects of simultaneous decline among trade partners) and of policy errors (such as initial overshooting). *Ultimately, therefore, much of the depth and persistence of the recession can be attributed to supply inertia.*

3. The adjustment of households, private and state enterprises

Different economic agents have different speeds of adjustment to the new incentives and disincentives activated by stabilisation and reform. Households are quickest to adjust to the new environment: they react swiftly to price increases through income and substitution effects, formulate reasonable if not rational inflationary expectations, substitute between domestic and foreign currencies, hoard or dishoard in response to relative yields of financial and real assets, and adjust labour supply and effort supply to real wages and to the changing degree of market imbalance. The end of the traditional over-valuation of the domestic currency, and of the equally traditional excess demand for goods at previously fixed prices, bring about a price rise that is compensated by money wage rises only partly and with a delay. The net impact of the households' adjustment in these conditions is negative on demand and indeterminate on their supply of labour and effort, while the potentially expansionary role of lower wages on output and exports depends on the supply response of private and state enterprises.

Private enterprises, through self-employment and old and new firms, respond to market incentives less promptly and less intensively than households. They have short time horizons due to long memories of past reversals both in government policies and in the state of market supplies; are reluctant to invest and therefore tend to favour trade, services and low capital-intensity activities, and to seek high short term returns in their pricing and investment behaviour. They are subject to rigid supply constraints especially for fixed assets (buildings, land, sometimes also capital goods); they respond more strongly to generalised contraction of demand than to relative price signals. Cooperatives may be subject to additional rigidities and even temptations of perverse response if they are at all concerned with maximisation of income per cooperative member. All private enterprises will suffer from poor access to risk capital due to lack of collateral, and from the difficulties of reaching from the start the minimum size necessary for their efficient operation, which may be quite high with respect to private agents' ability to raise and pool financial resources. In a capitalist economy most of the private sector growth comes from the growth of medium size firms, and from new firms founded by medium and large size private firms, whereas neither are available domestically in transitional economies. Hence the rather sluggish response of the domestic private sector to the new incentives provided by stabilisation and reform.

This domestic vacuum can partly be filled by foreign direct investment and joint ventures; however these will be guided by the same short-term, trade-oriented, high-risk/high-mean-profit propensities of the domestic private sector, or will undertake purely "toe-in-the-water" small size strategic investments to establish a presence for their future potential expansion.[8] Private foreign capital cannot be expected to fully supplement the sluggish response of domestic supply to the new incentives until after the transition, i.e. after the economy is stabilised and has fully implemented financial markets, ownership protection, a sound currency, and political stability (Hungarian relative success in attracting foreign investment shows that these factors are more important than formal convertibility of the domestic currency, which by the end of 1992 Hungary had not yet introduced). In other words, foreign private capital will speed up recovery once it has started, but should not be relied upon to "jump-start" the economy.

The main source of supply rigidities is the state sector. We know a great deal about state enterprise behaviour (for instance from Granick, 1954 and 1975; Berliner, 1957 and 1976; Izelt, 1987; Portes, 1969; Kornai, 1986a and 1986b; Hare, 1990). All studies of pre-reform state enterprises stress behavioural rigidities, risk-aversion, hoarding, pursuit of physical and/or gross value indicators ("*kult vala*"; see Nove, 1958), reluctance to innovate, and weakness of financial constraints. How will state enterprises respond to the replacement of commands by profit opportunities, of centralised supplies by horizontal contractual links, of softer by harder financial constraints?

A tentative answer to this question can be outlined with the help of recent empirical investigations (e.g. Jorgensen et al. 1990; Maj, 1991; Schaffer, 1992; Estrin, Schaffer and Singh, 1992; Pinto, Belka and Krajewski 1992; Kotowicz-Jawor 1992; Standing, 1992a and 1992b). State enterprises will respond to tighter budget constraints, i.e. to harder money and the cuts in subsidies, by reducing activity levels; their craving for liquidity may lead them to seek export outlets, especially after substantial devaluations of the national currency, but they may be caught in a vicious circle. Namely, they need to import materials and equipment in order to promote their exports, but their import capacity is restricted by a weak domestic currency, harder money and high interest rates. The incentive to export may lead them to distress exports, i.e. characterised by

8 Foreign direct investment in five countries of Eastern Europe totalled $ 2.3 billion in 1991 and about $ 1.3 billion in the first half of 1992; most of it went to Hungary (48%) and CSFR (33%), and the flow remains very small with respect to foreign direct investment in developing countries, estimated at some $ 28 billion in 1991 (UN-ECE, 1992).

low or even negative value added when inputs are valued at their replacement cost. Tight budget constraints and fear of bankruptcy, in any case, may induce managers at best to seek economic viability, i.e. a rate of return *sufficient* to service debt, not necessarily to pursue profit *maximisation*. Given the low and often negative real interest rate,[9] and the low leverage (due to past self-finance and past injections of free capital funds from the state budget), financial viability may be relatively easy to attain. Once their financial viability is ensured they may stop exploring new cost-saving opportunities generated by a change in relative prices, and continue to hold surplus employment and to waste materials and energy. Their time horizon will be short, in the turmoil of "shock treatment" stabilisation and liberalisation; the high rate of return on inventories (both financial and in terms of production flexibility) may continue to favour speculative hoarding relatively to production. At worst, managers will take advantage of their often high degree of monopoly power, holding back growth or even cutting production in line with monopoly prices; will gain command over real resources by holding back payment of deliveries, taxes, loan service; disinvest and finance higher wages by consuming their capital; and appropriate directly or indirectly the capital value of their enterprise through subcontracting, leases, sales (the so-called "wild" or "nomenklatura" privatisation). Hence the sluggish, sometimes comatose, supply response of the state sector in transitional economies.

An obvious remedy to this unfortunate state of affairs is privatisation; not, however, *nominal or cosmetic privatisation*, i.e. the facile transfer of ownership titles to private individuals and institutions, but *effective privatisation*, i.e. the additional activation of financial markets, liquidation and bankruptcy procedures, competitive commercial banking, regulatory and supervisory bodies. The trouble is that effective privatisation, even for the strongest, most stable, determined and unanimous government, takes a great deal of time. In the usual case of weak, frequently changing, undecided and divided governments, effective privatisation may take an inordinately long time. Hence the depth and persistence of recessionary trends in transitional economies.

The thesis put forward in this paper is that this state of affairs is not a necessary concomitant of transition, nor a consequence of "shock therapy" which might be eased by a more gradualist approach, but the totally unnecessary consequence of policy failures. Namely:

9 In 1992 in Russia the point-to-point yearly rate of inflation was of the order of 2,000%, while the monthly rate in November 1992 was about 25% to 30%; these rates correspond to a backward looking and forward looking real interest rates both of the order of -90%.

First, the failure to modify performance criteria and the structure of penalties and rewards for the managers of state enterprises – aggravated by the failure to announce and consistently implement a clear and coherent privatisation programme and, more generally, by uncertainty and non-credibility of government policies.

Second, the failure to speed up as a matter of absolute priority some of the measures of the reform package: anti-monopoly action, liquidation and bankruptcy discipline, financial restructuring of enterprises and banks.

Third, government mismanagement of the state sector: inappropriate, excessive, and discriminatory taxation of state enterprises; the continued redistribution of financial resources between profitable and unprofitable state enterprises through credit policy; neglect of intersectoral and interregional supply links (with cascade supply multiplier effects, and the real costs of *tâtonnement* in search of new patterns of *recurring* supplies), including international supply links (i.e. lack of regional cooperation within ex-CMEA, ex-USSR, ex-CSFR, not to speak of ex-Yugoslavia).[10]

Some of these failures affect also the private sector directly or indirectly, i.e. through reciprocal state-private demand and supply conditions and the general economic environment; however the treatment of factors affecting specifically the supply response of the private sector is outside the scope of this paper.

To a very great extent, these failures are linked with ideological totems and taboos, namely obsession with mass free privatisation and with instant free trade, and prejudice against the state sector and any attempt at its improvement and reorganisation.

Unchanged managerial penalties and rewards

4. Unchanged Managerial Penalties and Rewards

Enterprise managers throughout the world derive direct and indirect utility from the size of their establishments, as measured by employment or capital or output, and the growth of these measures: apart from direct satisfaction, these variables affect status, salaries, and career opportunities. The primary difference between managers of joint stock companies and those of state enterprises (especially if operating in a centrally planned economy) is not one of organising ability, drive, initiative, and imagination, but in their incentive structure and operational environment. Managers of joint stock companies are induced to attach impor-

10 These propositions are developed further in Nuti and Portes (1993).

tance to profitability and to stock market assessment of profitability prospects: profits are sought to self-finance and externally finance growth, to benefit from profit-linked bonuses and from the exercise of stock options, to protect managers from bankruptcy and from the potential threat of raiders who might replace them if they neglect opportunities for profits. Managers of state enterprises are not dependent on profit for their investment and growth, are safe from takeovers and bankruptcies, their incentives are geared to the degree of fulfillment of government objectives (in terms of output, employment, investment, prices, regional location, etc.). In addition, in the centrally planned economy state managers are input-constrained not demand-constrained, and have no control over prices.

Entrepreneurship, which was defined by Schumpeter (1950) as a combination of organisational skills and the ability to anticipate demand, is not absent in state enterprises, even in centrally planned economies; it is modified, oriented towards the security of supply sources rather than the penetration of market outlets, directed towards playing strategic games with central planners – anticipating *their* demands –instead of potential competitors and clients.

In the standard transitional set-up state managers are gradually liberated from central control. Their dependance from branch Ministries is loosened (in Hungary, this was already achieved in 1984-85); direct commands are replaced first by government contracts (Russian "*goszakazy*" or Polish "*zamowienia rzadowe*", voluntary but attractive because they involved guaranteed supplies of inputs and foreign exchange), then by contracts with suppliers and clients; their subsidies are cut but they can fix their own output prices. They have to search for new supply links and for new sales outlets; new and free market prices for inputs and outputs create opportunities for profitable input substitution and product differentiation. Their external financial resources from credit and budgetary allocations are squeezed; interest rates are raised substantially in nominal and real terms; fiscal pressure is made harsher.

State enterprise managers will certainly appreciate the new conditions and begin to adjust to them at once. But the performance of their enterprise is not judged by anyone according to their profitability, and there is no capital market to assess the value of enterprises as going concerns, nor are there potential raiders. Even if managers were concerned with bankruptcy constraints, they would continue to be motivated by preserving size – i.e. employment and output – and maintaining wage levels, far beyond the levels that would maximise the value of the enterprise, indeed right down to the point where the enterprise has zero net capital value –

beyond which the bankruptcy constraint might begin to operate. In Poland and Russia managerial salaries are often a multiple of the average salary of enterprise employees; this is a clear inducement not only to pay-out after-tax value added as wages, but to consume capital, paying wages also out of amortisation funds. The bankruptcy constraint, if felt, will force the reduction of loss-making activities, but once that constraint is met those activities will continue, cross-subsidised from other parts of the same enterprise, out of concern for the size of employment. But there will not be much profit, or even amortisation funds, available for reinvestment. Hence the simultaneous maintenance of some non-viable activities and the failure to invest in new or modernised capacity. This tendency will be reinforced by general uncertainty about government policies, and by specific uncertainty about privatisation: i.e. about whether or not the enterprise will be privatised, when, whether through direct sale or free distribution, with or without a privileged treatment of employees.

The simple transfer of ownership is unlikely to induce more efficient behaviour on the part of enterprise managers until they are subject to effective control on the part of financial markets, through the exercise of shareholders' voting rights, their sale together with the sale of shares and the associated threat of hostile takeovers. Neither the dispersion of shares across a large number of private shareholders, nor the concentration of shares in investment trusts is bound to implement such effective control: diffused share ownership will leave managers still quite comfortable in the exercise of their discretionary powers, while there is no reason to expect that investment trusts owned by a large number of uninformed investors will behave differently from the state holdings which have been rejected (perhaps wrongly? see Kumar, 1992) as inadequate forms of "subjectivisation" of ownership. Moreover, even if privatised state enterprises were instantly more responsive, privatisation will make those enterprises which have not been privatised even less responsive than they may have been in the past, because of additional uncertainties about the timing of further privatisation and about how managerial performance is going to be assessed and rewarded or penalised. The only managerial inducement to maximise profits in not-yet-privatised state enterprises is the hope of a merger with a joint venture or of a sale to a foreign company; even then managers' efforts may be diverted to strip assets to their own advantage rather than to maximise the return on the assets in their firm's possession. On balance, until privatisation has reached a critical mass its net effect on the bulk of former state enterprises may very well be negative rather than positive.

5. Slow implementation of essential reform

The adverse effects of an unchanged incentive structure are amplified by the usually slow progress of essential reform steps, namely the break-up of monopoly power; the implementation of liquidation and bankruptcy procedures; the financial restructuring of enterprises and banks.

i) Typically, centrally planned economies were characterised by extremely high industrial concentration, with single-product producers and producer associations responsible for supplying not only domestic markets but often the entire CMEA and exports to the rest of the world (see Newbery and Kattuman, 1992). Once enterprises are given decisional autonomy about their pricing and output, the monopoly and oligopoly power built into such industrial concentration and specialisation is bound to exacerbate inflationary and recessionary trends. The need for competition to ensure a sizeable supply response has been emphasised by Michael Burda (1991) and has led to calls for front loaded trade liberalisation and convertibility (Newbery, 1991).

The adverse impact of monopoly needs some qualifications. On the one hand, the temptation to maximise monopoly profit *per employee*, which might be present without a change in managerial performance criteria and incentives, is bound to encourage a more monopolistic behaviour than that of an ordinary monopolist maximising the absolute level of profits (Meade, 1972). On the other hand, once the structure of managerial incentives has been adjusted to the new system (see section 7 below), even monopolies will still respond to changes in demand and cost conditions, economising dearer inputs and raising the level of more profitable outputs. Therefore "entrepreneurial" enterprises, though monopolistic, are more flexible than unchanged state enterprises which, though stripped of their monopoly power, remain old-style inert administrative units. However, during the process of stabilisation, if we abstract from relative price changes,[11] the move from low-profit near-full capacity output to a monopoly-profit lower-level output is undoubtedly recessionary, whereas a move to a new competitive equilibrium would have been less recessionary or possibly not recessionary at all (depending on the relative position of initial and competitive output levels). Moreover, the anti-inflationary monetary policy pursued by the government, together with the price rise involved in monopolistic behaviour, and the high

11 I.e. we postulate that cost and demand curves remain unchanged in real terms. Relative price changes complicate the picture but do not introduce a systematic bias in the relative position of the new competitive equilibrium with respect to the initial output level.

wages that might be paid including an element of monopoly profit,[12] are also recessionary.

ii) Delays in the implementation of liquidation and bankruptcy procedures[13] are responsible for enterprises being able to pursue with impunity policies of greater disinvestment than those allowed by a solvency constraint, for the purpose of maintaining higher wages and higher, non-economic employment than otherwise would be the case. The lack of liquidation and bankruptcy procedures also enables enterprises to indefinitely postpone the payment of debt-service to banks, of goods and services to suppliers, of tax to the state budget. Arrears towards the state budget and banks are equivalent to a monetary expansion,[14] whereas inter-enterprise arrears involve a redistribution of profit from viable enterprises with a growth potential to non-viable enterprises which use it to sustain non-economic employment and output: the same process of inflationary disinvestment occurs as a result (Nuti, 1992b).[15]

iii) The enforcement of liquidation and bankruptcy procedures requires the prior financial restructuring of enterprises and banks; otherwise it might lead to the destruction of activities which, although unable to make enough profit to service past debts – incurred under a different system and therefore to be disregarded – have a present value as going concerns higher than their liquidation value. Thus inviable activities should be closed down and bankrupted, viable activities should if necessary be recapitalised through new capital injections or debt cancellation, with banks also recapitalised to make up for cancelled debt (Nuti, 1992b). Recapitalisation of state enterprises and banks is a net claim on the state budget, in competition with other claims, in consideration of

12 A special form of monopoly profit may be the exclusive or privileged access to under-priced non-reproducible natural resources.

13 On the specific problems of implementing bankruptcy procedures in transitional economies see Aghion, Hart and More (1992).

14 Of course inter-enterprise arrears do put pressure on monetary authorities to expand the money supply in order to extend credit to them: see the credit concessions granted by the Governor of the Russian Central Bank, Viktor Gerashchenko, to Russian enterprises in mid-1992. However this is not the same thing as arrears *being* automatic additions to the money supply.

15 Not all inter-enterprise arrears are necessarily bad loans. Let us call "primary arrears" the excess, if any, of an enterprise's overdue debts over its overdue credits, and "secondary arrears" all its other overdue debts (i.e. that part of its overdue debts which is covered – or more than covered – by its overdue credits). Then only primary arrears can be bad debts, and even those may partly reflect a problem of liquidity and not one of solvency.

which it may have to be postponed; however a case ought to be made for postponement rather than for early recapitalisation.[16]

6. Government mismanagement of the state sector

Beside the policy omissions listed above, governments of transitional economies have undertaken active policies which account for the further promotion of state enterprise supply inertia.

i) State enterprises have been subjected to inappropriate, excessive, discriminatory taxation. The tax basis has often been inappropriate, because unrelated to enterprise performance. Such is the nature of the Polish so-called "dividend", which is levied regardless of actual profits and of required reinvestment finance and is therefore not a dividend at all, but a tax geared to the state equity stake in enterprise capital, revalued in line with inflation – a historical accident. Another inappropriate form of enterprise taxation is that on excess wage payments over and above mildly indexed guidelines (Polish PPWW or "*Popiwek*", and a similar tax in Hungary; the highest rates are levied in the CSFR). After the initial exaggerated and unintended real wage fall due to higher than expected inflation, the unavoidable recovery of real wages has turned excess-wage tax into an inflation-multiplier by raising money wage costs of enterprises by a multiple of the money wage increase successfully claimed by workers to recover some of the excessive initial real losses. Through this mechanism the *Popiwek* tax is bound to have sometimes amplified cost-inflation.

State enterprise taxation has also been often excessive: in the first 11 months of 1991 with respect to the corresponding period of 1990 in Poland the total tax burden as a percentage of gross profits in state enterprises had gone from 50.6% to 106.4%, i.e. absorbed more than the total gross profits; profit tax rose from 37.7% to 53.4% of gross profits, while the relative weight of both "dividend" tax and excess-wage tax had increased considerably (respectively from 7.4% to 21.5%, and from 5.6% to 29.7%). A sectoral breakdown of such tax burden gives percentages of gross profits of 200% or more in coal (291.7%), iron and steel (382.5%), electromachinery (249.0%), light industry (200.0%). It is no

16 Portes and Begg (1992) argue that recapitalisation makes no difference to the net wealth of the state "if properly accounted". Of course in a trivial sense the payment of any debt makes no difference to anybody's net wealth, whether creditor or debtor, but all the same debt repayment is a net claim on the debtor's current cash flow. Thus recapitalisation either is a net injection of liquidity into the system, or crowds out other forms of expenditure.

wonder that, in such conditions, amortisation funds become the primary source of state enterprise investment (Kotowicz-Jawor, 1992). At that point a positive supply response becomes impossible not because of non-entrepreneurial behaviour of state enterprises, but because of their deliberate crippling by government policy.

State enterprise taxation has also been discriminatory: in Poland neither *Popiwek* nor capital taxes have been levied on private enterprises, which also explains the differential supply response of the two sectors. In 1991 (first eleven months) the tax burden on Polish private industrial enterprises has been 54.9% of gross profits, instead of the 126.4% burden of state enterprises (Kotowicz-Jawor, 1992). Similar privileges are accorded to the private sector in other transitional economies, contributing to a generalised fiscal crisis. Of course the traditional penalisation of the private sector should have been ended, to put both sectors on an equal footing; but government policy has been reversed, with undoubted adverse effects on the efficiency of resource allocation. What is striking, however, is not only the tax differential but also the inordinately high fiscal pressure on private profits – another factor frustrating recovery.[17]

ii) At the same time, cross subsidisation within the state enterprise sector has continued in practice, no longer through fiscal policy, i.e. lump sum and product subsidies (though enterprises have been allowed to accumulate unpaid tax bills), but through monetary policy. Namely, credit-worthy state enterprises have been subjected to indiscriminate cuts in their access to funds, while ailing state enterprises (even in the CSFR, and even notoriously unviable enterprises, for instance in the aluminium industry) have still continued to benefit from generous credits or from official acquiescence to the build-up of unpaid interest and amortisation on their outstanding loans.

iii) Finally, there has been a neglect of the preservation of essential intersectoral and inter-regional supply links. Switching from direct or indirect (through government purchases) central allocation to direct contracts between enterprises, short-term profit opportunities have been pursued at the expense of longer term supply links. The initially gross under-valuation of the currency, induced to support convertibility, has diverted to exports output which could not be internationally competitive in the medium-long run, disrupting traditional supply lines and leading to either unused capacity due to input shortages or to "distress imports" of

17 By comparison, in the European Community direct taxes on enterprise revenue and capital, as a percentage of gross operating surplus, averaged 12.3% in 1990 and 11.4% in 1991 (for the aggregate of state and private, financial and non-financial enterprises), ranging on average in 1991 from 6.0% in Belgium to 25.1% in the UK.

crucial components – often the same which were the object of "distress exports". While there is only anecdotic evidence of such phenomena, whose quantitative impact cannot be assessed, there is strong reason to believe that the disruption of international supply links – within ex-CMEA, ex-USSR, ex-CSFR, ex-Yugoslavia –has been a significant factor in the recession. The gains of political and economic independence have had a tangible cost in terms of mutual cumulative losses due to falls in the volume of transactions, especially with the switch to trade settlement in scarce hard currencies (see van Brabant, 1992; Rodrik, 1992a and 1992b).

7. Policy implications

The supply inertia deriving from the factors discussed above is a distinctive feature of the stabilisation and liberalisation experience of post-communist economies with respect to otherwise fairly similar attempts of developing countries, also undertaking stabilisation, privatisation and deregulation on a smaller scale. The costs of transition – over and above the legacy of the old system, premature free trade, deflationary overshooting – are to a great extent the result of neglecting such "*differentia specifica*", which is only beginning to be researched by the economics profession.[18] These costs could and should have been and still may be contained, by tackling systemic inertia and tailoring economic policies to the degree of success in restoring system vitality. This involves *not slowing down or reversing the path of transition*, as argued by most of the critics of stabilisation and reform plans, *but speeding up some of it, altering some of the policies in directions which mostly have been barred by ideology, and paying more attention to the sequencing of those reform steps which necessarily take time to implement.*

18 See for instance Norman (1992), reviewing the Amex Bank Review Prize Essays by Richard Rose, Michael Dooley and Peter Isard, Sweder van Wijnbergen (in Dooley et al., 1992, forthcoming). Rose argues the need for constructing a "civil economy" and "the rule of law" in the region, involving legislation on property rights, enforcement of contracts, security of investments. Michael Dooley and Peter Isard argue that special care must be given to institutions, incentives and planning: "Although we have great respect for the power of markets to help countries in transition join the rest of the world in the benefits of market oriented institutions, we see great danger in overlooking the non-market institutional structure upon which markets depend"; employment contracts, banking regulations, bankruptcy laws, payments systems "typically receive little attention in discussion of macroeconomic policy design". Van Wijnbergen argues that "Eastern Europe is not well served with straight textbook advice".

On or before day 1 of the shock treatment, state enterprises could be turned into joint stock companies (which can be done overnight). Managers could be asked to attach a value to their companies at which they would be exposed to privatisation if bidders came along, and on which they would have to make a normal rate of profit thereafter (including subsequent capital growth), obtaining a prefixed share of profits above that norm (for an illustration of such procedure see Nuti, 1988). Employees could be given a year's wage worth of shares at that valuation, transferable to other holders gradually over the following five years. This set up would expose managers to a discipline equivalent to that of their capitalist counterparts: they would benefit from profitability, reinvestment and growth, and they would be subject to takeover of physical assets if their own valuation was too low; employees would not have the same incentives to press for distribution of profits and assets as they have otherwise; in due course the development of a stock exchange – which could progress at the same time – would strengthen this incentive structure and bring it closer to the standards of advanced market economies. There must be a presumption that these changes would improve the performance and supply response of state enterprises, without any prejudice for either the progress of privatisation, which could still go on at the maximum practicable speed, and for the development of financial markets.

Monopolistic behaviour can be checked by external competition, even for a moderate degree of tariff protection; by splitting enterprise associations and multi-plant enterprises, which can be done fairly quickly; by setting upper price limits not administratively but with direct reference to world price levels.

In the delays of implementing liquidation and bankruptcy procedures, disinvestment can be prevented by legal obligations to maintain the level of enterprise real capital (assessed as indicated above, and not on the basis of historical capital, even if revalued in line with inflation).[19] The accumulation of inter-enterprise arrears can be prevented by the automatic application of punitive interest rates on such arrears (as attempted in Hungary, though at too low a rate to make a significant difference), or by the outright imposition of a cash pre-payment constraint (as established but only partially enforced in Russia in mid-1992).

Recapitalisation of state enterprises and banks – which for instance in Poland is coming to the fore only two-three years after the beginning of its stabilisation and reform programme – should be an early and urgent

19 This kind of obligation was typical of the old-style Yugoslav enterprise; see Uvalić (1992).

undertaking, worthier of Western support than the achievement of formal convertibility at fixed exchange rates.

State enterprise taxation can be levied on indicators of actual performance, at rates that allow enough reinvestable profits to enable enterprises to finance restructuring directly and through external funds, on an equal footing with the private sector. Their access to finance should neither be automatic, nor automatically barred, but based upon an evaluation of their general credit-worthiness (after the revaluation of enterprise capital and the recapitalisation mentioned above) and of the prospective present value of investment projects for which funds are being sought.

The disruption of essential intersectoral and inter-regional supply flows could be avoided domestically by the diffusion of greater information about enterprise input requirements, without reinstating any administrative planning machinery, and perhaps by giving long-standing large-scale buyers a pre-emption right to domestic supplies. Internationally, the simple introduction of automatic multilateral clearing, i.e. the transferability of bilateral trade balances among trade partners within former trade blocs,[20] even without attempting anything as ambitious as a payment mechanism such as the post-War European Payments Union,[21] could help preserve or restore those trade flows which – given the sunken costs of past good and bad investments – still correspond at least temporarily to comparative advantages.

20 Trade among former Soviet republics, in particular, has been disrupted by two totally unnecessary factors: i) the continuation of state purchase orders for the implementation of inter-state trade agreements (prices are fixed at too low a level and orders are not fulfilled); ii) the irrationality and instability of republican monetary regimes, amounting to a combination of roubles, rouble substitutes circulating in parallel, new republican currencies, together with the continued segmentation of monetary circulation between cash and non-cash circuits. The additional segmentation, from 1 July 1992, of rouble means of payments in republican Correspondent Accounts with the Russian Central Bank (which can be used to pay for net imports from Russia) and ordinary roubles, has effectively ended the rouble zone; see Nuti (1992c).

21 An EPU-type mechanism would involve, in addition to automatic multilateral clearing, also mutual credits, trade partners' discipline preventing large scale surpluses and deficits, and a large scale injection of external aid.

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