

# **Enterprise reform and increasing inequality – privatisation with no restructuring?**

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## **1. Introduction**

Early 1990's witnessed the start of huge political and economic reforms in Central and Eastern European transitional economies. These developments have been greeted with enthusiasm, support and advice from countries more familiar with market processes. On paper most of the reforms that awaited the countries in the former socialist block seemed relatively simple to achieve. For example liberalisation of prices and trade requires nothing more than an abandonment of restrictions and planning. Even the fundamentals of enterprise restructuring do not appear to be that complicated. The first policy advice for socialist economies willing to become market economies was simply to substitute public ownership with private.

Privatisation has proceeded in an unforeseen speed after the collapse of central planning. For small firms in retail sale, handicraft etc. there were no reasons to delay the inevitable process. Giving property rights to those who had been responsible for controlling small firms' activities already during socialist times is not expected to have any negative consequences. But even the privatisation of large and medium-sized enterprises was done very quickly. By the first half of 1996 the share of privately owned big and medium-sized enterprises had risen to more than 50 % in many transitional economies, including Russia (CCET 1995). Reforming large enterprises at such speed will have a dramatic impact on the corporate governance of these enterprises and the consequences for the aggregate economy – as it is easy to say afterwards – were different than just improved efficiency and better management.

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As tempting and easy as the idea of privatisation may have sounded, the most important step in transitional economies' enterprise reforms is not necessarily finding private owners as quickly as possible. Although theory on market economics says very little that questions the benefits of private ownership, "Western" economists did not have sufficient knowledge on the institutional background in transitional economies and on their initial conditions that make enterprise reform particularly difficult.

In this paper I do not intend to disagree with the superiority of private ownership from an enterprise's point of view. In transitional economies the goals of increasing incentives and getting rid of monopolies were stronger than in post-industrial market economies of Europe, North America and East Asia. Privatisation was certainly one step towards the right direction. However, what I do disagree with is the simplistic idea of finding private ownership the sufficient condition for a successful enterprise reform. Restructuring decisions have not always been done according to the ownership form. There have many been obstacles to enterprise restructuring especially in Russia and other countries of the former Soviet Union. This paper tries to solve problems related to slow restructuring from what could be called an institutional point of view.

I will start by summing up some institutional developments that have a strong impact on restructuring decisions of state-owned enterprises in chapter two. Chapter three sums up theories on a dual economy that have been designed for developing economies since early 1960's and looks at similarities between the conventional dual economy framework and the post-socialist economies. Chapter four applies the theory for a two-sector economy to the restructuring process in transitional economies. The final chapter concludes and gives some policy suggestions.

## **2. Some institutional aspects on the development in post-socialist economies**

To see why restructuring has not been taken place in a similar speed than privatisation one should first look at some deeper problems of post-communist societies. Since insider privatisation was a widely used method and in some cases a necessity to get rid from existing owners quickly, a useful way to start is to look at the changes in utilities and objectives of enterprise workers. Even if an enterprise is not owned by its workers, insiders were able to control the decisions of the management and delay reforms that are not seen as beneficial.

The following changes in transitional economies have occurred rapidly in the past decade and their impact on enterprise restructuring should not be undermined:

- i) Of all economies in the world socialist countries had smallest income inequality (see Milanovic 1998). The Gini coefficients of most Central and Eastern European countries were between 20 and 25, lower than in the most equitable market economies (for example the Scandinavian countries) and even for most of the former Soviet republics the figures were clearly below 30. Since most assets were owned by the state or collectively there was basically no wealth inequality. After transition both the distribution of income and wealth have become more unequal. The consequences of the increase in both wealth and income inequality have varied widely among different countries (Honkkila 1997).
- ii) Probably one of the best achievements of socialist economies and one major reason for low inequality was full employment. During the transition to market economy full employment clearly could not continue and unemployment figures have increased in Central and Eastern Europe and in the republics of the former Soviet Union. The official unemployment rates unfortunately do not tell the whole story – hidden unemployment is probably much larger than in most other industrial countries.
- iii) Because of the reform in labour markets and changes in industrial structure the demand for skilled workers has increased in spite of an overall decrease in labour demand. This will give a new kind of significance for education policies and on-the-job training. Even though enrolment rates were high in socialist economies, a large part of the human capital acquired has become obsolete or has lost its value due to the changes in industrial structure. Therefore the distribution of human capital has become more skewed. In addition, returns to skills and education have risen (Rutkowski 1996).
- iv) Privatisation of control rights in enterprises means that decisions on labour and wages no longer are made by state officials. In spite of that, the heavy subsidisation that gave socialist firms soft budget constraints is still continuing either directly or in the form of non-payments of taxes or payment arrears. In transitional economies insiders – enterprise workers and managers – have frequently obtained a significant share of ownership. Regarding all the issues mentioned in i) – iii) restructuring decisions are not necessarily

always made on the basis of profit maximisation. On the contrary, if restructuring is assumed to be an endogenous process dependent on the utility of workers, it is not at all clear that private ownership has changed much in the decision making routine of enterprises.

The problem that enterprises face after privatisation are strongly affected by these developments. Income and human capital inequality can have extremely negative effects on restructuring, since enterprise restructuring is affected by the objectives of enterprise workers. Also the impact of these institutional changes on the macroeconomic level should be derived from the micro-level decision making in privatised enterprises. The concept of endogenous restructuring – decisions on whether to restructure and join the private sector or to delay restructuring and continue a survival strategy with excess employment similar to that of the socialist firms – is the main topic of this paper. The problem is that restructuring is not beneficial to all employees in state-owned enterprises. Therefore restructuring even in privatised enterprises has not proceeded in a most efficient way.

### **3. Transitional economies – a unique form of a dual economy**

In development economics a much studied issue are so called dual economies. The original idea of the development theory in a dual economy was to analyse a less developed economy with two sectors: the modern (or advanced) and the traditional sector. The traditional sector referred to agricultural production while the modern sector referred to manufacturing industry. Dual economy models were created to analyse economic growth and labour migration in economies which can not be described as having only one output and a single production relation. Development in a dual economy means that the share of the traditional sector decreases because production and labour is shifted to the modern sector.

The basic idea in a dual economy growth model is that in developing countries there has to be surplus from agricultural production so that the manufacturing sector will grow steadily (Jorgenson 1961). These ideas of traditional sector production surplus and growth are hardly appropriate for transitional economies and neither are the different production functions used for the agricultural and manufacturing sector. However, the idea of a dual economy has been developed further and what is well applicable to the post-socialist economies is the concept of two different sectors with productivity differences and with a labour surplus in the traditional sector.

Sen (1966) examines labour migration in a peasant society. There is surplus labour in the traditional sector (meaning that a small reduction in the labour force does not reduce output in that sector). Also, there is a wage gap between the two sectors in the economy. Although Sen's research was designed for agriculture-based economic systems which are completely different than industrialised transitional economies, the outset of the model has many similarities to the economic system in Central and Eastern European and FSU countries after the collapse of central planning as will be demonstrated later on. Todaro (1969) also analysed labour migration in an economy with a rural and an urban sector. He introduced urban unemployment to the model and analysed more deeply the impact of income gaps between the sectors. He concludes that when individuals decide to move to the urban sector they face the probability of becoming unemployed. If the income gap between the two sectors is large, it is hard to increase employment in the urban sector because low relative income in the rural sector will increase migration faster than the urban sector employment can grow.

In more recent studies the concept of information asymmetries has been mentioned in the theory of a two-sector economy. In the traditional sector there is better information about the members of the society and that will improve the possibility to get consumption loans in that sector and make the move to the modern sector less attractive. Hence, information constraints lead to a lower modernisation rate than the optimum (Banerjee and Newman 1998).

Some transitional economies, at least the least successful ones, have nowadays many characteristics of a dual economy. First of all, there is a modern sector and a traditional sector. The modern sector refers to those enterprises that have cut excess labour, started to produce goods that have a real value in the markets and that have changed their production technology and corporate governance to correspond the requirements of a market economy. In the most successful post-socialist economies the share of the modern sector is fortunately close to 100 %, but that is not the case in all countries, the best known example being Russia.

As a "left-over" of the socialist regime there is what can be called a traditional sector. In the case of transitional economies the traditional sector does not refer to agricultural or non-industrial enterprises but rather to enterprises that are still to a large part working according to the rules of a centrally planned economy. In the traditional and modern sector ownership is neither the relevant issue. It should not be claimed that the modern sector and private sector are synonyms, neither are traditional and state-owned sector. Changes in legal ownership and in control rights do not occur in

tandem. Rather the decisive point is the change in control rights, whether the enterprise management decides to restructure the firm or not.

There are several other features in the dual economy models that are applicable to the dual economy of a post-socialist country. During transition there is labour migration from the traditional to the modern sector. Unlike in the case of developing economies, surplus labour does not arise from increased productivity in the traditional sector but it is inherited from the socialist economy which rehearsed a full employment policy that led to excess employment in state-owned enterprises. Migration might not even mean that the worker has to move at all, a worker can move to the modern sector without a change in his workplace if the firm he is employed in restructures and is transferred to the modern sector.

Furthermore, a wage gap between the restructured (modern) and non-restructured (traditional) sector has been observed empirically and is also theoretically justifiable because of higher productivity in the modern sector. Sen's model included non-negative non-decreasing marginal disutility from labour. Since excess employment in socialist countries led to more lax working conditions, an increase in effort can be seen as a cost of higher productivity and wages in the modern sector. Finally, the concept of information asymmetries can also be applied to the dual economy in transitional economies. Socialist enterprises were large and it was not unusual that one enterprise employed the majority of the working age population in one city. Workers were tied to the firm also because socialist enterprises provided most of the social services to their workers. After restructuring the ties between the workers and the firm have weakened and the tasks of workers require new kinds of skills and more effort. Managers have less information about their workers and their productivity in the restructured sector.

#### **4. Restructuring decisions in post-socialist firms: a move to the modern sector**

In the original dual economy models the migration to the modern sector will occur with the increase in the surplus production or surplus labour in the traditional sector. The traditional sector refers to enterprises involved in agricultural production and its coexistence with the modern sector is economically an understandable issue. In transitional economies enterprises in the traditional sector rehearse similar economic activities (industrial production) as the in the modern sector and the main difference between the sectors is relative inefficiency. Hence, there should be no economic

justification for the long or even medium term existence of the traditional sector. Still the traditional sector coexists with the modern sector in many transitional economies a decade after the transfer to the modern sector started.

Why have some enterprises then not joined the modern sector but stayed in the less efficient and less productive traditional sector? And on the other hand, how is it possible for a country moving from socialism towards a more market-oriented regime to maintain a traditional sector – the share of which is significant in many cases? These problems can not be explained by economic theories based on identical preferences or economically rational behaviour. The reasons lie deeper in the institutional design of the countries. In a more empirical level, it would therefore also be interesting to analyse why the share of the traditional sector differs a lot in various countries that have abandoned socialism almost simultaneously.

Several papers on transition economics analyse a two-sector economy, mainly from the enterprise's point of view. Blanchard (1997, 25-51) builds a theory on the reallocation of labour from the state sector to the private sector. He concludes that production does not adjust overnight because the initial cut in the inefficient state sector production is not immediately followed by an equal increase in the efficient private sector production. One reason is what Blanchard calls disorganisation: production in socialist firms was based on bilateral relations between firms. Transition breaks these relationships and reallocation will start with a lag during which there is unemployment. Other causes for a delay in restructuring are insufficient wage adjustment and large cuts in subsidies.

A similar model by Blanchard and Aghion (1994) looks at enterprise restructuring as an endogenous process dependent on workers utilities. During transition there is a new private sector that creates jobs and a state sector that slowly dies out. Worker's utility is simply a function of wages in each sector and unemployment benefits. There is an equilibrium rate of unemployment and job creation during the period in which state sector employment is replaced by private sector employment. Transition can fail if the initial increase in unemployment is too high and the tax burden of the private sector is too heavy.

Both of the models above describe the development of a dual economy towards a one sector market economy. The dynamics of job creation and unemployment are analysed in a plausible fashion, but the approach is very much one that sees restructuring as a problem of an enterprise rather than as a process driven by enterprise's workers. To analyse the obstacles to restructuring, the objectives of

enterprise workers are probably more relevant than has been recognised so far. Especially one should take into account the institutional changes introduced in chapter two of this paper.

The dual economy theory designed for developing economies can help to answer the slow move to the modern sector of some enterprise. After all, in most cases restructuring has been blocked by workers of enterprises who think they can not benefit from the move to a modern sector. Even if a move to the modern sector would in the long term lead to higher average wages due to better enterprise productivity, there are other factors that make restructuring less appealing for workers in a socialist enterprise. Because socialist enterprises had excess employment, restructuring would mean at least short term unemployment for many workers. In addition, effort costs for workers would rise in the modern sector. For enterprise managers survival risk and monitoring costs would increase. Even reforms do not guarantee a rise in the profitability of an enterprise with hard budget constraints. In the process of reforming the labour force new kinds of skills are demanded and because of asymmetric information it is not clear which workers are suitable for which positions.

The explanation for the possibility to keep an inefficient traditional sector is in most cases the weakness of the government. Russia is a much studied case in that respect. Ickes and Gaddy (1998) consider relational capital as an alternative survival method to restructuring for Russian firms. If an enterprise can avoid tax payments in cash because its managers have good relations with the central and/or local government, it does not have to move to the modern sector. Even goods that do not have a market value (soft goods) can be produced as tax compensations. The use of barter in inter-enterprise trade is another issue that has delayed restructuring.

The main characteristics of an enterprise classified as belonging to the traditional sector are several kinds of maladjustments to the market economy rules. One of the most referred maladjustments are soft budget constraints (Kornai 1992). Even though the role of the government has diminished in transitional economies and there have been major cuts in direct subsidies, there are still lots of firms that do not operate under hard budget constraints. Schaffer (1997) says that soft budget constraints still exist to a much larger extent than can be estimated from the cuts in direct budgetary subsidies. Soft budget constraints appear in different forms, mainly as tax arrears. Schaffer's conclusions strengthen the view about a weak government, banks and other firms usually apply hard budget constraints to enterprises.

## **5. Conclusions – how to increase the speed of restructuring in post-socialist economies**

The main argument so far has been that considering the institutional developments in transitional economies since the beginning of the 1990's, privatisation alone has not provided sufficient incentives for a successful enterprise reform and restructuring activities. The outcome of fast privatisation has been a form of a dual economy with the existence of an inefficient sector that has not adjusted to market economy rules and still operates under soft budget constraints. This inefficiency is not only a problem of publicly owned firms. Lots of privatised firms belong to this traditional sector. In order to complete the enterprise reform process the traditional sector should be abolished, but since enterprise restructuring especially in the former Soviet republics has been very much influenced by the actions of enterprise workers, the process is a complicated one and requires different policies than have been experimented so far.

Since the problem is the existence of an inefficient traditional sector in an economy where workers make the decisions on restructuring, there are two ways to overcome the problem. Because the efficient modern sector is the desired one, the policies should be addressed in a way that makes the move to the modern sector more attractive. And looking from the opposite point of view, the existence of the traditional sector that has really no economic justification, should be made more difficult.

There are several constraints to restructuring which should be recognised in order to complete the reform of the enterprise sector. Starting from the microeconomic level, the incentives of traditional sector workers to start restructuring are clearly not adequate. One of the key issues is inequality, both in income and in skills demanded in the restructured sector. Inequality and unemployment have been mentioned as constraints to restructuring in the previous literature (see Blanchard and Aghion 1994, Honkkila 2000). Inequality is harmful for investments (Bénabou 1994) and hampers growth and job creation of modern sector enterprises, while unemployment has a similar effect by increasing the tax burden of profitable enterprises.

In a two-sector economy the possibilities for job creation and an increase in expected income in the modern sector should be the main incentive for workers in non-restructured enterprises to start restructuring. If expected income in the modern sector is not sufficient because of high unemployment probabilities (either due to low job creation or to lack of individual skills) restructuring can be blocked, because workers prefer to stay in the non-restructured sector with

slightly lower wages but secure employment. Therefore policies that decrease inequality are much more important than has been realised in many transitional countries. Optimistic considerations from early transition theories on the short-term nature of the inevitable increase in unemployment and inequality have not been met in reality. The bigger the share of the people ending up losers in transition and the longer the duration of the drop in living standards for the low-income and low-skilled class the more difficult the restructuring process becomes. The desired policy is not only a decrease in income inequality but also a decrease in human capital inequality (with the means of schooling and on-the-job training) which would make restructuring more attractive to a larger share of traditional sector workers.

A second way to improve enterprises reforms are policies that force enterprises in the traditional sector to operate under hard budget constraints. Especially in Russia it has been far too easy to stay in the traditional sector, to keep producing soft goods and to avoid tax payments in cash through barter or veksel. A government that enables these kinds of survival strategies for inefficient firms is not working in an optimal way. Privatisation has not been a sufficient policy to stop firms having other objectives than profit-maximisation. Therefore the public sector should be more operational in collecting revenues and in rehearsing active bankruptcy policies and stop subsidising loss-making firms with no real hopes of becoming profitable. This way a stay in the traditional sector would become less appealing and the government would get revenues for supporting the restructuring process and job creation of modern sector firms. Naturally, a sudden closure of all loss-making firms can lead to a social disaster and these changes in policies can not occur overnight, but the direction in many economies is completely opposite – in many countries the government is too weak to start any policies against the survival strategies of loss-making firms.

Although the enterprise reforms of many transitional economies started quickly and have led to many positive results, there is still a long way to go, especially in Russia and other countries of the former Soviet Union. Encouraging results from the early transition years from Central and Eastern Europe gave probably a misguided belief that privatisation alone would lead to automatic restructuring and increase in efficiency of firms. However, there are still lots of major barriers to restructuring even in the privatised sector. More comprehensive institutional reforms are needed that can reverse some of the developments from the first transition decade – like the increase in inequality and unemployment and the lack of skills required in market economy firms. The role of the government in supporting reformed enterprises and in applying hard budget constraints to non-

restructured firms has to become stronger. Only this way it is possible for the countries with less favourable transition progress to follow the footpaths of the more successful countries.

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