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Output decline and recovery in Central Europe : the role of incentives before, during and after privatisation

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OUTPUT DECLINE AND RECOVERY IN CENTRAL EUROPE
The Role of Incentives Before, During and After Privatisation

by
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I. Introduction*

Since the demise of socialism, policymakers in Central and Eastern Europe have been bombarded with Western advice on how to stabilise, privatise and liberalise their economies. Reform programmes centered around these three catchwords had proven quite successful in highly distorted developing economies such as Chile since the mid-1970s, and more recently Mexico and Argentina. So, why shouldn't this panacea work in countries struggling with the legacies of central planning and guarantee their smooth transition to market economies? Euphoric expectations have been frustrated by the depth and the length of the transition crisis. The ongoing debate on the nature of this crisis clearly suggests that not only policymakers had to learn their lessons, but also external advisers, whose cookbook remedies turned out to be insufficient.

This paper argues that the earlier neglect of incentive problems during transition to a market economy figures prominently among the deficiencies of traditional policy prescriptions. Economic reforms in Western style, though heavily distorted economies could build on existing basic institutions and familiar mechanisms of economic policy design. This well established framework limited the uncertainty of economic agents. By contrast, economic transformation in Central and Eastern Europe is complicated by the simultaneous and complete redesign of institutional arrangements, including the entire body of laws, regulations and conventions under which economic agents operate [Schmieding, 1993].

Unless this institutional void is overcome, producers and investors are confronted with an unprecedented degree of uncertainty. Unsettled issues relating to the new division of labour, the allocation of property rights and the system of coordination create macroeconomically perverse incentives, e.g., resulting in wait-and-see attitudes of private entrepreneurs, end-games played by managers in state-owned enterprises and myopia of employees. The first aim of this paper is to present an analytical framework for analysing such incentive problems by referring to the well-known concept of soft budget constraints (Section II).

The empirical analysis concentrates on the Czech and Slovak Republics, Hungary and Poland as the most advanced economies in transition. Section III provides an institutional interpretation of the common output decline in these coun-

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tries. It is shown that serious incentive problems prevailed during the early phases of transition. To improve the chances for economic recovery, removing perverse incentives is crucially important. In this respect, significant differences have recently emerged among the post-socialist economies (Section IV). Adjustment incentives are shown to depend critically on institutional arrangements and policy interventions that encourage discipline in the financial sector, shape the process of wage formation, and prevent a persistent struggle over the distribution of property rights. The analysis reveals that the prospects for recovery are relatively favourable in the Czech Republic which has governed the transition more efficiently than its neighbours.

II. Incentive Problems in the Presence of Soft Budget Constraints

The concept of soft budget constraints has been developed by Kornai [1980] to explain industrial inefficiency in centrally planned economies. Evidently, the incentives of enterprises to strive for a cost-minimising use of scarce resources are seriously impaired as long as input and output prices are determined by political bargaining rather than market forces, tax obligations are negotiated in a discretionary way, subsidies are easily available, and preferential access to credit is guaranteed. Prices in factor and goods markets are deprived of their signalling role with detrimental effects on allocative efficiency [Raiser, 1993b]. The macroeconomic spillovers of budget softness at the enterprise level are twofold [Hofman and Koop, 1990]: First, microeconomic inefficiency translates into macroeconomic instability to the extent that state-owned enterprises (SOEs) absorb public resources to maintain inefficient operations. Second, the lack of competitive market forces weakens the incentives for process and product innovations, which is likely to result in lower growth of the economy.

Budget constraints of enterprises are not perfectly hard in any other system of economic coordination. However, they are definitely much harder in a market economy. The substitution of paternalistic government protection of inefficient SOEs by market relations can reasonably be expected to ultimately result in an incentive structure of enterprises which is conducive to efficiency and economic growth. Privatisation, liberalisation and stabilisation are indispensable for this transformation to succeed:

- Privatisation is meant to overcome the entrenched system of patronage, and to replace the maximisation of material claims prevailing in a shortage economy by profit maximisation. The enforcement of hard budget constraints is rendered easier especially if privatisation involves the demonopolisation of

SOEs and, thus, reduces leverage with the government [Nunnenkamp and Schmieding, 1991].

- The liberalisation of factor and goods markets serves the purpose to let prices reflect relative scarcities, which is a necessary condition for allocative efficiency. Moreover, internal and external liberalisation subjects established producers to competitive pressure. The threat of market exit faced by non-competitive suppliers creates incentives for cost efficiency and structural change.
- Macroeconomic stabilisation is important to prevent high inflation from eroding the informative value of liberalised prices. Inflation-induced uncertainty about the development of relative prices might weaken the response of producers and investors to economic liberalisation and encourage wait-and-see attitudes. Furthermore, stabilisation can be interpreted as an attempt by the government to regain control over the economy [Lal, 1987]. In other words, the government indicates that it is no longer prepared to give in to the demands of enterprises for public resources.

It should be evident that deficient incentive structures cannot be removed overnight by a reform programme encompassing these three elements. Transitional problems stem from the interrelations between policy measures which take (different) time to become effective. Policy inconsistencies are thus difficult to avoid, and incentive problems due to uncertainty are likely to persist during the transition period. In particular, the slowness of establishing private ownership rights on a significant scale (mass privatisation) may impair the degree to which liberalisation and stabilisation are successful.[1] Price liberalisation preceding privatisation may open the room for monopolistic price increases, while sanctions through competitive markets remain absent for firms unable or unwilling to cut costs sufficiently. Moreover, the credibility of stabilisation remains open to question as long as the government appears to be the victim of blackmailing by huge and powerful SOEs.

As we know since Coase [1960] and more recently from the literature on transaction cost economics [Eggertson, 1990; North, 1990], institutions are needed to coordinate economic exchange in any society. The inefficiency of the institu-

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[1] That privatisation in the state-owned industrial sector would necessarily be slow was anticipated by Kornai [1990]. Csaba [1992] has recently argued that managing the public sector efficiently may have higher priority during economic transition than pushing ahead with privatisation at all costs.

tional framework in socialist economies notwithstanding, this literature suggests that budget softness may become even more pervasive in the early phases of transition, i.e., once the central plan is abolished. Though seriously deficient, the system of government planning imposed at least some discipline on SOEs, which were constrained by administrative price controls, output targets and credit allocation [Nunnenkamp and Schmieding 1991]. The desire by economic reformers to dissociate themselves firmly with the past led to a rapid dismantling of traditional coordination mechanisms that were still functionally existent prior to the start of economic transformation. By contrast, it is time-consuming to establish new mechanisms for coordinating the division of labour. Behavioural modes have to become engrained in economic agents, legal codes set up, and administrators trained to apply new and less cost-intensive decision algorithms. The slow process of institutional change may result in an "institutional void" in the interim [Schmieding, 1993], with uncertainty and short-termism dominating the behaviour of economic agents.

Transaction costs rise when binding commitments that ensure the honouring of exchange contracts do not exist, and third party enforcement is absent or not credible [North, 1990]. The benefits from the division of labour are reduced, and overall economic prosperity falls. Hence, the design and implementation of institutional substitutes for the political control exercised by planners and bureaucrats under the old system should have ranked high on the reform agenda in emerging market economies (EMEs), if their reform programmes were to be consistent and credible [Funke, 1993]. It was not enough to abolish the central plan and decentralise economic decision making in order to create an incentive structure conducive to cost efficiency and economic growth.[2]

Price liberalisation and profit orientation serve as a "carrot" only if the "stick" of financial discipline is in place, too. As long as the costs of adapting can be socialised, enterprises have still insufficient incentives to cover their costs out of revenues, to pay for the goods they buy, to honour their debt contracts, and to meet their tax obligations [Kornai, 1993]. The persistence of soft budget constraints may be reflected in payment delays and inter-enterprise credits [Raiser, 1992]. Non-performing bank assets are their counterpart in the financial sector.[3] Furthermore, soft budget constraints are indicated by wage increases that are not

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[2] This is amply demonstrated by Kornai [1986] in his analysis of the Hungarian reform process.

[3] These phenomena may replace more traditional fiscal aspects of budget softness, such as loose tax enforcement and subsidies.

in line with the development of labour productivity. Such a discrepancy points to collusion of managers and workers in running down the assets of enterprises that are still owned, but no longer effectively controlled by the state [Schmieding, 1993, p. 239].

Given that institutional change is slow by its very nature, the major task of reducing the costs of transition rests with the governments in EMEs. The crucial question is how to fill the institutional void left under the ruins of the centrally planned economy. The concept of soft budget constraints suggests that the governments' principal role is to monitor the behaviour of SOEs until privatisation is completed and a market-based incentive structure conducive to minimal friction in industrial adjustment has been established. The different aspects of budget softness indicate various ways in which governments may influence the incentive structures of economic agents during the transition period. Lower transaction costs are to be expected if governments succeed:

- to enforce tax obligations and to cut subsidies,
- to overcome the inherited bad debt problem and to improve financial discipline with regard to the extension and allocation of new credits,
- to prevent inter-enterprise debt from becoming an alternative source of easy financing,
- to ensure wage flexibility in the absence of well functioning labour markets,
- to enforce market exit of permanent lossmakers, and
- to design privatisation strategies in a way that a persistent struggle over the distribution of property rights is avoided.

Governing the transition to a market economy is obviously more demanding than economic reforms in highly distorted, but basically market-oriented developing economies. In the latter, reforms have frequently failed due to the governments' inability to credibly impose harder budget constraints on politically influential economic agents [Raiser, 1993b]. Haggard and Kaufman [1989, p. 236] have shown that for reforms to succeed, governments have to be strong enough to act "against the interests of groups usually able to organize against the imposition of austerities". This leads to the proposition that strong governments are even more important in EMEs facing the arduous task of containing the transaction costs during the transition.[4]

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[4] It should be noted that authoritarian governments are not necessarily strong. The decay of central planning in Eastern Europe indeed suggests that the respective governments could

The remainder of the paper seeks empirical evidence to support the above contentions. First, we stress more or less common incentive problems at the beginning of economic and institutional transformation. Second, we discuss emerging differences in the reform strategies of the EMEs already well into the second stage of transformation, and analyse the consequences of such differences for overcoming perverse incentive structures.

III. Incentive Problems Before Privatisation: An Institutional Explanation of the Common Output Decline[5]

In the Central European economies that we consider in more detail, the first two years of transition were marked by unexpectedly large output declines and gradually rising unemployment. Furthermore, in Hungary, Poland, and recently Slovakia, fiscal deficits rose after initial surpluses, and persistent moderate inflation followed the adaptive price shock (Table 1). The varying combinations of these stylised facts have to be taken into account in order to understand the nature of this "transformation crisis". Structuralist interpretations [Gomulka, 1991; Siebert, 1991] suffer from the inability to explain the uniformity of output declines across sectors [Hare and Hughes, 1992; Borenzstein et al., 1992]. Demand-led explanations [e.g. Brada and King, 1992] fail to account for the resilience of inflation. Calvo and Coricelli's [1992a, b] credit crunch hypothesis does not match up with the similarity of output falls in all EMEs despite of significant differences in monetary policy [Raiser, 1993a; Schmieding, 1993]. This is why the role of institutions warrants closer attention.

Our central argument is that increased uncertainty and the institutional void characteristic of the initial phase of economic transition are main factors behind the common output decline in all EMEs. The rise in transaction costs can be modelled as a supply shock affecting all firms, regardless of their market potential. Only managers that expect a long run personal gain will take the risk of investing in new customer networks, marketing skills and demand-oriented product innovation, which is why growth remains concentrated in the embryonic

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not withstand blackmailing by SOEs and prevent planned targets and achievements from being manipulated by systematic misinformation of central authorities. As a corollary, the newly established democratic governments in post-socialist countries are not necessarily weak. The experience of developing countries reveals no systematic association between either democracy or dictatorship and the ability to stabilise and adjust; see Haggard and Kaufman [1989], and the literature given there.

[5] For a more detailed analysis, see Raiser [1992].

Table 1 - Selected Macroeconomic Indicators: Czech and Slovak Republics, Hungary and Poland, 1990-93

	1990	1991	1992	1993 predictions
	Gross domestic production (percentage change)			
Czech Republic)				±0
}	-0.4	-15	-7.1	
Slovak Republic)				-8
Hungary	-4	-12	-5	-2
Poland	-11.6	-7	1	2
	Industrial production (percentage change)			
Czech Republic)				
}	-3.5	-24.7	-13.8	-
Slovak Republic)				
Hungary	-9.2	-18.1	-9.8	-
Poland	-26.1	-11.9	4	-
	Unemployment (per cent of labour force)			
Czech Republic)		4.1	2.6	6
}	1.0	6.6	5.1	
Slovak Republic)		11.8	10.4	12
Hungary	2.5	8.0	12.3	13
Poland	6.1	11.8	14.0	16
	Fiscal balance (per cent of GDP)			
Czech Republic)				
}	0.1	-2.0	-3.3	-
Slovak Republic)				
Hungary	0.8	-3.2	-8.1	-
Poland	0.7	-6.5	-6.1	-
	Inflation (per cent increase in consumer prices)			
Czech Republic)				20
}	10.8	58.7	10.9	-
Slovak Republic)				25
Hungary	29	34	23	23
Poland	585	70	43	39

Source: EBRD [1993a; b], Statistické Prehledy [1993].

private sector. SOE managers by contrast economise on input purchases, reduce output and collude with workers in running down the assets of their firms. Falling SOE profitability depresses fiscal revenues, while the reliance of SOEs on monetary substitutes, such as inter-enterprise credits to finance wage increases in excess of labour productivity growth, undermines price stability.

In what follows we briefly consider some of the temporal policy inconsistencies that may account for the depth and length of recession in EMEs. In line with our hypothesis, the institutional framework created by the timing and/or the neglect of specific reform measures will emerge as a crucial determinant of the costs of transition. It also follows that the absence of post-stabilisation inflation, large scale unemployment and rising fiscal deficits in the Czech Republic may be related to its institutional policy design already at an early stage.

The severity of the transformation crisis in all EMEs can be attributed to three policy inconsistencies in the institutional realm.[6] First, the coordination mechanism in EMEs has become decentralised at an early stage, while the actors operating under these new institutional constraints have as yet no long term perspective guiding their decisions due to the delay in privatisation. Insiders in SOEs and the state-owned banking sector cannot be sure to remain in place, once their firms or banks have been privatised. The uncertainty prevailing in the economy and the inheritance of financial legacies that bear little or no relation to an enterprise's market potential make any evaluation of performance extremely difficult. But, if good behaviour is likely not to be rewarded in the future, while monitoring of present transactions is weak, the incentives to play "end-games" are large. One manifestation is the consumption of SOE assets by managers. There is some evidence to the effect that asset depletion has been used as a method of insider privatisation in Poland and Hungary [Heinrich, 1993; Pinto et al., 1993]. In Czechoslovakia the relatively early progress with mass privatisation and the close monitoring of SOE behaviour via credit and wage controls have limited the scope for asset depletion. Another consequence of end-game strategies by SOEs is the spread of inter-enterprise credits. If the managers of an SOE have little stake in its future, they can afford to accumulate debt on account of unpaid bills,[7] and they will not enforce payment contracts on their own customers. The dramatic rise in inter-enterprise credits in Poland, Hungary and

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[6] The subsequent paragraphs draw substantially on Schmieding [1993].

[7] For an interesting parallel in the public sector of developing countries, see World Bank [1988] and Raiser [1993b].

Table 2 - Inter-Enterprise Credit in Czechoslovakia, Hungary and Poland, 1990-92, quarterly

	1990				1991				1992			
	1	2	3	4	1	2	3	4	1	2	3	4
Czechoslovakia												
bln. Ksc.	–				88.6	113	147.1	174.3	170.2	–	154.4	–
in per cent of bank credit	10.1				13.4	17	21.2	23.0	22.8	–	18.6	–
Hungary												
bln. Ft.	90.5[a]				159.8[a]				197.0	–	–	104.0
in per cent of bank credit	14.2[a]				20.8[a]				26.5	–	–	13.4
Poland[b]												
trl. zloty	75.1	81.5	77.3	103	109.1	126.1	143	153.3	177	190.6	197.5	217.3
in per cent of bank credit	234	207	167	184	140	138	135	145	130	127	125	117

[a] End-year figures. - [b] Dues and claims resulting from the delivery of goods and services (receivables).

Source: Czechoslovakia: 1990: Buch and Schmieding [1992],
1991-92: Czech Ministry of Finance, unpublished data
Hungary: Kornai [1993]; NBH [1993]
Poland: GUS [various issues].

Czechoslovakia is displayed in Table 2. Inter-enterprise credits are one crucial element of budget softness for SOEs, once official bank credit has been tightened [Bofinger, 1992; Raiser, 1992; Kornai, 1993].

The second element of temporal policy inconsistency is found in financial deregulation under the conditions of little competition and a lack of supervision in the banking sector. With the introduction of a two-tier banking system early in the transition, most EMEs have now laid the foundation for a more efficient allocation of capital and an active monetary policy. However, the commercial banks, cut out of the old state monobank, typically inherited highly concentrated and fundamentally weak portfolios [Buch and Schmieding, 1992]. Enforcing debt repayment by old customers could cause their financial collapse and would ultimately threaten the survival of the banks themselves. The assessment of creditworthiness requires skills that are mostly absent. As long as the state remains the owner of the newly founded commercial banks and private competitors are few, bank officials have little incentive for prudent capital management. Rather, a wait -and-see attitude is adopted towards corporate clients in the public sector and non-performing loans are rolled over. Such a strategy may undermine the stability of the entire financial system, if, as in EMEs, the banking sector's capital base is weak. In 1992 it was estimated that 20 per cent of all bank loans to the enterprise sector in the Czech Republic, and around 30 per cent in Hungary and Poland were non-performing [Buch and Schmieding, 1992, p. 20; Szanyi, 1993, p. 3; Raiser, 1993a, p. 36].[8] This is the second crucial element of budget softness, and it makes the control of credit volumes by indirect monetary instruments largely elusive. Early government action to sever old credit lines and recapitalise the banking system may be crucial for ensuring financial stability. Arguably, Czechoslovakia was more successful than Hungary and Poland on this front, explaining its remarkable success in the area of price stability.

The third inconsistency concerns the premature liberalisation of wages. When soft budget constraints persist, incentives for cost minimisation are greatly reduced. At the same time, governments of EMEs are reluctant to enforce existing bankruptcy regulations as they fear the social costs of large scale unemployment. Of course, when sanctions for cost-overruns are absent, while non-revenue

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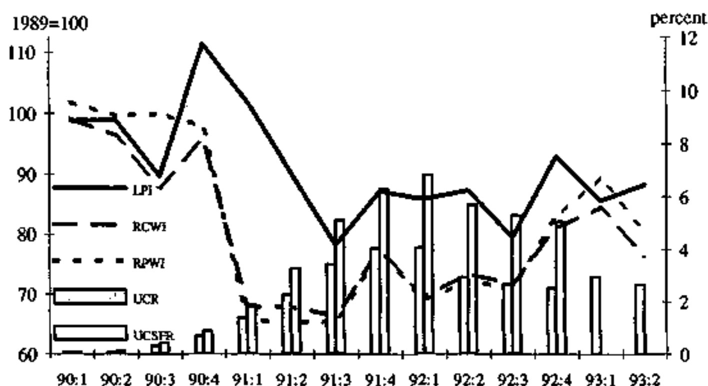
[8] In Hungary 85 per cent of bad loans accumulated after 1989, and in Poland the high inflation of 1989 had all but wiped out inherited bad debts. Hence rather than merely attributable to financial legacies, the bad debt problem goes to the heart of lacking financial discipline in EMEs. For an interpretation of reform failure in Chile during the early 1980s stressing loose financial discipline, see Corbo and de Melo [1985].

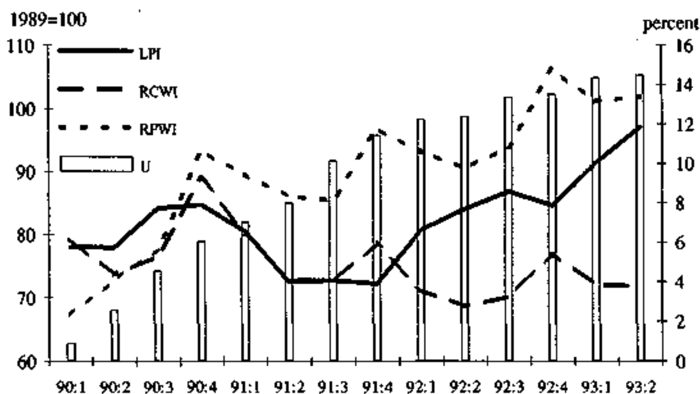
Graph 1 - Labour Productivity, Real Wages and Unemployment in the Czech Republic[a]



[a] 90:1 - 91:4 labour productivity data for the CSFR.

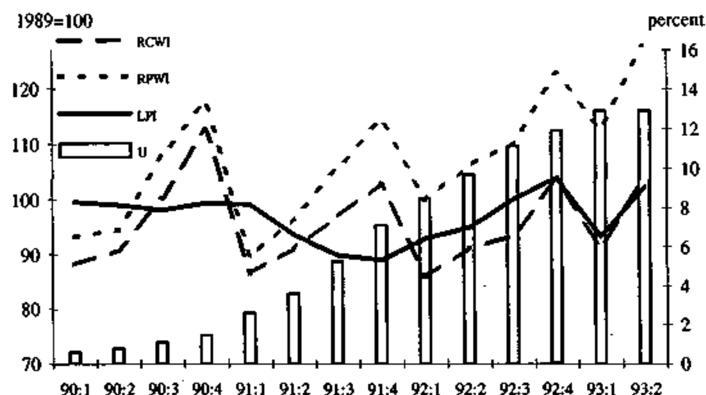
Definitions and sources:
LPI: labour productivity index [IMF, 1993; PlanEcon, 1993]; RCWI, RPWI: real average wage index, Czech industry (deflator: CPI and PPI, respectively) [PlanEcon, 1993]; UCR: Czech unemployment rate [PlanEcon, 1993]; UCSFR: Czechoslovakian unemloyment rate [Statisticke Prehledy, 1993].

Graph 2 - Labour Productivity, Real Wages and Unemployment in Poland



Definitions and sources:
LPI: labour productivity index in industry [PlanEcon, 1993]; RCWI, RPWI: real average wage index (deflator: CPI and PPI, respectively) [PlanEcon, 1993]; U: unemployment rate [PlanEcon, 1993].

Graph 3 - Labour Productivity, Real Wages and Unemployment in Hungary



Definitions and sources:
RCWI, RPWI: average monthly nominal industrial wage [PlanEcon, 1993; Statisztikai Havi Kozlemenyek, 1991], deflated by CPI and PPI respectively [IMF, 1993]; LPI: labour productivity index [PlanEcon, 1993; Statisztikai Havi Kozlemenyek, 1991]; U: unemployment rate [Kopint-Datorg, 1992; PlanEcon, 1993].

sources of finance are available, SOE workers have very few incentives to keep wage demands in line with labour productivity. To ensure worker cooperation in running down a firm's assets, SOE managers give in to worker demands, thus exacerbating the profitability crisis in the public sector and ultimately worsening fiscal problems for the government. The developments of real wages and labour productivity in Czechoslovakia (and after 1992 the Czech Republic), Hungary and Poland have differed substantially during their transition path so far (Graphs 1-3). In Czechoslovakia a rise in unit labour costs was largely avoided, giving the country a competitive edge against Hungary and especially Poland, which both registered real product wage increases substantially above labour productivity growth [see also Estrin, Schaffer and Singh, 1992]. The underlying reasons for these divergent developments are addressed in the next section. At this stage, it is suggested, that the fact that labour remained remarkably cheap in Czechoslovakia, until quite recently, has enabled the former federation as a whole, and the Czech Republic in particular, to limit unemployment and avoid a fiscal crisis during its transition so far.

IV. Government Monitoring and Adjustment Incentives During Privatisation

1. Institutional Reforms: An Overview

All EMEs considered here enacted a number of significant institutional reforms simultaneously, or even before price liberalisation and macroeconomic stabilisation. Apart from the crucial role of privatisation, considered further below, capital market reforms, bankruptcy enforcement, tax reforms and labour market interventions feature most prominently among the institutional requirements for successful transition. Table 3 provides an overview over the most important measures taken by the Czechoslovak, Hungarian and Polish governments.

In the capital market, all three countries created a two-tier banking system prior to full-blooded price liberalisation, as a crucial precondition for the efficiency of capital allocation. Hungary got a head-start, with four commercial banks operating by 1987. Poland followed in 1988, while Czechoslovakia started its banking reforms only in 1990. However, Hungary's and Poland's relatively early start was severely hampered by the failure to introduce banking regulation at an early stage, and by the legacy of a highly concentrated loan portfolio. Moreover in all EMEs inadequate human capital and information technology would necessarily inhibit the smooth functioning of capital markets for some time.

Table 3 - Overview over Institutional Reforms: Czechoslovakia, Hungary, Poland

	Czechoslovakia	Hungary	Poland
Two tiered banking system	Jan. 1990	beginning 1987	Jan. 1988
Foreign bank access	1/92 full access for foreign banks	8/90 opening to foreign banks; access limited	9/91 opening to foreign banks; access limited
Bank regulation	• minimum reserves: 8% term deposits 2% demand deposits • capital adequacy ratio: 4.5% by 12/91 6.25% by 12/93 8% by 12/96 8% for new banks	• 11/91 weighted risk reserves, tax deductible • capital adequacy ratio: 8% by 1/93	• 11/92 weighted risk reserves, compliance Dec. 1993 • 8% capital adequacy ratio applies since 3/92
Interest and credit ceilings	• credit ceilings and maximum interest spread until April 1992	• deposit rates fully liberalised • no maximum spread, no credit ceilings	• credit ceilings 1990-92; 7/92 raised • no interest ceilings but moral suasion by central bank • preferential housing and agricultural credits
Competition in capital markets	• monobank split into three banks only • concentration ratio (3-firm) 66.9% • 1992: 43 commercial banks operating	• monobank split into four banks • concentration ratio (3-firm) 61.2% • 1992: 70 banks operating	• monobank split into nine banks • concentration ratio (3-firm) 47.4% • 1992: 120 banks operating
Debt consolidation scheme	• 110 bn Ksc. of PICs converted • 12/91: 50 bn Ksc. bond issue • 1/93: 65 bn Ksc. trade credits assumed by MoF of Slovak and Czech Rep.	• mid 92: 104 bn Ft. debt conversion • 1993: second debt conversion planned	• end 92: bank restructuring programme passed by parliament • IMF stabilisation fund to be used for recapitalisation
Tax reform	• 1/93 VAT • profit taxes reduced 65-75% → 55%	• 1/88 VAT and personal income tax • tax incentives for DFI, abolished 1991 • profit tax 35-40%	• 1/92 personal income tax • 1989 profit tax reduced 65% → 40%

continued Table 3

Privatisation	• small-scale privatisation completed • large-scale privatisation: first wave of voucher programme completed by Nov. 92	• small-scale privatisation completed • 18 per cent of SOEs sold though various means	• small-scale privatisation completed • some large SOEs privatised by voluntary liquidation; mass privatisation agreed 4/93
Bankruptcy law	• 10/91 new law; implementation deferred to April 93 • by mid 93 only 17 bankruptcies	• 1/88 bankruptcy law • 12/91 amendment; end-92: 4331 filings	• 9/91 law on liquidations • by beginning of 93: 920 forced liquidations
Tax based incomes policy (TIP)	• TIP from 1/91-12/92; again from 7/93 effective	• 2/91 TIP	• 1/90 TIP • ineffective from 10/90
Unemployment benefits: Burda index coverage duration	 • 522 • 38.2% • 3 months	 • 3388 • 77.8% • 18 months	 • 1240 • 72.6% • 12 months
Active employment measures	yes rising	yes falling	limited

Source: Buch [1993]; Burda [1993]; EBRD [1993a; b]; The Banker [1993]; PlanEcon [1993].

In response to the monopoly position of state-owned commercial banks, Czechoslovakia and Poland used credit ceilings and direct or indirect controls over interest rates in order to monitor the growth and distribution of credits. In Hungary, no credit market controls were effectively operated and real credit to enterprises contracted sharply only in response to the introduction of accounting and bankruptcy legislation in December 1991.

In the medium term, the development of a well functioning capital market in EMEs hinges fundamentally on recapitalising the commercial banking sector, overcoming the bad loans problem and introducing financial discipline by strengthening bank competition, enforcing supervisory legislation, and enabling creditors to enact bankruptcy procedures [see also Begg and Portes, 1992; Buch and Schmieding, 1992]. In all Central European countries this process is now going on. Czechoslovakia was rather quick in introducing banking regulations and has taken significant steps towards recapitalisation. Moreover, a new bankruptcy law is in effect since April 1993. All indication is that the process will be closely watched by the government and restructuring will be favoured over liquidation [CBU, 1993, p. 391]. Hungary has pioneered the strict enforcement of bankruptcy legislation in 1992, but at tremendous costs for its industrial sector. Poland seems most advanced in the area of banking competition, while existing bankruptcy legislation remained largely unenforced until the second half of 1992.[9]

In the area of tax reforms, Hungary substituted value-added taxes (VAT) for turnover taxes in the enterprise sector in 1988 and introduced personal income taxation in the same year. It now faces the largest budgetary problems. This is mainly due to the rise in government expenditures (particularly for social security), rather than to a fall in revenues [EBRD, 1993a]. In Poland, the introduction of VAT has been twice delayed, while the Czech Republic introduced it rather successfully in terms of maintaining revenues in January 1993.

Finally, in the labour market Czechoslovakia has been most interventionist. Tight wage controls remained in place until December 1992, and have now reemerged in the Czech Republic in July 1993. In Poland, the tax-based incomes policy (TIP) was initially non-binding and later ineffective. The main reason was the relaxation of monetary policy in mid-1990, which provided SOEs with the resources for large nominal wage increases (Graph 2; see also Raiser [1992]).

[9] Two banks were proposed for privatisation in 1992, but political resistance delayed its conclusion.

The TIP in Hungary has not attempted a reduction in real wages at all. Hungary offers the most generous social security system, particularly to its unemployed, while the Czech Republic shows the largest activity in the realm of creating new employment.

This brief sketch of institutional reforms reveals that significant policy differences have emerged. The following two subsections look at the way in which specific interventions in capital and labour markets have enabled the Czech Republic to create an incentive structure that limits the frictions in transition towards a market economy. Apparently, the Czech government has not been constrained by strong opposition from powerful interest groups and its interventions have remained non-discretionary and credible. Typically, governments in EMEs are much weaker than in the Czech Republic. Hence, it may not be easy for them to copy the Czech experience.

2. *Capital Market Reforms: How to Discontinue Financial Laxity*

As long as banks are not privatised and competition in the banking sector is weak, there is little incentive for creditors to discontinue financial laxity. As a result, enterprises with soft budget constraints fail to undertake the necessary adjustments to new relative prices and the friction in economic transition increases. The first crucial step for the government is thus to limit the public banks' discretion in extending credit lines to their traditional customers. In this way it may contribute to the avoidance or at least the limitation of the bad debt problem during transition.

Czechoslovakia has been the most resolute in limiting credit access for SOEs [Raiser, 1993a]. Real credit to SOEs declined in both 1991 and 1992. At the same time, the private sector benefited from real credit expansion. Its share in total loans from the banking sector increased to 26.4 per cent in 1992 from a level below 1 per cent two years earlier. Significantly, this share was higher than the private sector's estimated contribution to GDP.

In Poland, 71 per cent of total credit went to SOEs in 1991, while the private sector had grown to 40-50 per cent of GDP.[10] Profitability in Poland's public industrial firms has declined dramatically in 1991 and 1992 (gross profits/total sales were 3.1 per cent on average; GUS [1993]). It is thus no surprise to find that bad debts grew rapidly to around 30 per cent of total bank assets by mid-1992. In February 1993, 4666 enterprises were declared uncreditworthy by

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[10] For Hungary no disaggregated figures are available.

Polish banks, involving over 50 per cent of all industrial firms [NBP, 1993]. At least in terms of the official figures available, bad debts are substantially higher in Poland than in Czechoslovakia.[11]

Hungary's early start with banking reform did not materialise into a more healthy capital market. The significant contributions to fiscal revenues of bank profits from corporate lending at high real interest rates, in the absence of bank regulation that would have necessitated more prudent financial management, blinded the government for the serious problem of non-performing assets building up in the banking sector [Abel and Bonin, 1992]. Moreover, until the end of 1991, the political will to enforce financial discipline of large SOEs was largely absent, as it was feared that rising unemployment would undermine the legitimacy of the new coalition government [Estrin, Hare and Suranyi, 1992, p. 797].

The enforcement of tight credit controls is, of course, only a makeshift replacement for an incentive structure conducive to efficient capital allocation. An appropriate regulatory framework in the banking sector is essential if banks are to improve their capital base and adopt prudent lending policies. At the enterprise level, sanctions have to be enforced through bankruptcy legislation. However, these "sticks" rely on the complementary existence of positive rewards. In the medium run these include debt consolidation schemes that support the banks' efforts to recapitalise themselves, and the option of debt-equity swaps if banks are willing to provide the necessary finance for enterprise restructuring.

Progress on this front has been extremely slow in Poland. In September 1991, a law on restructuring of SOEs opened the possibility of liquidation if a firm delayed tax payments for more than three months. However, the number of forced liquidations has remained rather limited. In mid-1992, out of 708 cases only 78 had been concluded [Heinrich, 1992]. Moreover, tax deferments have accounted for a rising share of budget deficits since 1991 [Raiser, 1992, p. 41]. Only at the end of 1992 was a bank restructuring programme considered.[12] As a result, interest margins have been rather high since 1990 (Graph 4). The fragility of Poland's banking system may still send a destabilising blow to its recovering economy and presents the biggest barrier for the restructuring of the remaining SOEs.

Hungary introduced virtually the entire package of regulations and sanctions at once in December 1991. The results of this financial shock are well-known. The

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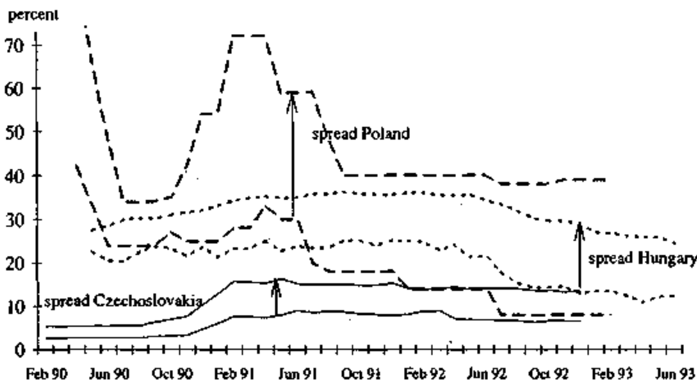
[11] Inter-enterprise credits by the same token are also much larger (Table 2).

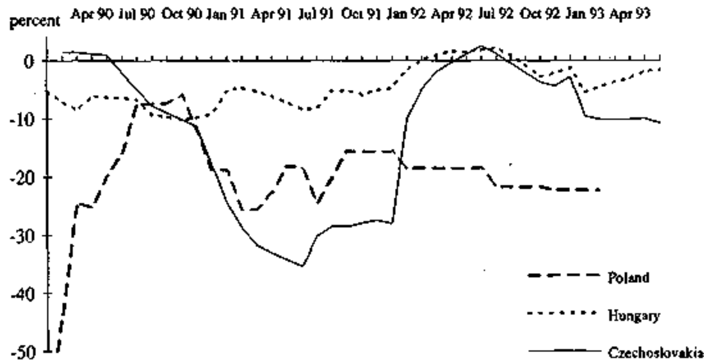
[12] The Zloty stabilisation fund was recently suggested as a source for bank recapitalisation.

Graph 4 -Nominal Interest Rate Spreads in Czechoslovakia, Hungary and Poland



Definitions and sources:
spread Poland: Lending rate on credits with lowest risk rates (one-six months) minus one month deposit rate [NBP, various issues];
spread Hungary: Lending rate by commercial banks (weighted average, maturing within one year) minus deposit rate by commercial banks (weighted average, fixed for less than one month) [NBH, various issues];
spread Czechoslovakia: Average nominal lending rate to enterprises minus average nominal deposit rate to enterprises [PlanEcon, various issues].

Graph 5 - Real Refinancing Rate in Czechoslovakia, Hungary and Poland



Definitions and sources:
Poland: Refinancing credit interest rate deflated by consumer price index (corresponding period of previous year=100) [NBP, various issues].
Hungary: Short-term refinancing rate (period between rediscounting and maturity less than 60 days) deflated by consumer price index (corresponding period of previous year=100) [NBH, various issues].
Czechoslovakia: Discount rate deflated by consumer price index (corresponding period of previous year=100) [SBC, 1992, various issues].

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number of bankruptcies is huge (over 4200 filings in 1992 alone) and unemployment has doubled. On the other hand, inter-enterprise credits have fallen dramatically and bad debts stopped accumulating. In fact real corporate lending was still declining in May 1993 [NBH, 1993]. Unfortunately, Hungary's government forgot about the "carrots" in the process. Banks were left alone in their attempt to reach the new capital requirements. Characteristically, the write-off element in Hungary's recent consolidation scheme has been minimal [Abel and Bonin, 1993], while huge budget deficits still push up the real cost of credit in the economy. Interest margins have been rising since 1991 and are unlikely to come down substantially in the near future (Graph 4). Finally, a large number of enterprises, public and private, find themselves stuck in court proceedings, because conflicts among creditors, over who is to shoulder the burden of restructuring, loom large [Szanyi, 1993].

In contrast to Poland's hands-off approach and Hungary's legislated shock-therapy, Czechoslovakia and recently the Czech Republic have attempted to complement tight monitoring of public banks and enterprises with well dosed capital injections and a rapid move towards clear structures of corporate control. Only three months after price liberalisation, Czechoslovakia founded the Consolidation Bank to take over 110 billion Ksc. of inherited long term credits from the banking sector. In December 1991, a further 50 billion Ksc. bond issue by the National Property Funds of the Czech and Slovak Republics allowed commercial banks to rid themselves of non-performing assets at a 50-80 per cent discount. At the same time, the government was careful not to administer too large a shock to its few and fragile banks. A predetermined schedule for capital adequacy ratios was announced in March 1991, raising the capital requirement gradually from 4.5 per cent of total assets (1991) to 6.25 per cent by 1993 and 8 per cent by 1996 (Table 3). The central bank's refinancing rate was kept low in real terms to allow recapitalisation, but there was a ceiling on maximum interest margins. As Graph 5 reveals, this has enabled Czechoslovakia, and recently the Czech Republic to avoid the explosion of lending rates characteristic of financial liberalisation in an environment of fragile capital markets and monopolistic supply structures (for an international perspective, see Raiser [1993b]). All is not yet well for Czech banks, with some of the largest banks still falling below the 6.25 per cent capital/asset ratio target for 1993 [The Banker, 1993, p. 27]. But falling real lending rates and constant interest margins (Graph 4) suggest that the times of creditor caution are over. As an immediate consequence, investment had picked up to 120 per cent of the 1989 level by the last quarter of 1992 [PlanEcon, 1993]. Moreover, the recent enforcement of bankruptcy legislation

has proceeded with the understanding that resources from the National Property Fund would be made available to facilitate restructuring rather than liquidation, if a feasible plan was presented. The substantial equity stake acquired during the first wave of privatisation by some of the major commercial creditors should enhance their monitoring role in the restructuring process (Section IV.4).

3. *Incentive Effects of Incomes and Labour Market Policies*

Possibly the most important real effect of different incentive structures in capital markets is their impact on adjustment in the labour market. If budget constraints remain soft, managers have scope for wage increases in excess of labour productivity growth. This in turn depresses profitability in the state-owned sector, while it raises the wage level for private firms, too. Hence, large unemployment becomes an unavoidable by-product of economic transformation. When it ranges in the order of 12-15 per cent as in Hungary or Poland, its social costs may be huge, and its fiscal costs certainly are. This sends a second round destabilising blow to transition economies, which could threaten the sustainability of economic reforms. It is in this respect that the Czech Republic's extraordinarily low level of unemployment (2.5 per cent in July 1993 [PlanEcon, 1993]), and its remarkable political stability warrant special attention.

At the end of the previous section, we contrasted the development of real wages and labour productivity in Czechoslovakia to that in Hungary and Poland. One obvious inference that may be drawn is that the relatively low unit labour costs in Czechoslovakia allowed more labour intensive production and thus limited unemployment.[13] The underlying dynamics are of crucial importance, here. Czechoslovak industry shed labour at a pace roughly similar to Poland's, but only in Slovakia were these redundant workers not absorbed by the labour market. In the Czech Republic the unemployment/vacancy ratio has remained extremely low [Burda, 1993, p. 38]. This suggests that low unit labour costs not only limited the profitability crisis in SOEs (thus stabilising fiscal revenues), but also lowered entry barriers for new private firms. Because these activities are concentrated in the services sector they are typically characterised by very low labour productivity, and initially go mainly unrecorded by official statistics

[13] A number of exogenous factors may have complemented the positive role of low unit labour costs. Amongst the most important are Prague's unique tourist attractions, providing work for a mushrooming services sector, and the proximity to Western labour and product markets. Other possible factors to account for low registered unemployment in the Czech Republic include tight eligibility criteria for unemployment benefits and remaining labour hoarding in SOEs; for an evaluation of these arguments, see Raiser [1993a].

[EBRD, 1993b]. Hence, the dramatic increase in private sector activities visible for any casual visitor to the country is not yet reflected in a rise in GDP.

The competitiveness of Czech industry is reflected in dynamic export performance. Remarkably, the Czech Republic increased exports to Germany by over 50 per cent in the first quarter of 1993, compared to the same period a year earlier, and this in the midst of a severe German recession.[14] By contrast, Poland and Hungary have recently moved into trade deficits with Western countries. Again, it may be argued that low unit labour costs have allowed the Czech Republic to make the most of its export potential. Parallely, the Czech Koruna has remained fixed against a basket of foreign currencies since January 1991, while the Forint and the Zloty have recently come under renewed pressures.

The most important government intervention in the Czech labour market has been a tightly enforced incomes policy. The determination of Czech policy makers to prevent SOEs from fuelling a wage-price spiral has recently been demonstrated with the re-introduction of wage controls in July 1993. Over 1991 a decline in real wages of 12 per cent was agreed with trade unions. When inflation overshot the expected target, nominal wage indexation was unilaterally abolished by the federal government [Myant, 1992, p. 195] and the overall decline in real wages had reached 24 per cent at the end of 1991.[15]

A less well-known aspect of Czech labour market policies is its combination of an extremely tight unemployment benefit system with substantial active employment creation. Burda [1993] provides scores for the disincentive effects of the unemployment benefit package for EMEs. The Czech Republic ranks most favourably (see Table 3).[16] The Czech government has additionally been active in employment creation. While total labour market programmes were limited to 0.51 per cent of GDP in 1992 [OECD, 1993, p. 78] against 2.78 per cent in Hungary and 2.51 per cent in Poland, active measures were over 60 per cent of total outlays (only 14 per cent in Hungary and 11 per cent in Poland). Thus in 1991, 157000 jobs were created in the Czech Republic alone, comparing to 221749 unemployed by December 1991 [Burda, 1993, p. 19].

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[14] Total exports increased from 660 million US-$ in December 1992 to 813 million US-$ in April 1993 [PlanEcon, 1993].

[15] We have already noted the importance of credit ceilings, for making the incomes policy effective.

[16] Note the dismal score of Hungary, whose fiscal problems are clearly related to the generosity of its social policies.

It is the combination of wage controls and tight social security policies that in our view explain the success of Czech labour market adjustment so far. The incentives for workers to register as unemployed, while at the same time earning a supplementary income in some grey market activity have been limited. Those willing but unable to find work can, however, rely on government help. As in the case of capital market reforms, the Czech government has intervened, where markets were as yet absent. Crucially, its controls have been non-discretionary and linked to fundamental economic principles. Inspite of a rather interventionist stance, the scope for rent-seeking in the Czech Republic has been minimal. That the government was able to impose its agenda on different interest groups within the country with the ultimate aim to transform it into an economy of private owners, acting on competitive markets, is evidenced in its approach to privatisation, considered next.

4. *Privatisation Strategies: Corporate Governance, Vested Interests and the Struggle for Property Rights*

Prior to the start of economic and political transformation, the rationale of central planning had been increasingly undermined by agency problems, i.e., the lack of effective control of SOE managers by the state as the principal of productive assets. Principal-agent relations were complicated by various layers of intermediating bureaucracy. Realising that insufficient corporate governance resulted in perverse incentives at the enterprise level, the solution was initially thought to be greater autonomy of SOEs. However, incentive problems could not be overcome by the retreat of the state in countries such as Hungary (particularly since the New Economic Mechanism of 1968) and Poland (since 1981), as long as there was no alternative monitoring system by which SOEs were effectively controlled [e.g., Kornai, 1990].

Since the demise of the socialist regime, privatisation was assigned the main task of introducing a rational structure of corporate governance, and thereby to create incentives for cost efficiency and structural adjustment. These objectives were relatively easy to achieve with respect to small enterprises in services, trade and industry. Small-scale privatisation is almost completed in Hungary, Poland and the former Czechoslovakia (Table 3). Agency problems are largely absent as most of these enterprises are managed by their owners. By contrast, progress proved much more difficult with respect to large industrial SOEs. Here, the speed of ownership transformation has been disappointingly slow. Further-

more, it remains heavily debated by which methods of large-scale privatisation to establish an effective structure of corporate governance.[17]

The speed of privatisation matters for shortening the interim period during which economic coordination in EMEs has already been decentralised, while the economic agents have still no long term perspective guiding their decisions (see Section III). Incentive problems resulting from ill defined and unprotected property rights, and uncertainty as to the future distribution of property rights persist in all EMEs. Large-scale privatisation is probably the reform area which has seen least progress, and is generally taking much longer than initially expected [AMEX, 1993; ECE, 1993, p. 41]. Nevertheless, significant differences have emerged as concerns the achievements in Czechoslovakia, Hungary and Poland:

- The process of ownership transfer appears to be most advanced in the Czech Republic [EBRD, 1993b, p. 40]. The first phase of mass privatisation through the voucher scheme was completed in December 1992,[18] and another wave is currently underway [AMEX, 1993, p. 6].[19]
- Hungary has adhered to gradual privatisation. The State Property Agency, founded in 1990, accepts initiatives for SOE transformations from insiders and outside investors, but retains the right to decide case by case. Apparently, the privatisation process has slowed down somewhat. While about 15 per cent of Hungary's larger SOEs had been privatised by mid-1992 [Heinrich, 1992], this share increased only to around one fifth until mid-1993 [AMEX, 1993, p. 6].

[17] This is not surprising since there exists no unanimous model of corporate governance in advanced market economies which might have guided privatisation strategies in EMEs. Developed countries such as Germany, Japan and the US differ significantly with respect to the institutional arrangements through which the behaviour of managers of large enterprises is subjected to external control [Williamson, 1992]. And "it would be fatuous to pretend that the literature contains any decisive arguments why this or another system is the 'optimal' one" [Frydman and Rapaczynski, 1992, p. 264]. Hence, it is clearly beyond the scope of this paper to determine the precise form of corporate governance that might work in EMEs; for major options, see EBRD [1993b, pp. 11ff.]. We rather concentrate on vested interests as a major stumbling bloc to overcoming property rights uncertainty, and on some institutional arrangements by which restructuring incentives might be improved.

[18] The first wave involved about 1500 SOEs. After several rounds of auctions more than 90 per cent of the shares offered for sale against vouchers had been placed [East European Privatization News, 1993].

[19] Slovakia has given up the voucher system of mass privatisation in favour of a wider variety of methods of sales.

- Large-scale privatisation in Poland has been sluggish even by East European standards [Winiecki, 1992a]. The mass privatisation programme, which had been discussed since late 1989, has so far failed to get off the ground [Heinrich, 1993, pp. 9f.]. Throughout 1992, political debates over the role of some twenty or so National Investment Funds continued [ECE, 1993, p. 41]. These funds are planned to assume control over several hundred SOEs, and are to be managed by international management firms and banks, but they have not been set up until mid-1993.

While the reasons for the different speed of privatisation in EMEs are manifold, the struggle between the state and various interest groups, particularly SOE managers and workers, over the distribution of property rights stands out from an incentive point of view [see also EBRD, 1993b]. The evidence for the EMEs considered here suggests that the delay of privatisation depends on the severity of such conflicts, and on whether vested interests in the form of customary property rights were taken into account when designing privatisation strategies.[20] It follows that the costs in terms of postponed microeconomic adjustment and persistent inefficiency, resulting from protracted struggles for property rights are probably highest in Poland, while they might be significantly lower in the Czech Republic.

The substantial decentralisation of economic coordination in Poland since 1981 resulted in a system of self-management by which employee councils were empowered with far-reaching (de facto) property rights.[21] The central authorities increasingly lost control over SOE operations.[22] Consequently, a rather weak state had to deal with entrenched insider interests after the political revolution in 1989. The mass privatisation programme was a futile attempt to regain control by abolishing the employee councils and installing the state as the majority shareholder, before the shares were then to be transferred to the above mentioned National Investment Funds.

Not surprisingly, this programme met with the strong resistance of SOE insiders, the customary property rights of whom were threatened. Paradoxically, the man-

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[20] The subsequent paragraphs draw substantially on Heinrich [1993].

[21] Their competences included the hiring and firing of managers, wage setting and profit allocation.

[22] The worker dominated councils learned how to play off various levels of the bureaucracy against each other and, thereby, to achieve their own objectives (mostly wage increases) [Szomburg, 1991].

agers and workers of SOEs were legally enabled "to block any practical privatization move" [Winiecki, 1992b, p. 80], as ownership transformation was made contingent on prior approval of the respective employee council. Potential outside investors were discouraged to incur the costs of formulating an adjustment strategy, and most SOEs were kept in a state of limbo. Survey results reveal that the struggle for control resulted in wait-and-see attitudes, insufficient efforts at technological and organisational adaptation, and deteriorating profitability [Dabrowski et al., 1992].

Given the effective lack of government control, a more promising privatisation strategy would probably have been "to buy off the resistance of insiders by recognizing customary property rights and officially granting insiders substantial ownership rights in their firms" [Heinrich, 1993, p. 3]. This proposition is supported by the observation that adjustment efforts were more pronounced in firms under "voluntary liquidation", most of which were ultimately owned or leased by SOE insiders.[23]

Decentralisation of SOE decision making had an even longer tradition in Hungary. State control was further weakened since 1985 when enterprise councils were empowered with similar competences as in Poland. Notwithstanding that the councils in Hungary were dominated by SOE managers rather than the workers, top down privatisation strategies suffered from the same constraints, i.e., a weak state being confronted with powerful insider interests. The situation was complicated by the passivity of commercial banks, which had neither an interest to conclude cases of SOE liquidation nor sufficiently strong incentives to insert fresh money for restructuring potentially healthy firms (Section IV.2).

The foundation of the State Property Agency indicates that Hungary, too, attempted to reinforce state control over the privatisation process, after earlier spontaneous privatisations had fuelled public resistance against fraudulent insider deals [Crane, 1991]. Nonetheless, the Hungarian government respected the customary property rights of SOE managers, thereby containing adjustment disincentives due to persistent uncertainty about the outcome of conflicts between the government and the enterprises. Decisions on the privatisation procedure by the State Property Agency are not binding for self-managed enterprises. The employees of such firms are entitled to 20 per cent of privatisation revenues.

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[23] Apart from SOEs forced into liquidation because they did not meet their tax liabilities, SOEs have also been liquidated voluntarily, i.e., upon initiative or subject to the consent of employees.

Most importantly perhaps, small and medium-sized enterprises may perform their own privatisation without direct government involvement since late 1991 [East European Privatization News, 1992].

In contrast to Poland and Hungary, SOEs in Czechoslovakia had been tightly controlled by the state until the regime change of late 1989. As a consequence, the new government was in a relatively strong position to pursue privatisation strategies of its own design, without being constrained by customary property rights of SOE insiders.[24] The government grasped this opportunity (although the voucher system took more than two years to be implemented): "The scheme involved neither a preferential treatment of managers or workers in the auction process nor any up-front concessions to induce enterprises to participate" [Heinrich, 1993, p. 9].

Ownership transformation appears to be progressing rather smoothly and rapidly in former Czechoslovakia, and now especially in the Czech Republic. This suggests that the costs to a strong government of breaking insider resistance to privatisation are comparatively low. However, a new ownership structure of former SOEs is not necessarily conducive to cost efficiency and restructuring.[25] Much depends on whether a strong or a weak property rights regime fills the gap created by the withdrawal of the state from the position of the principal of productive assets [Williamson, 1992; Frydman and Rapaczynski, 1992]. The voucher system may well result in a weak property rights regime, if it leads to extreme fragmentation of ownership.[26] The shareholders would then lack the incentive and ability to exercise any meaningful control over the management.

Investment funds play a crucial intermediating role in the Czech voucher system [EBRD, 1993b]. Thereby, corporate governance has been strengthened. The large majority of individual investors took the option to place their vouchers with these funds, rather than buying shares of particular enterprises.[27] The impact of privatisation on managerial efforts for efficiency and restructuring thus

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[24] For an overview on the various avenues of ownership transformation in the Czech Republic, see Ceska [1993]. As shown by Burger [1993], the relative importance of different privatisation methods varied from sector to sector.

[25] Aliber [1992, p. 57] noted: "Private ownership may be the necessary condition for the most effective set of incentives, and the sufficient condition may still need to be satisfied".

[26] See also Schmieding and Koop [1991], and the literature given there.

[27] 72 per cent of vouchers have been invested by investment funds on behalf of individuals [EBRD, 1993b, p. 40]. The ten largest funds (out of more than 400) had a market share of 56 per cent [Heinrich, 1992, pp. 311f.].

depends on the behaviour of investment funds. On the one hand, the funds' incentives to monitor the management of privatised firms may have been weakened by requiring each fund to limit its share in one particular firm to 20 per cent, and to include at least ten firms in its portfolio. In particular for small funds, a broadly diversified portfolio of minor shareholdings renders monitoring very expensive and encourages free riding [Frydman and Rapaczynski, 1992].

On the other hand, the chances that the new owners will contribute to the restructuring of privatised firms appear to be comparatively favourable in the Czech Republic [Raiser, 1993a]. Some investment funds have already shown their willingness to be active in controlling the enterprises in which they have significant stakes [CERGE, 1993]. Moreover, the Czech commercial banks are better prepared than their Hungarian counterparts to play a positive role with respect to monitoring enterprise behaviour. First, banks have played a major role in mass privatisation.[28] The acquisition of significant equity stakes is a necessary condition for effective monitoring and provides incentives to overcome bottlenecks such as lacking expertise and deficient accounting systems. Second, equity holdings strengthen the banks' interest in the solution of the bad debt problem, which is important in order to prevent the value of their shares from being eroded by non-performing debt. Third, the Czech recapitalisation scheme (Section IV.2) encourages banks to use their leverage to initiate and supervise the restructuring of privatised firms.[29]

V. The Government's Retreat: Incentive Compatibility After Privatisation

We have argued that governments bear major responsibility in reducing the costs of transition from socialism to a market economy and improving the chances for economic recovery. The question for policy makers in EMEs is not whether to intervene at all, but how to fill the institutional void typically prevailing in the early phases of transition, and how to contain incentive problems stemming from uncertainty of economic agents and temporal policy inconsistencies. The degree of transitional friction depends on the strength of the government, i.e., its ability

[28] Three of the largest four investment funds are run by banks. The three banks accounted for 13 per cent of the total book value of firms approved for privatisation [PlanEcon, 1993].

[29] Given that the sum of bond issues by the Consolidation Bank was fixed in advance, banks might be expected to select firms considered to be potentially healthy, for write-offs of inherited debts. Effective monitoring is a prerequisite for such a decision. By contrast, the largest banks in Hungary have shown reluctance in participating in debt consolidation and await future bail-outs in the light of increasing social pressures [e.g., Szanyi, 1993]. On the link between privatisation and financial reform, see also Corbett and Mayer [1991].

to effectively monitor the transformation process and resist rent-seeking by pressure groups (especially SOE insiders). A strong government is less prone to erratic policy shifts and better prepared to create a predictable and harsh environment for enterprises and banks. The higher the government's credibility and reputation of unconditional commitment to reform, the easier it will be to enforce direct controls and later prevent moral hazard problems.

The experience of the frontrunners in economic transition suggests three major areas where governments in latecomer EMEs could contribute to lowering transition costs. First, the lack of competitive capital markets requires government action to discontinue financial laxity. Second, government intervention is required to shape the process of wage formation in the absence of well functioning labour markets. Third, the speed of large-scale privatisation matters for shortening the interim period during which incentive problems result from ill-defined and unprotected property rights.

Direct interventions cannot remain forever. The progress made with privatisation and the extent to which redundant labour may easily be absorbed by the growing private sectors determine the appropriate timing for the government's retreat [Burda, 1993]. In this respect, the Czech example suggests that the more effective direct controls have been, the earlier they may be replaced by indirect measures. For example, the volume of credit in the Czech Republic is now controlled with interest-rate policy. Falling real lending rates may lead the path to economic recovery. With an expected private sector share in GDP reaching 35 per cent by the end of 1993 [PlanEcon, 1993; EBRD, 1993b], an incomes policy may no longer be needed to avoid a second-round wage push.

Nonetheless, some incentive problems may persist even once privatisation has been completed. The crucial question remains whether the change in ownership results in a strong or a weak property rights regime. Only a strong property rights regime would minimise principal-agent problems and create sufficiently strong incentives for cost efficiency and restructuring. The ongoing debate on alternative systems of corporate control in advanced market economies suggests that a clearly superior model, which might be copied by EMEs, does not exist. Nonetheless, there is some evidence on how to strengthen corporate control after privatisation, or at least to circumvent major pitfalls.

It is important to avoid extreme fragmentation of ownership. As a promising avenue towards effective monitoring, investment funds might be put in a controlling position in important parts of the economy. If as in the Czech Republic commercial banks are actively involved in the management of these funds, the

incentives for banks to acquire the skills necessary for monitoring of and sound lending to enterprises would be strengthened. At the same time, the profit chances of banks having a strong say in enterprise restructuring can be expected to induce more competition in the financial sector of EMEs. This would help overcoming the chicken-and-egg problem [EBRD, 1993b, p. 18], namely that a viable banking sector is required for sustained economic growth, but new banks are unlikely to consider market entry unless the economy is reviving. Universal banking may thus become the hallmark of investment-led growth in EMEs.

Furthermore, the positive incentive effects of privatisation depend on whether the government strictly adheres to a hands-off approach after the change in ownership. The failure of large-scale privatisation in Chile in the 1970s is telling in this respect [Agarwal and Nunnenkamp, 1992]. The new private owners had easy access to public loans in financing the acquisition of firms and maintaining their operations, and could reasonably expect to be bailed out once financial problems emerged. Basic solvency rules were not in place. In other words, the budget constraints of privatised enterprises remained soft. Under such conditions, the incentive structures of the new owners are not too different from those which had prevailed in SOEs. Moral hazard can only be contained if privatisation definitely releases the state from entrepreneurial risks. This may be easier to achieve if privatisation goes along with deconcentration, as huge industrial conglomerates have significant political leverage irrespective of whether ownership is public or private. Ultimately the success of privatisation hinges on the government's credibility to organise its own retreat once and for all.

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