On Privatisation and Restructuring

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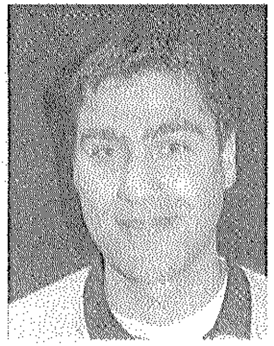

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On Privatisation and Restructuring

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Abstract: This essay deals with the issues of privatisation and restructuring in transition economies. The topics are addressed in both a descriptive and empirical manner, but omitting a formal treatment. The centre of the analysis is the interrelation of privatisation, the resulting ownership form and the expected and actual effect on restructuring behaviour of firms. The essay identifies a slow progress in privatisation, paired with an overweight of insider owners. Furthermore substantial evidence on slow restructuring is collected. Overmanning and excessive social assets prevail in the privatised firms - in part regardless of the new ownership structure. Finally, the link to the government's fiscal situation is drawn, the costs of restructuring to the government budget are identified. In presenting such account of the privatisation and restructuring situation, the essay provides a basis for formal explanations of slow privatisation and sluggish restructuring.

Key words: Privatisation, Restructuring, Transition

JEL classification: L33, P20, O00

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1. The idea for this essay was advanced to me by Stephen Pudney, Peter Skott and Alf Vanags. In writing it I benefited from the comments of Ebbe Yndgaard and Jørgen Drud Hansen. The usual disclaimer applies.

1. Introduction

Transition is the move from a centrally-planned system with nationalised enterprises, collectivised farms and housing, price controls and trade restrictions, towards a market economic system. Parallel to this economic transformation, transition countries typically have to re-installed or re-invent their entire political structure. In the initial situation of central planning both prices and quantities are controlled by the state. Accordingly, the flows of goods and supplies are planned as well and scarcity cannot be signalled by prices - this results in the characteristic queuing. Since the theory of central planning relies heavily on economies of scale, we find enormous state owned enterprises (SOEs) that in many cases assume monopolistic positions. At the outset of transition the private sector is rudimentary or non existent. Such centrally-planned system features tremendous inefficiencies: waste of resources and labour, excess demand and supply, soft budgets and economic dissatisfaction.

On the other hand, socialist economies displayed a considerable degree of social security. Education and training were free and are usually assumed to be of good quality. Firms are supposed to feature a great deal of worker involvement and there was little or no open unemployment. In principle there was wide reaching economic equality among people; further there was a large share of female workforce participation. Social institutions, like healthcare or child care have traditionally been free of charge. However, many of these social services were provided through the SOEs.

Government revenue was largely financed out of the revenues of SOEs, on top of the fact that many traditional state functions (like certain social services) were also provided via the firms. During the early years of transition tax revenue fell and demands on the state rose. This poses a common problem to all governments in transition economies. An additional disadvantage for the republics of the former Soviet Union was that no administrative or legislative body was in place, hence a tax system, monetary policy tools, government ministries, bankruptcy laws and legal enforcement all have to be created, mostly from scratch.

Having almost all productive capacity, land and property collectively - or rather state - owned, poses a common challenge to all transition economies: privatisation. Enduring delays in privatisation, and schemes that are constrained by political objectives, created major holdups to the economic reform process. Privatisation in itself - of course - is not a sufficient condition for economic transformation. The ultimate aim is the restructuring of firms. Restructuring concerns the efficiency of firms, while privatisation concerns the ownership of firms. Privatisation and restructuring are of course interrelated. In particular, privatisation will install owners that face the right incentives to optimise (hence restructure) their firms. Thus, in theory privatisation promotes restructuring.

This latter point, however, depends on a fairly complex reasoning of economic theory.[2] Within the envisaged mechanics there may be failures and pitfalls, a number of which are addressed in Schröder (1997, 1998a, 1998b). In fact the present essay finds that both the progress of privatisation and the actual restructuring rate falls short of expected levels. Further, it appears that the problem is in part independent of the new ownership form of a firm after privatisation. Such lack of restructuring (and the sluggish privatisation record) is a puzzle, and it is at the foundation of the continuing economic difficulties in transition economies. By focussing the present paper on the actual experience and problems of transition economies, in respect to privatisation and restructuring, we can motivate and underpin the theoretical models mentioned above. The descriptive aim - in particular on the problems associated with the lack of restructuring - matches exactly the focus of these theoretical papers.

The contents of these papers can be summarised: Schröder (1997) considers manager's incentives to restructure in a setup of insider privatisation. The paper challenges the common claim that manager owners are eager to prove their restructuring ability. The argument is based on the fact that managers' motivation - namely career concerns - does in fact depend on the structure of the entire economy. Hence, the restructuring effort depends on the overall outcome of the privatisation program. If it is the case that the majority of firms - after privatisation - is owned by workers and that workers dislike tough (restructuring) managers, then a manager owner of a firm might choose not to restructure in order to improve his future career opportunities. Schröder (1998a) generalises on this type of effect by formalising the shareholder/stakeholder conflict. That is, those that receive the shares in the privatised enterprises are also stakeholders in those enterprises. They may be workers, managers, suppliers, creditors, etc (i.e. hold a stake in the firm). How and when the shareholder/stakeholder conflict results in low or no restructuring is identified in the paper. Additionally a government is introduced into that framework, and the choice of a privatisation program (i.e. the mix of new owners chosen by the government) examined, given some political objective function. Finally, Schröder (1998b) identifies and formalises a

2. For an authoritative introduction to the theoretical side of the privatisation issue consider part 1 of Vicker's and Yarrow's well-known book (1988). Part 2 of that book concerns the British privatisations of the 1980s, which are the best known source of cases on the topic. However, note that the situation in transition economies is quite distinct from the British experience, largely because of the size of the undertaking. Accordingly, we often find the term mass-privatisation applied to Central and Eastern Europe.

fiscal constraint to restructuring. Namely, at the governmental level full restructuring of the privatised firms strains the budget: unemployment rises, so does benefit expenditure. On the revenue side the tax base shrinks. Accordingly, governments find them selves in a squeeze of conflicting demands - promoting structural adjustment and stabilising the economy (keeping a low budget deficit). Hence, the government may opt for slow privatisation and/or install owners that only restructure moderately.

The present essay identifies three interrelated elements as crucial. The privatisation method paired with the 'available' new owners. The resulting ownership form, and the progress of privatisation as a whole. The new owners' theoretical and actual preferences for restructuring.

The macroeconomic setting of transition

To put our examination of privatisation and restructuring into a broader economic perspective, table 1.1 presents data on GDP and inflation for a selection of transition countries.[3] Both the transitional recession and the high inflation experience can be identified. This is the setting in which both the privatisation of SOEs and enterprise reform have to take place.

Table 1.1 (column 2) shows clearly a major economic down turn for all transition economies, in fact only 3 of the 14 shown countries are estimated to have reached above their 1989 GDP levels by 1998. Generally the collapse of GDP appears to be more severe for the former Soviet Republics, than for the Central European countries. However, we have to bear in mind that there are considerable problems in calculating GDP levels. Firstly, quality improvements are not entirely accounted for. Secondly, the high inflation of the period distorts the data. Nevertheless, as an illustration of a common feature for transition economies it is striking. More trustworthy are the estimations on GDP growth for 1998. Even though we find impressive growth levels for some countries, the weighted average for Central and Eastern Europe including the Baltic states is at only 3% in 1998, while the Commonwealth of Independent States experiences a decrease of -3.6% (mainly due to the Russian fall in GDP). In any case, talk of 'booming' or 'tiger' economies would be inappropriate. Of course, the underlying problem must be the performance of enterprises. This in turn depends on privatisation and ultimately restructuring.

3. The same selection of countries will be presented wherever possible throughout the paper. The grouping consists of three sub groups: the first seven countries stand for 'Central Europe', than follow the three Baltic republics, followed by a sample of four Commonwealth of Independent States countries.

Table 1.1 GDP and Inflation in Transition Countries

	GDP (in real terms)		Inflation (end-year)	
	Growth 1998 (percent)	Level 1998 (1989=100)	1992 (percent)	1997 (percent)
Bulgaria	4.0	66	79.4	578.5
Czech Republic	-1.0	97	12.7	3.8
Hungary	4.9	95	21.6	18.4
Poland	5.2	118	44.3	13.3
Romania	-5.0	78	199.2	151.4
Slovak Republic	5.0	100	9.1	6.4
Slovenia	4.0	103	92.9	8.8
Estonia	5.0	77	953.5	12.0
Latvia	4.0	58	959.0	7.0
Lithuania	3.0	63	1161.1	8.5
Armenia	6.0	40	10896.0[1]	21.8
Georgia	9.0	35	1176.9	7.1
Russia	-5.0	55	2506.1	10.9
Ukraine	0.0	37	2730.0	10.1

Source: EBRD (1998), table 3.1 , table 3.3.
Note: GDP growth and level data for 1998 are EBRD projections. The inflation data is the percentage change in the year-end retail/consumer price level. Inflation data for 1992 comes from national authorities, IMF, World Bank, OECD and PlanEcon. Data for 1997 are preliminary actuals, mostly from official government sources.
1. Data for 1992 is not available the figure shows 1993 instead.

Turning to the inflation figures presented in table 1.1. We find stabilisation across the board. Recent major increases are only found in Bulgaria and Romania, which in fact had reduced inflation substantially in the intermediate period. The stunningly high levels found in 1992 are clearly connected with the Russian price liberalisation - which transmitted into the other Soviet Republics (in fact the Ruble was still legal tender for many of the republics at the beginning of 1992). This environment of macroeconomic distress and stabilisation sets the stage for structural reform: privatisation and restructuring.

Structure of the paper

The paper proceeds as follows: Section 2 deals with the topic of privatisation. We discuss theoretical methods of privatisation and the actual choices made by different transition countries. In section 3 the issue of restructuring is reviewed. Evidence of low restructuring levels and prevailing inefficiencies (including overmanning and excessive social assets) is presented. The possibility of a fiscal constraint to restructuring is discussed in section 4. The mechanics of the fiscal constraint are outlined and some evidence is provided. Section 5 concludes the paper by placing the debate on privatisation and restructuring in a broader context. In particular the link to the requirements of EU-enlargement is drawn.

2. Privatisation

The initial focus of the transition literature on the question of SOEs was on privatisation. This is the starting point of section 2. Privatisation reallocates the ownership rights - i.e. the rights to the revenue of a company - from the public domain into the private domain. An early overview on privatisation can be found in Bolton and Roland (1992) who compare strategies in Poland, Hungary, Czechoslovakia and East Germany. Hare (1994) identifies the core methods, constraints and costs of privatisation. More recent assessments can be found in the EBRD Transition Reports (1997 and 1998). Section 2.1. below starts out by Hare's segregation of modes of privatisation, the *a priori* advantages and problems associated with each mode are discussed.

To get an overview on the actual privatisation programs chosen by transition countries we present EBRD (1997) data in section 2.2. Other such surveys can be found in the World Development Report 1996 (World Bank, 1996). The results and progress of privatisation, for example the degree to which GDP is produced in the private sector, are summarised and presented in section 2.3.

During the discourse of section 2 I address several dimensions judged to be relevant in relation to privatisation. Namely: Restructuring effectiveness; in how far will the privatised enterprise engage in restructuring. Administrative demands of a certain program; how easy and swiftly can SOEs be privatised. The need for existing wealth in the economy; in how far does a certain privatisation method depend on the availability of domestic funds. The political feasibility; do certain privatisation methods or outcomes meet political resentment.

These dimensions can be understood as the constraints to a privatisation method, and will thus feature in the discussion. In section 2.4 I will summarise our results by ranking a number of privatisation methods (resulting ownership forms) according to these constraints.

2.1. The theoretical modes of privatisation

In principle, as a phase zero of any privatisation program, socialist enterprises have to be modified into legal entities at first. Typically this will take the form of a joint-stock company, where all shares are held by the state or local municipality. Only now can the enterprise be sold (or given away). In theory there are a host of modes or methods of privatisation. However, only a few are of empirical relevance, this will become clear in section 2.2. below. What may be the cause of this will be discussed in turn for each of the methods. We will focus on their theoretical advantages and problems, their associated costs, and their necessary pre-conditions. The methods of privatisation can be grouped as shown in table 2.1.

Tabel: 2.1 Methods of Privatisation

	Description of method	Alternative term
a)	Sale by public offering of shares	Sale of shares
b)	Closed or limited tender (sale by private treaty)	Tender
c)	Sale by public auction	Auction
d)	Leasing of firm assets	Lease
e)	Management and/or worker buyout	Insider privatisation
f)	Free (or token) distribution of shares/vouchers to population	Voucher privatisation[1]
g)	Free (or token) distribution of shares to wokers/managers	Insider privatisation
h)	Free distribution of shares to social institutions	-
i)	Restitution of property to former owners	Restitution

Source: Hare (1994), p.194.
Note:
1. Often the term equal access voucher privatisation is used, indicating that no concession to insiders is given.

The various methods require different degrees of wealth and expertise on behalf of the new owners, as much as different amounts of administrative capacity and time from the privatising government. While a voucher privatisation may be open to all citizens independent of wealth, auctions are only open to citizens with financial funds. Tender procedures may require a comprehensive business plan from the potential new owner, while sale of shares requires no expertise on behalf of the new owners what so ever. While insider privatisation may be administered fairly easy and swiftly, the restitution of property to former owners can be a length affair - in particular given the complex history of many CEEC countries.

The potential 'buyers' of SOEs

Before we proceed to discuss some of the central methods in depth it is important to state explicitly the pallet of potential 'buyers' of SOEs (table 2.2). The combination of method and buyer then creates the new ownership structure - hence, is relevant for corporate governance. As was mentioned in the introduction, dependent on ownership, we expect different restructuring performance. One central theme of ownership discussed in the next paragraphs is concentrated versus disperse ownership. The typical *a priori* restructuring decision per ownership/privatisation form is discussed in the reminder of section 2.1.

Table 2.2 Possible buyers/new owners of SOEs

	Description of group	Alternative term
a)	Incumbent management	Insider privatisation
b)	Workforce	Insider privatisation
c)	Insiders (mix of managers and workers)	Insider privatisation
d)	Existing domestic firms	Takeover
e)	Domestic investment funds / banks	Institutional
f)	General population	Disperse ownership
g)	Foreigners (Firms, banks, private)	Foreign / FDI
h)	State / municipal	Non-privatised

The first three owner groups/forms in table 2.2 are all cases of insider privatisation. Insiders may have a knowledge advantage when engaging in privatisation; however, they are linked to the enterprise in several ways - in particular they are also stakeholders. A manager owner can be considered a concentrated ownership form, while worker owners are more disperse. In theory a concentrated ownership form where one individual (or small group) holds all the shares should result in optimising the profits of the firm. In disperse ownership forms coordination difficulties and free riding can be expected to emerge. An extreme scenario in terms of disperse owner ship is clearly the allocation of SOEs to the general public. Each agent is endowed with a share in a certain enterprise too small to make his effort in engaging in the destiny of the firm worthwhile.

The role of existing firms (d in table 2.2), as new owners, is naturally very limited in a scenario of mass-privatisation - only in later stages can those firms privatised previously act as buyers. In terms of governance, corporate owners of enterprises are expected to monitor subsidiaries effectively. However, a principal problem in transition economies is industry concentration. Given the typically few competitors a ‘German-style’ cross ownership has substantial hazards. The relevance of domestic banks and more importantly investment funds emerges in a situation of voucher privatisation. The general public posts its vouchers/shares in a fund. The fund may now have ‘critical’ mass in terms of corporate governance, i.e. problems of disperse ownership are overcome. However, banks and/or investment funds as in the Czech experience might still be short of know-how on certain industries. More critically, they are also potential stakeholders in the firms they own/monitor. For example a bank that is both the creditor and the ‘indirect’ owner of an enterprise can end up in a conflict. As a shareholder the bank might want to seek extended credit for a troubled enterprise it owns - however, as a bank, it ought not to extend such credit.

Foreign owners have advantages in terms of available wealth and expertise (ergo the possibility of concentration in ownership), yet, their practical relevance in the privatisation programs of transition economies has been minor. Sinn and Weichenrieder (1997) discuss this problem and possible remedies in depth. The general theme is that there is more or less latent resentment to foreign owners - a problem christened the ‘family silver problem’. Transition governments find it politically impossible to sell SOEs at the current ‘fire sale’ prices to foreigners. However, in terms of restructuring, foreign owners are *a priori* the most rigorous. Thus, the lack of their involvement in the privatisation programs of most CEEC countries poses a grave deficit.

Finally, the outcome of any privatisation program and/or sub-phase of a privatisation program may be that a certain SOE is not sold at all - it may merely be converted into a joint-stock company with all shares held by the state (h in table 2.2). In principle state ownership of firms need not be the worst outcome. The state as a shareholder could vote and monitor for full efficiency. However, in practice the state as an owner of enterprises is a stakeholder of magnitude. The state has a major stake-holding in firms in various ways. Some of those stakes are: the general employment level in the economy, wage setting in the state sector - which is typically less flexible, various political objectives (regional development, equality, environment, etc). Additionally, most privatisation programs in Central and Eastern Europe have excluded some strategic industries which are to remain in state hands, at least for some time. Typical cases are telecommunication, energy, transportation, harbours or military industries. These are industries that, at least until recently, have typically be state-run in most Western European countries as well. A core problem of firms that remain in state hands is that in the absence of control (i.e. the planning authority is non-existent) the insiders fill the power vacuum. Such firms can be expected to behave similar to insider owned firms.

We can now turn to a discussion of the central privatisation methods introduced in table 2.1.

Sale of shares and auctions

Sale of shares and/or auctions are the traditional means of privatisation in Western Economies. In particular the British privatisations of the 1980s used these methods. The auction has the advantage that it determines the 'right' price of the asset to be privatised, contrary to the 'sale of shares' method which can undervalue the asset and give windfall gains (or loss) to the first generation of owners. On the other hand the 'sale of shares' method will result in widespread ownership while an auction results in owner concentration. Disperse ownership - despite the corporate governance problems introduced above - might be considered politically desirable.[4] Common to both methods is that they require a substantial amount of wealth on behalf of the new owner. This is what makes them less-suitable for transition economies - unless, of course, foreign ownership is not met by political resentment. The problem is that in socialist economies the accumulation of private wealth has been quite difficult. What ever savings people may have had, have been eroded by the high inflation of the early transition years (see table 1.1). Ownership of land and property was forbidden or tightly regulated. Hence, assuming that only domestic ownership is aimed at, then auctions and/or 'sale of shares' will not yield particularly high revenue for the state. Additionally, the individuals that managed to accumulate some wealth are typically associated with the nomenclatura - awarding them with a good starting position by sale privatisation has been politically unpopular.

Despite these problems, auctions and the 'sale of shares' method did play some role in the mass privatisation programs of CEE countries. In particular the management and /or worker buyout of small business. Small service firms or retail outlets with only a couple of employees like restaurants, hostels, kiosks were mostly privatised in this manner. Also - if possible - households purchased the flats or houses they were living in. Yet, in particular the latter purchase - even though state owned at the outset - is not the type of asset we usually have in mind when discussing issues of privatisation and restructuring.

Lease and spontaneous privatisation

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4. This was in fact the case in some of the British privatisations - the 'nation of shareholders' was part of the political objectives. The case of underpriced shares in the 'sale of shares' method occurred in the privatisation of British Telecom.

The method of leasing firm assets has been little used. The main reason for this are the immense administrative costs involved. However, in practice the sale of firms for a token value can be interpreted as an indirect lease, where the actual fee is paid continuously via the tax system.

In technical terms related to official/legal leasing is 'unofficial' leasing, namely asset stripping or spontaneous privatisation. These phenomena - even though not part of official privatisation programs - hence, not introduced in table 2.1, do feature in transition economies and need to be addressed. By an asset stripping arrangement we usually mean a situation, where the incumbent manager of a SOE establishes (or let's some associate establish) some new private company. He then hires (or leases) the SOE's productive facilities at a token price to that new company. Like this he can extract the possible surplus of the SOE, whereby the SOE is turned into an even bigger loss maker. This in turn makes the privatisation of the SOE more difficult, i.e. it is harder to find a buyer. I would describe spontaneous privatisation in fact as a similar arrangement.However, here the SOE's assets are transferred permanently via sale or outright stealing. Naturally it is hard to measure the extent of those practices - despite for the anecdotal evidence available. It is my impression that the evidence points to an increasing frequency of asset stripping and spontaneous privatisation the further east we get.

Voucher privatisation

Voucher privatisation overcomes the main problem of the auction and 'sale of shares' method. For a voucher privatisation program there need not be wealth accumulated in the population. Each household or individual is endowed with a voucher, entitling it, him or her to a certain share value. Vouchers can now be used like money in the purchase of shares or an auction. The amount of vouchers, allocated to each person and/or household, may depend on age, years of employment, previous income, etc. or simply be a flat rate.[5] Further, we can distinguish between equal access voucher privatisation, where the general population receives vouchers usable on all assets, and voucher terms with considerable concessions to insiders (e.g. the Lithuanian case introduced below).

The best known case of voucher privatisation is the Czech program. Here the emergence of investment funds made it possible for the individual voucher owners to place their portion in

5. In fact privatisation vouchers have also been used as compensation devices - i.e. substitute for money. Note that here they do not feature on the government balance. For example the Lithuanian government used privatisation vouchers as compensation on restitution claims, while the Ukraine used vouchers to recompense people for lost bank deposits.

a fund which then managed the deposited vouchers in a portfolio of firms. In several other cases, best known are Russian examples, the workers and management of a SOE pulled their vouchers to purchase the firm they work at (resulting in insider privatisation). In the reality of many other voucher programs, vouchers have often been used to purchase the flat a household lives in.

Insider privatisation[6]

Of particular importance is the case of insider privatisation, no matter if the transfer of ownership rights was compensated with money, lease fees or vouchers. Insider control of firms occurs once a decisive portion of shares is hold either, by the management, the workers or a mix of the two groups.[7] Insider privatisation is commonly held to be the fastest road to property rights redistribution. Because of the easy administration and maybe because it was typically politically popular, this type of privatisation features extensively in many CEE countries.[8]

The usual claim for insider ownership is that the allocation of control rights to the management will ensure fast and complete restructuring, as opposed to worker controlled companies. The reasoning behind this argument is in fact based on a classic shareholder/stakeholder conflict. The reasoning goes as follows: The inefficiencies in SOEs are not only in the form of wasteful production methods and inferior quality products but also in the form of excess and idle labour (McMillan, 1995). Additionally, SOEs provide a wide range of social services from food subsidies to housing to their workers (Freinkman and Starodubrovskaya, 1996).[9] The extension of the firm's activity into the sphere of municipal duties (namely social services) parallels the excessive production depth we find in centrally planned economies (Mayhew and Seabright, 1992, p.107). Having privatised firms, it should be part of restructuring to bring down overmanning and excessive provision of firm social services. Here the problem emerges: these particular inefficiencies are in part in the workers interest, especially since overall unemployment is on the rise and state social provisions are shed in the transitional recession. Accordingly, workers' incentives to restructure are low.

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6. Part of the discussion in the next paragraphs is also found in Schröder (1997).

7. Of course, in the absence of any dominant shareholder, insiders may be able to control a firm without having any property rights at all.

8. Privatisation programs where insider privatisation was a main element (at least as an outcome, even though not always intended) took place in Romania, Slovenia, Croatia, Poland, Lithuania, Mongolia, Georgia and Russia (World Bank, 1996, ch.3). The report forwards also rationales for this development. In section 2.2 the extent of insider privatisation will be shown.

9. Evidence of both overmanning and firm social assets will be presented in section 3.

The issue of insider owners that benefit from firm inefficiencies is well known in the literature. By now it should be clear that this type of conflict in general arises once shareholders are also stakeholders - i.e. supply labour to (receive social provisions from) the enterprise. Nuti (1996a+b) points out that as soon as an individual holds a smaller share in equity than in the total input supplied (benefits received) their stakeholder interests override their shareholder interests. This point is extended and formalised in Schröder (1998a). Contrary to worker owners managers are assumed - given that they are not stakeholders and that there is the right compensation scheme - to be tough in fighting inefficiencies. The motivating compensation scheme will be some share of the property rights in the firm - which is the whole point of insider privatisation.[10] Of course the managers in transition economies might be in quite a different setting. This is the subject of Schröder (1997) where managers' career concerns can result in a non-restructuring outcome. Additional disadvantages of manger ownership - specific to transition economies - stem from their alleged lack of know-how. The incumbent managers might be ill-suited to turn around the old ways of their enterprise. However, in practice new expertise can only be imported and is typically associated with foreign owners or foreign participation (FDI).

Finally, - and in part because of the corporate governance problems associated with insider ownership - insider owners may find it hard to raise capital on the financial markets. The reason is, that their stakeholding in the firm gives them the opportunity to defer funds away from the repayment of debt . Paired with the generally weak and short-term oriented financial sector of transition economies, this puts insider-owned firms at a particularly bad starting position.

Issues of worker ownership

In relation to insider privatisation it is important to discuss the issue of workers' coalitions and worker ownership of firms. One of the core problems of insider owners - that we identified above - was that firms, managed or owned by workers are run inefficiently, because the employees try to maximize total wages instead of profit. In particular, via their

10. However, as is argued above, outsider ownership of the firm is a necessary condition for comprehensive restructuring. Having this in mind, then the initial insider share allocation should only be judged according to resale possibilities. Namely, are the new owners chosen such that they would want to sell their shares to an outsider with a profitable business (turn around) ides. Now manager block share holdings can be a disadvantage. Disperse worker shares are preferable because they can more easily be purchased by outsiders with the right investment and restructuring plan (Aghion and Carlin,1996) and (Aghion and Blanchard, 1996). Further, from a corporate governance point of view it is not entirely obvious that share ownership is the optimal mechanism for enforcing efficiency. See Thompson and Wright (1995).

stakeholdings (as wage earners) the workers can defer profits to them selves. However, this argument need not hold. If the firm is really completely owned by the workers, then they must be indifferent to receiving the surplus through wages or dividends. Additionally, such firm ought also to engage in restructuring. Namely, a majority coalition of non-shirking workers would find it beneficial to dispose of their idle colleagues. Even if workers are identical, the gain can in principle be large enough to compensate the workers for the risk of being one of those that gets fired.

It can be argued that the Yugoslavian experience of worker cooperatives is exactly supporting the case for efficiently run insider-owned firms. However, some of the more recent evidence on transition economies, part of it presented in section 3.3 below, indicates that insider privatised firms underperform. Still, the reasons for this could be the lack of know-how and the lack of financial resources. Thus, it is not fully evident that worker-owned firms will and do display inefficiency, because of their stakeholdings.

2.2. Actual choices: routes chosen by transition countries

In general all forms and mixes of privatisation methods were and are applied in transition countries. Hereby it is important to note that privatisation is far from concluded for most transition countries. The constraints of public wealth and expertise make some modes more applicable than others. In particular, as an outcome, elements of insider privatisation feature in many programs.

Table 2.3 gives an overview of methods for a number of transition countries. A main obstacle to summarising the actual routes chosen by transition governments is that countries have to launch several privatisation waves. Firstly, in case of a change of government the new government will typically adjust the existing privatisation program. Secondly, programs may fail to give the required results. For example sales or auction programs could well fail to actually allocate all firms. Hence, table 2.3 shows the two main means of privatisation per country. The material is collected by the EBRD (1997). In terms of the degree of privatisation only the Czech Republic, Hungary, Slovak Republic and Estonia reach satisfactory levels by 1998, that is they have completed more than 50% of medium size and large enterprise privatisation. All other countries stay below that threshold! These measures of how far privatisation is concluded come from the EBRD (1997, table 5.7; 1998b, table 2.1). For small scale privatisation the figures look better: Complete privatisation of small enterprises is achieved by 15 out of the 25 surveyed transition economies in 1998.

Nevertheless, contrary to common opinion, privatisation is far from concluded and continues to be a topic of paramount importance to transition countries.[11]

Table 2.3 Main Privatisation Methods per Country (Status 1997)

	Main Mode of Privatisation	**Secondary Mode**
Bulgaria	Sale to outsiders	Voucher (public)
Czech Republic	Voucher (investment funds)	Sale to outsiders
Hungary	Sale to outsiders	-
Poland	Insiders (mebo)*	Vouchers (public)
Romania	Insiders (mebo)*	Sale to outsiders
Slovak Republic	Insiders (mebo)*	Vouchers (public)
Slovenia	Insiders (mebo)*	Sale to outsiders
Estonia	Sale to outsiders	Insiders (mebo)*
Latvia	Vouchers (public)	Sale to outsiders
Lithuania	Vouchers (public)	Insiders (mebo)*
Armenia	Vouchers (public)	Vouchers (insiders)
Georgia	Vouchers (public)	Insiders (mebo)*
Russia	Vouchers (insiders)	Sale to outsiders
Ukraine	Insiders (mebo)*	Vouchers (public)

Source: EBRD (1997), p.90.
Note: Voucher (public) indicates that the general public had access to the vouchers, i.e. equal access voucher privatisation. Vouchers (insiders) indicates that significant concessions to insiders were made. All other terminology is used as defined in section 2.1.
*: management employee buy out.

Table 2.3 indicates clearly the important role of insider privatisation. In fact those countries that I have omitted in the table (Albania, Croatia, Macedonia, Azerbaijan, Kazakhstan, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan, Uzbekistan) follow either in that pattern or

11. Note that there is an essential difference between the percentage of state assets privatised (as in the present measure) and the percentage of GDP produced in the private sector. Differences in productivity, growth, size of firms and old or *de novo* private firms make the two measures differ from each other. The latter measure will be explored in table 2.4 below.

are at a very early stage in privatisation.[12] In section 3 we consider whether or not this ownership pattern has led to the *a priori* expected delays in restructuring.

The second most relevant method of privatisation - as shown in table 2.3 - is voucher privatisation. As discussed in section 2.1. the chief reason for this is the lack of wealth in the population. Also, on pure ideological grounds is the transfer of collectively owned assets of production most 'fair' via vouchers - hence, generates political support. Sale of shares (or auction) to outsiders appears to be the third most relevant means of privatisation. In the discussion of theoretical advantages this method ought to give the best results in terms of restructuring, hence, in terms of efficiency it should have featured the most.

I shall now sketch some components of privatisation and the current state of the programs for three countries. This overview aims more at variety than completeness. Comprehensive accounts of individual countries privatisation policies are found in EBRD (1995, 1997, 1998b). The three country accounts presented below build on this reports.

Czech Republic

The success and effectiveness of the Czech voucher privatisation (the first wave of privatisation) was largely determined by the emergence of investment funds. Such funds made it possible for the individual voucher owners to place their personal vouchers in a fund which then managed the deposited vouchers in a portfolio of firms. In hindsight the construction of investment funds appears to be a mixed blessing. This will be discussed in section 3.2 below. An important feature in the Czech republic is that the state held on to minority shareholdings via the National Property Fund (NPF), the privatising agency. Such minority holdings are ignored when computing the private sector share in GDP, as calculated in table 2.4. Hence, considerable privatisations remain to be completed, state holdings in strategic enterprises and banks are substantial. Currently the state continues to sale off its minority holdings (in those enterprises not designated 'strategic') by direct sale, auction and public tender. Despite the major first wave of privatisation by voucher, the government still holds on to a considerable amount of shares. The EBRD states that for 1996 the NPF is assumed to hold 40% of all shares, with another 30% held by the investment funds that emerged under the first wave of privatisation. Hence, we see that the resulting structure of ownership in the Czech case is far from the patterns of western economies.

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12. A differnet approach that identifies the same dominance of insider ownership is given by the World bank (1996, chapteer 3). The find that insider privatisation was particularly extensive in Romania, Slovenia, Croatia, Poland, Lithuania, Mongolia, Georgia and Russia.

Lithuania

Lithuanian privatisation was split into two waves, the first wave was voucher based in the period from 1991 to 1995. The second wave since mid 1995 tries to focus on sale for cash and the involvement of foreign investors. Of the more than 70% of all state assets that were put up for privatisation in the first wave, only 30% were actually privatised by 1995.[13] Hence, the need for a second wave. The new strategy established a state privatisation agency - analogous to the German Treuhand. Again from the ambitious list of 400 enterprises to be sold in 1996, only 50 got actually privatised. Besides, the participation of foreign investors is still minimal and only picking up in 1997/98. As a particular concession, the Lithuanian program had for most enterprises reserved up to 50% of shares for the enterprise's employees. Hence, resulting in considerable insider dominance.

The Lithuanian example emphasises the qualitative difference in the privatisation of small versus medium and large enterprises. Privatisation of small enterprises and the state housing stock proceeded rapidly. Actually this phase was completed in the early years of the first wave. This is in fact were most vouchers have been used. A starting problem in the Lithuanian privatisations has been that the government and privatisation agency had been relatively lax in awarding firms the title 'strategic' or 'special purpose'. Such enterprises were excluded from privatisation - even though, they often were the most attractive objects. This exception policy has only been tightened in 1997/98. The Lithuanian case exemplifies that privatisation is an ongoing problem.

Ukraine

Ukraine has traditionally been one of the laggards in transition. The political landscape is marked by resentment, disagreeing reformers, U-turns and backlash. Privatisation started slowly in 1992, resulting mainly in insider ownership. The methods that were used are the lease of firms to insiders and management employee buyouts. In 1994 the president tried to step up privatisation by the introduction of vouchers and compensation certificates. The compensation certificates were paid out as a reparation of lost savings - more than 17% of the

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13. Compared with the privatisations in Western Economies the possibility of 'simply not being able to sell' strikes me as odd. There are two elements in explaining it. Firstly, the supply of vouchers is in principle limited. If prices are overheated in the early phase the vouchers may be used up before all assets are sold. Secondly, firms may not be sold because information on the true value of the firm is not accessible to outsiders (voucher owners). Insiders may not be interested to reveal the true value of their firm (e.g. that might be the value after restructuring, namely firing the manager). However, the value of your own flat you got a pretty good idea about - as in fact agents may be able to establish the value of a small enterprise they are working at. Thus, this is where vouchers get used.

population received such compensation certificates. Vouchers and certificates are used at auctions, parallel sale through cash auctions and tender continued. Overall privatisation proceeded slowly, the distribution of vouchers to citizens took three years, and the private sector's share in GDP is at 55 % in 1998, one of the lowest rankings in Central and Eastern Europe (see table 2.4). By 1997 the sole progress areas were: 1) small enterprises mostly sold to the insiders and 2) housing, where 40% of the formerly state owned housing stock was privatised by 1997. Again these two areas prove to be the 'easy wins'.

In response to the voucher based part of the privatisation program, investment funds - similar to the Czech construction - emerged. The investment fund collects the vouchers of the participants and bids then for a portfolio of privatisation objects. A core problem in the Ukrainian case is a strong lobby against the sale of agricultural land. This leaves farming in a close to collectivised state. Finally, it can be noted that the Ukrainian privatisation did not engage in any restitution of former owners. Overall the Ukrainian example shows two things: Firstly, insiders are frequently installed in the new owners of those firms privatised. Secondly, much is still to be privatised. Hence, policy advise or insight as to the design of privatisation programs - and their effect on restructuring - is not merely of academic interest. A new effort to speed up privatisation has been launched in 1998. Preliminary data suggests that this program is more successful than the previous attempts.

2.3. Privatisation results and outcomes

In this section the theoretical outlook of section 2.1 and the evidence presented in section 2.2. will be synthesised to generate a general picture of the privatisation results in transition economies. The three topics of interest are: how far has privatisation proceeded, what are the dominant ownership structures, what is the role of the entire private sector in the economy?

Concerning the question of how far privatisation actually has proceeded, we find that privatisation is not concluded. After more than 5 years of reform only few countries in Central and Eastern Europe have progressed satisfactorily with the privatisation of their state owned assets. The EBRD (1997, p.90; 1998b, table 2.1) reports in its measure of privatisation progress that only the Czech Republic, Hungary, Slovakia and Estonia reach satisfactory levels by 1997/1998. That is: they have completed the privatisation of more than 50% of medium and large enterprises. All other countries stay below that threshold. Hence, contrary to common opinion privatisation is far from concluded. On the other hand, progress in the privatisation of small enterprises and of formerly state owned housing has been rapid in almost all transition countries. The main difference is that agents have a better chance to assess the value of what they purchase. Further, the wealth (or vouchers) of a few persons (household members) might suffice to purchase the object.

As to ownership we can summarise several facts. As one of the dominant ownership forms that resulted from privatisation, we identified insider ownership. Insiders have either obtained control over enterprises via management employee buyouts, via lease arrangements or by using their vouchers as a means of payment. Insider ownership is of a problematic nature due to the stakeholder/shareholder conflict. Voucher privatisation - or elements hereof - has featured in many countries. The reason for this was that private wealth was almost non-existent in socialist economies. So both on grounds of practicability and on grounds of fairness has the construction of voucher privatisation be used. As a result we find either relatively disperse ownership or the emergence of investment funds. Disperse ownership can give considerable problems in corporate governance. However, a dominant investor - maybe in form of an investment fund - can remedy such problems. A problematic issue of investment funds occurs, if they assume a dual role: once as the owner of firms and once as a creditor (via their involvement in banking activities). Such set-up gives again rise to a shareholder/stakeholder conflict. A clear-cut outside owner and/or foreign participation - which were on theoretical grounds advantageous ownership constructions - features relatively seldom in the privatisation programs of Central and Eastern Europe.

The size of the private sector

Having established the privatisation methods and resulting ownership forms, it is important to ask what role the private sector plays in the economy. In a sense this provides a measure of how far a country has moved away from central planning, i.e. an aggregate of structural reform. Estimates of the size of the private sector vary in the definitions used and in the actual numbers quoted. Typical variables used are private sector share in GDP, share in total employment, share in industrial output. Often data is distorted by including or excluding estimates for informal activity. Table 2.4 assembles an overview for three time points 1994/95, 1997 and mid-1998 using EBRD transition reports. In those cases where there is a conflict in data, the most recent report is used.[14]

14. Note that the measure of the 'progress of privatisation' in section 2.2 (in connection with table 2.3) is fundamentally different from the share of GDP measure in table 2.4. The 'progress of privatisation' adressed the percentage of initially state owned assets privatised (medium and large scale enterprises only). The 50% threshold was named as a boundary for 'good' progress. The measure collected in table 2.4 measures the actual contribution to GDP that comes from the private sector, i.e. small, medium, large scale privatised SOEs, and *de novo* firms.

As a means of comparison for the figures in table 2.4 note that for example the Danish private sector share in GDP is at about 80%. In table 2.4 we find that a number of countries approach levels of private sector share in GDP comparable to Western Europe. Also, a trend of increasing private sector activity across the board becomes clear. Several elements contribute to this development. Firstly, ongoing privatisation, which converts state production into private sector production. Secondly, *de novo* firms are established and increase the private sector share even though privatisation would stand still. Finally, private or privatised firms are usually found to experience larger growth rates, hence increase their share in GDP.

Table 2.4 Share of the Private Sector in GDP (percent of GDP)

	1994/5	1997	1998
Bulgaria	-	46[1]	50
Czech Republic	64	75	75
Hungary	65	78	80
Poland	55	65[1]	65
Romania	35	55	60
Slovak Republic	-	77	75
Slovenia	40	55[1]	55
Estonia	55	67	70
Latvia	34	55[1]	60
Lithuania	55	68[1]	70
Armenia	40	-	60
Georgia	-	55	60
Russia	50	70	70
Ukraine	30	50	55

Source: EBRD (1995, 1997, 1998b).
Notes:
1. 1996.

Overall, we have found that privatisation is not concluded. Much of the state assets remains to be privatised. In terms of the emerging ownership forms, the privatisations of transition economies have favoured constructions that install insiders as the new owners. The most effective ownership forms (foreign, and concentrated outsider) feature relatively little.

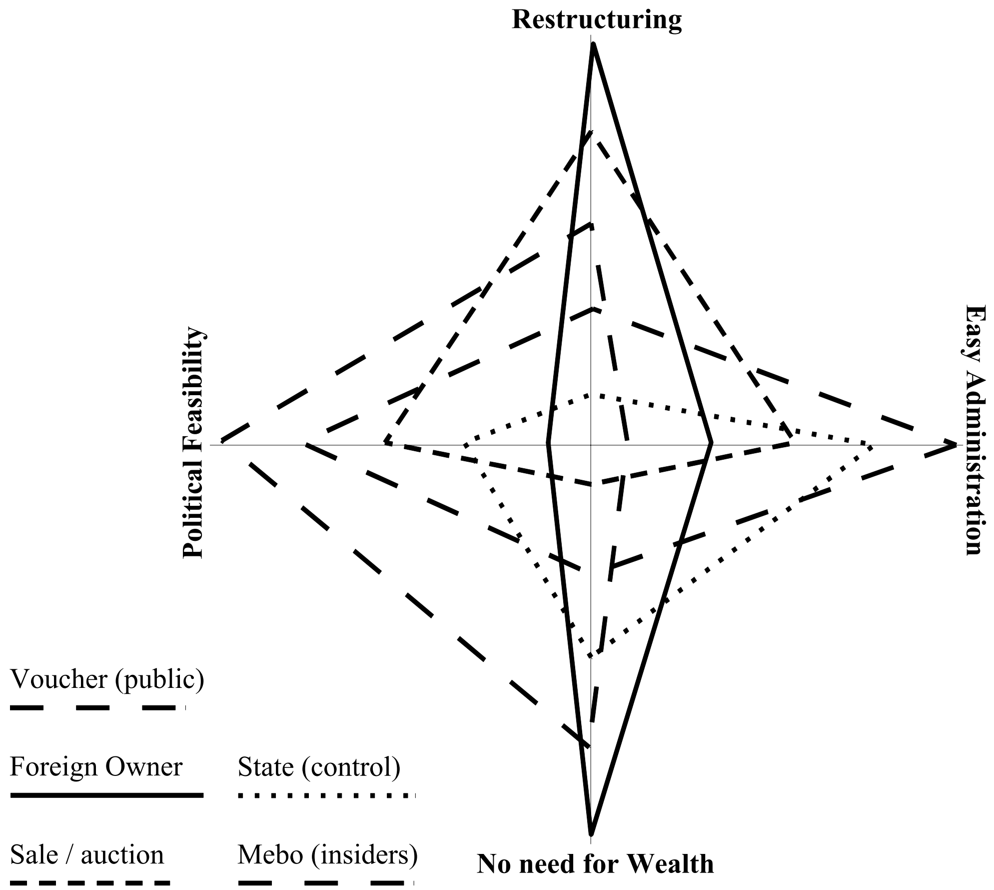
2.4 Privatisation methods and constraints - revisited

To conclude and summarize the discussion on privatisation, I return to the constraints introduced at the outset of the section. 1) Restructuring: In how far do the privatised firms engage in restructuring (*a priori*). 2) Administrative demand: How easy (and swiftly) is a certain privatisation method. 3) Need for wealth in the economy[15]: How much does a certain method depend on the availability of domestic funds. 4) Political feasibility: How much public support (or rather resentment) will a certain method get.

15. Note that we also could have utelized a 'revenue from privatisation' constraint. However, naturally such dimentsion is the flip side of the 'No need for wealth' constraint, with the exception of sale to foreigners - here no domestic wealth is needed - but the revenue from privatisation would (in principle) be substantial.

In figure 2.1 I show a ranking of five important privatisation methods (resulting ownership forms), in terms of these constraints. The inherent conflicts and tradeoffs between constraints and methods become visible. The further out on an axis a method is positioned,

Figure 2.1 Privatisation Methods and Constraints (subjective ranking)



the higher (positive) does the method score in this particular dimension. For example consider the 'no need for wealth' dimension. Privatisation to foreign owners ranks the highest (5), since no domestic funds are needed. Voucher privatisation ranks next. The worst performer in this dimension are Sale/auction methods - here the buyers (if intended to be domestic) will be severely constraint by their limited wealth. Slightly more relaxed are manager employ buyouts (mebo), reflecting the opportunity for lease arrangements Finally, continued state ownership ranks in third place. Naturally, such enforced ranking is purely subjective - and far to simplistic, however, it still captures many of the arguments forwarded in the discussions of section 2.

What becomes clear in figure 2.1 is that no single method captures the entire constraint space satisfactorily. Visual inspection shows that the 'smallest' area is covered by continued state control. The sale/auction method scores high in terms of expected restructuring, but loses out at the ‘no need for wealth’ constraint. Voucher privatisation scores relatively high at three dimensions, namely political feasibility, no need for wealth and (*a priori*) good restructuring results. Insider ownership (Mebo in the figure), is certainly easy in administrative terms, and will (due to lobbying) have good political support. However, in theory, their restructuring performance would be weak. Finally, foreign owners get the highest ranking on the restructuring dimension and the ‘no need for wealth’ dimension. However, they are ranked lowest on the political feasibility dimension.

The ranking within each constraint is certainly debatable. Still, the exercise can be used to interpret structural reform during transition. Policy is governed by emphasis on certain constraints. While a high degree of restructuring may be a declared objective of the government’s privatisation program, political feasibility may be the binding constraint. Alternatively, a lack of administrative capacity can be the binding constraint, and makes, the else chosen, voucher privatisation impossible. The ‘no need for wealth’ constraint certainly has played a substantial role in the reform process of many countries. In this interpretation figure 2.1 illustrates the inherent problem in designing the perfect privatisation method.

This concludes section 2 on privatisation. We will now proceed to examine the topic of restructuring closer. Hereby we will pay particular attention to evidence that can help evaluate the *a priori* expected restructuring behaviour of the different ownership forms introduced above.

3. Restructuring

The restructuring of a firm addresses the efficiency of the entity. Recall that privatisation was concerned with property rights - the rights to the revenue of a company - in particular, moving away from the nationalised construction. This chapter will examine the extent and speed of restructuring. It is found that restructuring in most transition countries has proceeded far slower than one would expect. One chief reason is the delayed advancement of privatisation identified in section 2. However there are additional delays in restructuring, we observe that employment is falling by less than output, ergo, a continued overmanning policy prevails within many firms. Also, enterprises continue to maintain a host of social assets for the benefits of their workers. Hence, inefficiency persists.

The inheritance of state owned enterprises

Before we can start to examine the restructuring record of firms in transition, we have to identify their starting position, namely the features of a socialist firm. At the outset of transition the socialist enterprises of central planning are marked by some unconventional characteristics: overly large size, excessive vertical integration, high market concentration, low quality products, excessive levels of employment, a wide range of social services to their employees, strong employee involvement in decision making, grotesque incentive systems.[16]

Large size and vertical integration were a direct consequence of the mechanics of central planning. Size was opted for due to a belief in scale economics, each industry was limited to only a few or a sole producer. Also, planning was made a lot easier by dealing only with one firm. Vertical integration was a consequence of the permanent threat of (or actual) shortages in the supply chain. A highly integrated firm, could wrestle some of the planning responsibility away from the central planning authority and ensure like this a smoother flow of production. Large size and high vertical integration resulted for many SOEs in a monopolistic position. However, such high market concentration was not that easily abused - remember that prices were controlled, too. Nevertheless, large size and monopolistic position gave some power in the 'negotiations' with the central planning authority. The giant SOEs had, via their informational advantage, ample opportunity to influence (manipulate) their production targets (statistics). Low quality products are in fact partly based on such power. Given that no competitor can step in, and given that the price cannot be used to reap monopolistic profits, then the 'effort' supplied - in total the quality - can be reduced. This conclusion rests on the assumtion that effort (higher quality) is costly to the firm (and individual) supplying it. Both the supply situation and the low quality of products were easily observable to the western visitor.

Maybe less visible - but not less known - have been the other four characteristics of socialist enterprises: excessive employment levels, extensive social provisions to workers, employee involvement in decision making, distorted incentive systems. Most problematic was the extent of overmanning and idle labour. For political reasons socialist economies displayed virtually zero percent unemployment. This could only be achieved by 'planning' enterprises into taking on more labour than needed. The management of an SOE would not mind, as the expense of the extra wages would not affect their own salary, nor the 'rating' of the enterprise. To the contrary, size and the number of employees could be seen as a symbol of status and importance. Further, such system of an employment guarantee to the citizens implies that there is practically no cost of shirking. In fact there was little punishment to

16. These starting position of socialist enterprises are also addressed in Mayhew and Seabright (1992), McMillan, (1995) and Freinkman and Starodubrovskaya (1996).

shirking; most bonuses were awarded collectively, ergo, a free riding problem was pre-programmed. It is important, in this context, to understand, that even though there was an implicit or explicit right to work, there was no free choice of what job one would get. This in turn resulted often in a bad worker/job match and in low worker motivation. Parallel to their excessive production depth (vertical integration) socialist enterprises did also branch into a host of social services for their employees. For a large size SOE it was not unusual to provide housing, child-care facilities, transportation, company supermarkets (stocking goods that are else hard to get), on the job healthcare and firm run holiday resorts for free or at a token price to it's employees. Additionally firms implicitly provided job insurance by taking on unemployable persons, and part of pensions by extended provision of housing etc. Hence, a socialist enterprise actually providesda number of services that else are provided by the state. These social services did create attachment of workers and were a rudimentary means of worker motivation. They also reflect the influence of employees in firm decision making - not so much on the bold direction, but in terms of harvesting liberties and concessions for the employees. The influence of insiders in firms increased during the last years of central planning and the early years of transition. In correspondence to the withdrawal of the state the insiders filled the power vacuum - this generated often their platform for extensive influence on the design (and exemptions) of privatisation programs. The distorted incentive system of socialist economies stemmed from an overly focus on quantity and an inability to use prices (wages) as a motivation device. There are plenty of anecdotes on incentive failures in central planning. Tales of measuring/monitoring firm output by piece or weight - and the resulting response of the firms, are almost comical.[17] The bonus system of socialist economies invited similarly miss focus and fraud in the reporting of actual output as much as the setting of targets.

Having introduced the starting point of an SOE, which sets the agenda for initial restructuring, one more item needs to be mentioned: The quality and skill of employees. It is obvious that the qualification of a socialist manager is short of what is needed to run a firm in a market economic setting. This can only be rectified by training or import - the latter often met by the aforementioned political resentment. The general qualification and skill level of the socialist economies is usually said to be high. However, more recent views on the human capital in Central and Eastern Europe identify severe flaws. Boeri et al (1998, pp.25) present evidence of low education levels and low standards in qualifications. Møllgaard and Schröder

17. I think of stories on nail factories that switch from 5 inch carpenter nails to tiny pins all according to their production plan being defined in weight or pieces. Or the abundance of children shoes once piece output is aimed at.

(1998) report, in a case study of foreign direct investment, similar problems with worker and managerial qualifications. This concludes our introduction to the type of problems inherent in socialist enterprises. A major challenge in restructuring is, of course, to tackle these obstacles.

In section 3.1 I will identify different concepts of restructuring, distinguishing reactive versus deep restructuring. Furthermore, I will introduce measures of restructuring, ranging from the more result orientated 'business' economics measures of profitability, to the more aggregate economics measures of employment levels and finally the provision of social services by firms. In section 3.2 I proceed to present evidence on these measures. It is found that inefficiency prevails in a number of countries and firms. Finally we will examine the relation of ownership structure to restructuring. Here we find that the ownership form (i.e. the outcome of privatisation) is not always a good predictor of firm restructuring behaviour. However, some outstanding ownership forms are identified, namely continued state ownership is related to little restructuring, and foreign participation is related to much restructuring.

3.1. Two concepts of restructuring

By now there is a consensus to distinguish restructuring into two qualities. 1) Reactive restructuring; 2) Deep restructuring.[18] By reactive restructuring we mean measures that are executed in response to tightened outside conditions. For example the elimination of soft budgets and/or the transitional recession forces enterprises to abandon certain activities or shed part of idle labour to ensure survival. Such behaviour should in fact be independent of the ownership form of the enterprise, as long as the outside tightening is credible and enforced. Note, that in reactive restructuring inefficiency is only attacked until break-even is achieved. Deep restructuring on the other hand encompasses new investments, strategic reorganisation and an overall reorientation of the firm's activity. By this type of restructuring the enterprise is fully trimmed and all inefficiency is eliminated. For deep restructuring we expect certain ownership forms to be more active than others.

According to this distinction we can identify different contents of the term restructuring, which in turn leads to different indicators of restructuring. Reactive restructuring - the relatively easy to do step - namely, fire idle labour and scrap social functions, does not

18. Other terminology used is: first and second layer restructuring, defensive and strategic restructuring, passive and active restructuring, etc. All capturing the same distinction.

require know-how and/or new capital. It is important to note that reactive restructuring, even though some of the firm inefficiencies are rectified, will typically not result in complete elimination of these types of inefficiencies. However, note that firms that were striving for pure profit maximisation would go for the entire gain. Deep restructuring, on the other hand, requires capital, know-how and managerial skills. So here we can find firms that might want to engage in deep restructuring but lack one or more of the necessary inputs. Thus, in terms of expected observation, we can in fact subdivide three stages of restructuring: Reactive restructuring, complete elimination of 'easy to rectify' inefficiencies and deep restructuring.

In line with these distinctions we will observe different variables as indicators of progress. At one end we get measures of employment developments, and case studies of firm social assets and excess labour. At the other end we get more 'business' type measures like profit ratios, investment over asset ratios and surveys of the introduction of new technology as indicators of deep restructuring. All these measures are presented in section 3.2.

3.2. Measuring the restructuring performance / inefficiency

Before we proceed to a discussion on developments in excess employment and excess firm social assets, I will start by presenting some restructuring accounts reported by the EBRD (1997, 1998b).[19] In particular I examine the three countries that were presented as actual privatisation routes cases in section 2.2. The EBRD accounts - as most business accounts - on restructuring are more focussed on profitability and growth, and not so much on the underlying mechanics of efficiency. Hence, in this 'business' terminology restructuring is a slightly different concept (as discussed in section 3.1.) and far more result orientated. After the restructuring cases for the Czech Republic, Lithuania and Ukraine, table 3.1 creates an overview of 'business' type restructuring measures for several countries.

Czech Republic

Via the NPF the Czech state continues to sell off its minority holdings in privatised enterprises. The EBRD states that for 1996 the NPF is assumed to hold 40% of all shares, with another 30% held by the investment funds that emerged under the first wave of privatisation. This constellation has a negative impact on restructuring. Even though the large block shareholdings of investment funds should smoothen corporate governance, their entanglement with banks has weakened their actual effectiveness. Furthermore, investment

19. The cases are based on the 'transition indicators for each country' chapters of the transition report (EBRD, 1997, 1998b).

funds are not allowed to hold more than 20% of the shares in any one company - thus excluding them from a decisive majority share. Some investment funds reacted to this by transforming into holding companies - which are not subject to the 20% rule.
In any case, by 1996 it is estimated that the majority of firms of the first privatisation wave has now a dominant or outright majority owner. Nevertheless, the EBRD (1997, p.164) assess that restructuring is not proceeding satisfactorily. In particular have pre-tax profits fallen by 40% in medium and large companies (more than 100 employees). Further, an increase in inter-enterprise arrears is observed. As an underlying problem the entanglement of investment funds with banks is identified. Again the effect on restructuring stems from the stakeholdings that such agents have in the firms they own - i.e. being the creditor to the firm they own/control. In recent policy packages the Czech government has attempted to regulate banks/investment funds control over firms.

Lithuania

The voucher method of the first wave of privatisation in Lithuania resulted in insider domination for many of the privatised firms. Still, restructuring, as measured by profitability, in the privatised sector by far exceeded the performance of the firms that remained in state ownership. The profit over assets ratio in 1995 is 5.8% for private enterprises and only 1.8% for state enterprises. Part of this difference can be explained by selection bias. For example, the firms that remain in state hands by 1996 are generally much larger than those that got sold off. It is argued that the problems of inefficiency are disproportionally larger as well. Nevertheless, the relative good performance of firms under extensive 'insider' influence has to be reconciled with our *a priori* view on insider incentives. The EBRD (1997, p.184) assesses that further increases in profitability in the privatised sector stems primarily from labour shedding and reduced capital utilisation. Redundancies have resulted in an 20% increase in labour productivity from 1995 to 1997. This tells us three things: Firstly, deep restructuring (new investment, etc) is still not found in Lithuanian enterprises. Secondly, firms in 1995 - that is after the first privatisation wave was concluded - had still considerable excess employment. Thirdly, insider dominated firms can be seen to engage in the shedding of excess labour.

Ukraine

The Ukrainian privatisation started out by management employee buyouts and lease arrangements for insiders. In a later stage, voucher privatisation was introduced. Overall privatisation is proceeding slow. The EBRD judges that restructuring in those sectors that have not been privatised is non-existent. By 1997 the economy features extensive payment arrears to power utilities (US$ 1.9 billion), and growing wage (US$ 2.5 billion) and tax arrears. Such defaults on payment should be interpreted as inefficiencies - and in fact the persistence of soft budgets. The low degree of restructuring, found in the Ukrainian case, mirrors both the slow pace of privatisation and the type of owners that are installed. This is fully in line with our theoretical discussion of ownership and restructuring.[20]

Restructuring indicators

Now, in order to create an overview on restructuring performance as measured by result, i.e. in the more 'business' type perception introduced above, I present a number of restructuring indicators based on Djankov and Pohl (1998). They also do present measures on productivity, which directly translate into our interests in overmanning. Table 3.1 reproduces their data which is based on survey results.

Table 3.1 Various Restructuring Measures

	Percentage of firms with positive operating cash flow (1995)	Average operating cash flow as percent of revenue (1995)	Annual percentage growth in Labour Productivity (1992-1995)	Annual percentage growth in total factor productivity (1992-95)
Bulgaria	74	1	-2	0
Czech Republic	98	14	7	5
Hungary	90	8	3	4
Poland	87	7	5	5
Romania	49	1	-1	-1
Slovakia	90	12	5	5
Slovenia	90	10	3	3

Source: Djankov and Pohl (1998).

Table 3.1 shows that the speed of restructuring varies across countries. We find five countries

20. It is remarkable that the EBRD (1997, p.208) interprets the non-payment of wages as an indication of lack of restructuring, and most business economists would agree to this. However, in the formalised versions of firm behaviour, non-payment of wages is the 'optimising' flip side to 'not firing' idle workers. However, once we include social benefits into the consideration than such firm still 'over-employs'. In fact this must be the case since else workers would have no reason to stay on.

with impressive adjustment and positive factor productivity growth rates (Czech Republic, Hungary, Poland, Slovakia, Slovenia). The other two countries - Bulgaria and Romania - experience a standstill and decline in productivity respectively. Most notable does a decline in labour productivity indicate persistent excess employment, while a rise in labour productivity will primarily stem from the shedding of idle labour. The most striking result of table 3.1 is the relatively large number of firms with negative or zero profits that remain in some of the countries.[21] While their support through direct subsidies is substantially reduced, soft budgets (indirectly through tax arrears) might be the explanation of the observed. In any case, the evidence shows that inefficiencies prevail.

3.2.1. Persistent overmanning

In this section I will show that part of the remaining inefficiencies stems from excess labour. That is that reactive restructuring measures - firing of idle labour - are far from concluded, even though reform and privatisation have been progressing for years.

As a first indicator of overmanning one can consider the economy at a fairly aggregated level. Table 3.2 provides the development in output and employment for a number of countries. Ignoring the developments in absolute levels, table 3.2 shows the percentage point change in the share of GDP (employment) for two sectors - industry and services.[22]

In terms of the composition of GDP table 3.2 shows a clear contraction of the industry sector and a matching increase in the service sector across all countries. This fits to a switch away from the industry focus of central planning times. However, the corresponding effect on employment is - with the exception of Hungary - weaker. In fact the (unweighted - across countries) average increase in the service sectors share in GDP of 17.6 percentage points is generated by only 11.1 points increase in the employment share. Accordingly the average decrease of the industry share in GDP of 17.5 percentage points in associated with a 7.8 percentage point decrease in the share of employment. There are several interpretations. Firstly the developments in the service sector could be associated with a parallel surge in labour productivity for that sector. Accordingly the labour productivity in industry must have

21. See also Blanchard (1998, p.65) who interprets on a different data set that the bunching of profits at zero indicates the appropriation of profits by insiders. An alternative deduction could be that firms hide profits from the tax authority.

22. Of course ignoring the absolutedevelopments in GDP and employment is a stark simplification. Generally GDP has been falling at first and then recovering over the period, while employment stagnated or fell. However, the overall trend still remains as shown by the relative measures provided in table 3.2.

been falling. This would indicate increasing overmanning in the industry sector - typically the sector where we find the privatised SOEs, and full efficiency in the service sector - typically the sector with the most *de novo* firms. Secondly, the observed could simply stem form the absolute movements in GDP and employment. Nevertheless, I take table 3.2 to establish one thing. In relative terms the industry sector is lagging behind in productivity improvements. Also realise that this sector started out with considerable inefficiencies, including excess employment. I conclude from this evidence that by 1994/95 (some years into privatisation) reactive restructuring measures, namely labour shedding, have not been exhaustive.

Table 3.2 Output and Employment, 1989-95

	Percentage points change in the share of:	
...originating in	**GDP**	**Employment**
Industry		
Bulgaria	-28.0	-8.0
Czech Republic[1]	-14.9	-4.0
Hungary2	-2.7	-9.6
Poland2	-11.9	-3.4
Romania2	-20.5	-14.1
Slovakia	-27.1	-7.4
Services		
Bulgaria	26.0	4.0
Czech Republic1	14.2	9.1
Hungary2	6.4	22.4
Poland2	17.5	10.4
Romania2	14.3	1.7
Slovakia	27.0	19.2

Table 3.2 Output and Employment, 1989-95

Source: Boeri et al. (1998), table 4.1. They have assembled the data from various sources: EBRD Transition Reports, OECD CEET database, European Commission employment and service sector surveys.

Note: The values of the third sector (agriculture) are residual to the presented values.

1. 1991-95

2. 1990-94

Blanchard (1998) builds several arguments that are based on an assumption of persistent labour hoarding. Namely, considerable overmanning remains, even though labour productivity has been rising for some years. Out of the evidence he provides I reproduce here one table originally from a survey based analysis by J. Köllô (1996).23 Table 3.3 shows the elasticity of employment with respect to sales (output) for a sample of Hungarian firms. Hungary started already in the mid 80's to introduce more autonomy of firms.

Table 3.3 Hungary: estimated elasticity of employment with respect to sales

	1986-89	1989-92	1992-93
All firms	0.13	0.33	0.22
Firms with decreasing output	0.21	0.34	0.33
(Proportion of firms)	(50%)	(91%)	(66%)
Firms with increasing output	0.01	0.04	0.04
(Proportion of firms)	(50%)	(9%)	(34%)

Source: Köllô (1996), here quoted from Blanchard (1998) table 3.3.

Note: In the original regression by Köllô a constant term is included in the regression which is not reported in Blanchard (1998, p.72).

The table shows a stark asymmetry in the employment response to a change in output, depending on a decrease or an increase in sales (row two and four respectively). In particular those firms suffering a decrease in output do cut employment, while those firms experiencing an increase in output do not hire new workers in response. This implies that firms still had excess labour even in 1992-93, several years after the start of reform. Via this excess labour, firms manage to increase production without increasing the number of workers. Further, Blanchard (1998, p.72) concludes that given this type of evidence we can assume that the increases in labour productivity, we observe in subsequent years, will most likely stem from labour shedding (reactive type of) restructuring measures, and not from deep restructuring. In fact Blanchard (1998, chapter 4) stylizes the unemployment path in transition into two steps. A ‘first’ unemployment surge - purely reactive to the tightening of the budget constraint, than a ‘second’ stage of a continuing stream of unemployment, caused by subsequent reductions in overmanning. Whereby the later reductions depend on the firms restructuring decisions - i.e. are influenced by corporate governance and the outside conditions.

23. Blanchard (1998, chapter 3) provides also evidence on the reaction of wages. He finds that in general transiton firms are willing to cut wages in order to avoid employment losses to a larger degree than western firms.

Further evidence of two waves of labour shedding and the relation to efforts of reducing overstaffing is collected in Boeri et al (1998, pp.32). They do also examine job creation, and find that job growth is almost exclusively obtained in the private sector. Evidence on persistent overmanning (Boeri et al, 1998, pp.42) is introduced in order to explain the 'jobless' recovery of transition economies.

Related to this arguments let's return to table 3.1. The growth in labour productivity presented in the table can be interpreted as evidence on overmanning in Bulgaria and Romania. If one agrees that in 1992 all transition countries did suffer from excessive employment levels, then the countries that experienced negative growth rates in labour productivity (since 1992) must continue to have excessive levels in 1995. The simple elimination of idle labour would bring about a steady rise in labour productivity - as observed in the other countries.

Evidence for another transition country can be found in a survey of 439 Russian firms in 1994. Commander, Dhar and Yemtsov (1996, p.25) find that 25% of firms admit to at least 10% of their employees being redundant. Another 20% of the surveyed firms believe that between 5%-10% of their workforce is not needed. Hence, we get a total of 45% of firms that admit to excess labour of at least 5% of their present workforce. This result is from a period where the first major wave of privatisation had been concluded in Russia.

I will now briefly present a specific case, a classic example of a privatised SOE:

*The case of VSZ*24

Central Europe's larges steelworks, the Slovakian VSZ has been indebted and troubled for years. To see the magnitude of the enterprise note that VSZ accounts for 8% of Slovak GDP. Several rescue and debt restructuring operations have failed. Business analysts find that in principle VSZ should be a healthy and profitable undertaking, having customers like Czech Skoda in its portfolio.

To relate the problems to our discussion on ownership in section 2 it is interesting to note that VSZ is owned by a consortium of politicians, who - being stakeholders as well as shareholders - have abstained from any serious restructuring efforts, and instead obliged to their political agenda. As a result the directly employed workforce of 25000 people25 is estimated to be four (4!) times as much as is needed for efficient production. Sean Murphy - a steel industry analyst - comments: "the company is being run for the benefit of its employees, not its shareholders." (The Economist, 1999, p.63)

This case both illustrates the existence of stunning levels of over-employment, as much as it gives an indicative link to the ownership structure of privatised SOEs.

*What are the underlying issue of overmanning*26

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24. This case is found in: The Economist, January 2nd, 1999, pp.60-63.

25. For 1998/99. Another 75000 people are estimated to be employed through VSZ's supply network.

26. The next paragraphs are partly reproduced from Schröder (1997).

Before proceeding with the evidence on firms' social assets, it is relevant to ask why and when overmanning (and/or excessive social assets) does pose a problem. As the discussion will show it is not entirely obvious that overmanning always is harmful. There are several scenarios under which overmanning poses a severe problem: Firstly, new and profitable activities and new firms might be constrained by an inadequate labour supply - i.e. overmanning ties up labour. Secondly, overmanning and excessive social assets result in low retained earnings. Since the capital markets in transition economies are in disorder, retained earnings are a crucial source of finance for new investments. Given the continuing inefficiencies such investments will not come about. This in turn has effects on growth and further (potentially costly) restructuring measures - i.e. scrapping excess labour might be a necessary first restructuring step. Thirdly, firing of excess labour might be an important measure in adjusting the bad initial person-to-job match of the formerly centrally planned economies. Fourthly, certain industries might feature decreasing returns. In particular, from a sociological point of view overmanning might depress work ethics and productivity across the board and not just for the actually idle workers. Finally, remaining inefficiencies might be a symptom of bad firm behaviour. For the individual firm there is a gain in removing the inefficiency. If the firm does not go for this gain then something must be wrong. However, from a macro perspective, transforming overmanning simply into open unemployment - in the absence of the above problems - is no gain at all and accordingly overmanning need not be bad.

There are other scenarios in which overmanning is a non-problem: Firstly, firms might simply be labour hoarding in expectation of a future rise in demand. Secondly, if labour is very cheap - and in fact it is very cheap in many transition economies27 - then the value of the marginal product might exceed wage cost, even though the employee appears idle to the western observer. However, this reasoning need not apply for the social assets of firms - which are in fact the very reason why workers will continue to work at low or no wages. Anyway, in both cases what appears like overmanning is sound maximising behaviour. Finally, overmanning can be beneficial since it turns marginal labour cost to zero - hence, firms have the incentive to raise production.

It is impossible to determine the balance between the two directions of the theoretical arguments. Yet, in the actual debate on transition economies, there is no doubt that the elimination of overmanning is a primary target of restructuring, and a necessary condition for a success of these economies.

3.2.2. Remaining firm social assets and services

In this section I will present evidence of the existence and persistence of social benefits in firms in transition economies. The core types of social benefits provided by the enterprises of central planning are: child care, health care facilities, food subsidies, subsidised factory shops, housing, holiday resorts, transportation. To what extent do we still find these worker specific benefits before and after the start of reform? The evidence shows that social benefits or in kind compensation continue to play a major role.

In a survey of more than 400 Russian firms Commander, Lee and Tolstopiatenko (1996) assess the importance of the core benefits for 1990 and 1994. Their findings are presented in table 3.4.

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27. As an extreme case, take the non-payment of wages - mentioned in our Ukrainian case above.

Table 3.4 Provision of Benefits in Russian Firms (percent of firms surveyed)

... benefits provided.	**1990/91**	**1994**
Childcare / childcare subsidy	79	66
Healthcare facility	71	70
Food subsidy / cafeteria (subsidised)	83	78
Sale of food and/or consumer goods (shops)	52	60
Construction of new housing	73	50
Housing / housing subsidy	59	55
Holiday resort / holiday subsidy	57	45
Transportation / transportation subsidy	57	57
Other	17	21

Source: Commander, Lee and Tolstopiatenko (1996), table 3-1.

Note: The data is based on a survey of 407 Russian enterprises

Table 3.4 shows that Russian firms have both at the outset of privatisation and several years into reform and privatisation provided a host of social services to their employees. Even though the numbers are generally falling, cuts are far from the anticipated reduction levels. In fact the largest reduction (32%) is found in the construction of new housing for workers (new!). The level is still at 50% in 1994, i.e. half the firms in the sample are engaging in erecting new residential facilities for their employees. Yet, these are firms which generally are assumed to be in difficult economic situations, desperate for new investment, firms that are privatised, about to be privatised or still state owned. It becomes also clear from the table that firms provide an entire portfolio of social benefits to their workers. In fact, 79% of firms in the sample supplied more than three of the core benefits in 1990/91, by mid 1994 this number had only fallen to 72%. Hence, social benefits continue. As to the cost of providing these social benefits Commander, Lee and Tolstopiatenko (1996, p.68) find that the gross operational cost average at around 18-21% of the wage bill. So the provision of benefits is by no means cost free to the firms.

A similar survey of Ukrainian enterprises reveals the same finding on the provision of social benefits. Table 3.5 presents the extent of the four main benefits.

Table 3.5 Provision of Benefits in Ukrainian Firms (percent of firms surveyed)

... benefits provided.	**1990/91**	**1994**
Childcare / childcare subsidy	59	45
Healthcare facility	91	95

Table 3.5 Provision of Benefits in Ukrainian Firms (percent of firms surveyed)

Construction of new housing	65	50
Housing / housing subsidy	47	47

Source: Commander and Schankerman (1997), table 1.

Note: The data is based on a survey of 59 Ukrainian enterprises.

Again we find that firms persist in the provision of social benefits. In fact the provision of health care has been rising in the observation period, while the largest relative reduction is found in the provision of childcare or child care subsidies.

The overall picture becomes clear: firms in transition economies have traditionally executed a host of social functions for their employees. Despite reform and privatisation a large part of firms continues to do so at a significant cost.

3.3. Evidence of restructuring performance according to ownership

In this section I will present assessments of the relation between ownership and restructuring. Do firms - i.e. their new owners - behave as we envisaged from a theoretical point of view in section 2? The evidence presented is indicative of the following relations: Three repeated findings are that foreign owners, *de novo* firms and outside share holdings (less so) are clearly connected with a good restructuring record. On the other hand, there is no clear picture as to the restructuring performance of insider privatised firms, this is regardless of manager or worker dominance. Further it is often found that state owned enter prises only engage in reactive restructuring. However, overall the evidence is weak, at worst there is no clear connection between restructuring behaviour and ownership.

Much of the possible evidence comes from individual case studies of firm behaviour, little aggregated data exists. Carlin, Van Reenen and Wolfe (1994, or a shorter version 1995) accumulate the findings of numerous survey studies, covering firms from Poland, Hungary, Slovakia, Russia and the Czech Republic. They find for the period 1992/93 that deep-restructuring is still missing in wide areas of the privatised economy. This finding is independent of whether or not the position of management in the firms has changed to a profit related remuneration system. Among other causes they point to the power of workers as a main constraint to restructuring (labour shedding). Prime examples come from Polish firms, where the existence of Workers' Councils makes this type of effect very visible (Carlin et al., 1995, pp.438). This fits to our pre-perception of an insider owned firm. Further, their paper points to the absence of a managerial labour market as a source of passivity. In such case part of the motivation, that would drive mangers in a theoretical assessment, is absent. One clearly favourable ownership form, in terms of effective restructuring, is foreign participation. Evidence - predominantly from Hungary - indicates both reactive and deep restructuring of such firms (Carlin et al, 1995, table 4).

Table 3.6 provides some summary restructuring measures according to the ownership form for a sample of Hungarian firms. Ownership is divided into three categories: state owned, privatised and private (*de novo*). The distinction between the latter two is that privatised firms were state owned in 1990 and got privatised during 1992 to 1994, while private (*de novo*) firms were private already in 1990.

Table 3.6 Restructuring and Ownership: Hungarian firms, 1994/95 (percent of firms)

	State owned	Privatised	Private (*de novo*)
Investment in new capacity (1992-94)	*28.2*	*28.3*	*47.3*
Under-utilized capacity (1994)	*52.3*	*69.4*	*34.5*
Employment 95 (1990 = 100)	*41.0*	*43.0*	*89.4*

Source: Aghion and Carlin (1996), table 3. The original material comes from a survey of Köllô (1995).

Note: Privatised firms refers to firms that were privatised in the period 1992-94. Private (*de novo*) refers to firms that were either privatised before 1990 or founded *de novo* before 1990.

Table 3.6 shows that in terms of deep restructuring (investment in new capacity) private (*de novo*) firms were clearly leading, while privatised and state owned firms are indistinguishable. In terms of under-utilisation it even is the case that more privatised than state owned firms report problems. Finally, and most interestingly, for reactive restructuring, state owned firms report at least as aggressive a policy in labour shedding as do privatised firms. Note that private (*de novo*) firms have only a 10% reduction in the employment level, indicating that they were more lean already in 1990. Hence, in this Hungarian sample privatised and state owned firms are hardly distinguishable - contradicting our theoretical expectation. Of course, if privatisation of Hungarian firms had mainly installed insiders as the new owners, then the result would be reconcilable with the *a priori* view; however, as shown in table 2.3, the Hungarian privatisation relied mostly on sale to outsiders.

Turning to a database on Polish enterprise restructuring assembled by the EBRD (1995) we find a different picture of ownership and restructuring. In Poland, where privatisation often resulted in insider dominated firms (see table 2.3) we find a clear distinction between such firms and firms that remain state owned. Table 3.7 illustrates.

Table 3.7 Restructuring and Ownership: Polish firms, 1993 (percent)

	State	Insiders	Outsiders	Foreign	*De Novo*
Profit-to sales	*-0.7*	*5.5*	*3.5*	*-3.2*	*2.6*
Real wage change 1992-93	*-0.5*	*0.6*	*-3.8*	*14.6*	*-0.8*
Employment change 1992-93	*-5.5*	*-0.7*	*0.8*	*-5.5*	*13.6*
Labour productivity change 1992-93	*14.4*	*28.2*	*2.4*	*33.4*	*28.1*
Investment-to-sales	*1.2*	*2.8*	*0.0*	*5.8*	*2.6*
Firms introducing new technology	*51.6*	*75.0*	*71.4*	*87.5*	*73.5*

Table 3.7 Restructuring and Ownership: Polish firms, 1993 (percent)

Source: EBRD (1995), chapter 8. Here quoted from Aghion and Carlin (1996), table 4.

Note: Outsiders refers to domestic outside ownership. On Outsider and Foreign owned firms the sample consists of only five to ten observations. Firms introducing new technology refers to the share of firms in each group that has introduced major new technology in the last two years.

Table 3.7 shows that in terms of profitability insider owned firms have the best performance, this is contrary to our expectation. The theoretical view was that insiders would appropriate surplus via their stakeholdings, and hence drive profits down to zero. This appears to be the case in the state owned enterprises of the survey. Surprisingly, foreign owned firms do make negative profits, this could be caused by major restructuring measures that give a short-run loss.

In particular interesting is the data on real wage changes, *a priori* we would expect that the insiders award themselves with the largest pay rise. But this can hardly be identified in the data, foreign owned firms experience the larges wage rises. Case study accounts of firms with foreign participation point at one possible explanation: the new owners want to alter work ethics in the workforce through exceptional wages, i.e. make shirking costly. This evidence fits neatly with the reduction in employment levels; here foreign owned firms are most aggressive, shedding excess labour. Surprisingly state owned firms follow with a 5.5% reduction in their labour force, however this may point to a strong problem with selection bias. Namely, those firms that are attractive to private owners are relatively slim to start with, while those firms that suffer from extraordinary levels of inefficiency, have both strong insider opposition to privatisation and a hard time in finding possible buyers. Note that within the survey, state owned firms are on average much larger that both insider and outsider privatised firms. The fact that insider and outsider owned firms both do hardly change their employment levels, is contrary to our prediction. We would have expected outside owners to be more tough in cutting down excess employment.

Another interesting aspect of table 3.7 is the data on labour productivity developments, here we can actually match those to the reduction in employment. Hence, we can see what part of the productivity improvement stems from shedding of excess labour and what part from fundamental changes. Here, we find that for *de novo* firms and insider firms productivity improvements clearly must come from fundamental changes. For state and foreign owned firms the increase in labour productivity must in part result from the shedding of excess labour. Note that the same reduction of employment yields more than twice as much labour productivity gains for foreign firms, hence, foreign firms must experience additional fundamental changes in productivity. This is exactly in line with our pre-perception on deep- restructuring. Namely, foreign owners have both the capital and the know-how to engage in deep restructuring measures. The same pattern is found for the introduction of new technology.

Turning to a different study on Poland, Belka, Estrin, Schaffer and Singh (1995) find in a survey of 200 Polish firms some interesting results on excess employment and the reasons behind it. The management of firms was asked to access the current (1993) employment level relative to the 'optimal' employment level. If they answered that employment was excessive they were asked to provide one or more reasons for this. Table 3.8 shows a selection of their findings:

Table 3.8 Overmanning and the Reasons behind: Polish firms, 1993 (percent of firms)

Table 3.8 Overmanning and the Reasons behind: Polish firms, 1993 (percent of firms)

	State Owned	Privatised	*De Novo*
Employment level is...			
too high > 20%	*10*	*11*	*0*
too high 10-20%	*15*	*9*	*3*
too high 5-10%	*29*	*30*	*14*
about right	*45*	*43*	*60*
too low	*1*	*7*	*23*
Do not reduce employment because...			
causes no extra cost	*4*	*0*	*0*
recovery expected	*51*	*52*	*50*
legal obstacles	*7*	*33*	*33*
social reasons	*56*	*29*	*50*
workers' resistance	*30*	*33*	*0*

Source: Belka et al (1995), table 11 and table 12.

Note: The original data-set includes the ownership form corporatized: SOEs that are turned into joint-stock companies with the state holding 100% of the shares, i.e. awaiting privatisation. The figures for such firms are omitted. State Owned in the table refers to traditional state owned firms, i.e. not yet up for privatisation.

Table 3.8 paints a fairly clear picture. Excess employment features to an almost identical degree in both privatised and state owned firms. However, *de novo* firms feature less frequently excess employment, 23% of them even state too low employment levels (shortage) at the current wage rate. Turning to the reasons for too high an employment level. We have two possible explanations (causes no extra cost, recovery expected) where overmanning is a non-problem according to our discussion in 3.2.1. The reason of 'causes no extra cost' applies only very rarely, and only for state owned firms. But, the argument that recovery is expected is stated by approximately half the firms that feature excessive levels of employment. Most interesting - and fully in line with our theoretical considerations - is the fact that workers' resistance features as a reason for both privatised and state owned firms, but not *de novo* firms. Remember that the early Polish privatisation featured a lot of insider dominance. Also surprising is that both privatised and *de novo* firms see legal obstacles as a hindrance to firing, while this is seldom stated by state owned firms. I would claim that this shows that state owned firms operate in a more protected environment, while privatised and *de novo* firms are exposed to the full extent of legal requirements.

Further evidence on the relation between ownership and restructuring is found in a survey on Russian firms, Commander, Dhar and Yemtsov (1996, p.25). They observe that continued overmanning is found regardless of the ownership form of the firms:

> “Classifying by ownership status makes clear that excess employment was distributed with reasonable commonality in both remaining state firms and in firms that have either been privatized or are in the process of privatisation.”

In their analysis they find that the only ownership form that matters as a predictor of restructuring is outside ownership. In particular they find a ‘slight’ correlation of high outside shareholdings with the firing rate of firms (Commander, Dhar and Yemtsov, 1996, p.33).

In fact Commander and Schankerman (1997) utilize the same survey material to examine the relation between ownership and the provision of social benefit. In table 3.9 I reproduce part of their data on major benefits. Note that this material relates exactly to table 3.4 above.

Tabel 3.9 Benefit Provision and Ownership, Russian Firms 1994 (percent of firms)

... benefit provided.	State-owned	Privatised	*De Novo*
Childcare	*68*	*69*	*23*
Healthcare	*75*	*72*	*27*
Food subsidy /cafeteria	*79*	*81*	*25*
Food / consumer goods sold	*66*	*62*	*14*
Housing	*56*	*58*	*9*
New housing construction	*53*	*51*	*11*
Holiday resort / subsidy	*48*	*45*	*36*
Transportation / subsidy	*62*	*57*	*48*

Source: Commander and Schankerman (1997), table 2; and Commande, Lee, Tolstopiatenko (1996), table 3-5.

The table reveals that there is hardly any difference between privatised and non-privatised firms. Remember that privatised in the Russian case is most likely insider privatised. The only true difference exists for *de novo* firms. Commander and Schankerman (1997) proceed to run regressions of benefits provision on firm characteristics both on the Russian data set and on a similar Ukrainian data set. The findings - indicatively found in table 3.9 - get reproduced.28 Hence, the restructuring of excess social benefits follows the same mechanics as other restructuring activities.

Earle et al. (1996, p.245) draw similar conclusions on ownership and restructuring for the Russian case:

28. Commander, Lee and Tolstopiatenko (1996, pp.68) using the same data base, derived the same results: there is no significant relation between provision of social benefits and ownership status (i.e. privatised and non-privatised).

> “(...), the most striking result is that the difference between state-owned and privatized firms, regardless of majority ownership form, are typically not very great, especially regarding the key issue of restructuring.”

In fact they find that pre-restructuring profitability of the firm is a much better predictor of deep-restructuring than ownership (Earle et al., 1996, p.208). This can clearly be linked to the effect of retained earnings as a means of financing deep restructuring measure.

This concludes the evidence on the link between ownership and restructuring. Who are the owners that are hesitant of restructuring, and which ownership forms result in extensive restructuring? The core findings are that foreign owners and *de novo* firms are clearly connected with a good restructuring record. On the other hand are insider privatised firms, probably regardless of manager or worker dominance, often found to behave similar to state owned enterprises, namely, only engage in reactive restructuring. For domestic outsider owned firms it is hard to determine a clear pattern. Overall we can conclude that only part of our *a priori* expected restructuring behaviours are supported by the evidence.

4. The Possibility of a Fiscal Constraint to Restructuring

In this section I will take a closer look at one particular mechanism that may be underlying to the observed delays in privatisation and restructuring. The fiscal constraint to restructuring is both a convincingly simple but also a fightingly effective obstacle to progress in transition economies. The mechanism has been identified both appreciatively and formally by several authors (Blanchard, 1998, chapter 4; IMF, 1996, chapter 5; Boeri et al., 1998, chapter 4). The present exposition relates to Schröder (1998b); in particular I present evidence in support of the formal model therein.

4.1. The mechanics of the fiscal constraint29

The decision to restructure a firm or not depends crucially on its ownership form, i.e. its corporate governance structure in interplay with outside incentives, e.g. tax rules. Hence, it follows that the restructuring speed in a transition economy is more or less directly determined by the privatisation program of the government, because privatisation settles the ownership of firms. The ‘fiscal constraint to restructuring’ model claims that at the governmental level there may exist a decisive structural barrier to effective restructuring - causing governments to privatise slowly and/or in an inefficient manner.

To contain the inflationary consequences of transition and to reduce the dominating role of the public sector, the government is urged by international organisations and other advisors to keep the public deficit within narrow limits. Also, - but with less weight - transition economies are expected and advised to perform a fast and effective privatisation of their economies in order to create the basis for growth (Frenkel and Khan, 1994).

However, the classic chicken-egg problem of macroeconomic stabilization versus structural reform is lurking behind such objectives. In fact this has long been recognized by international organisations like the IMF (Tanzi, 1993). There is an inherent conflict between a low budget

29. This part is also found in Schröder (1998b).

deficit and effective privatisation. Privatisation of SOEs - resulting in restructuring - stretches the government budget on both sides. Firstly, restructuring releases an upward pressure on the public expenditure side: a) firms scrap social functions that have to be taken over by the state, b) excess labour is freed and government expenditure on unemployment rises. Secondly, restructuring exerts a downward influence on the revenue side, because the reorientation of the incentive structure typically includes a lower than average tax on profits.30 Hence, the government is left in a squeeze where the effects on the two sides of its budget create a blocked situation. The government 'cannot afford' to let firms restructure in an effective manner. Thus, the endeavour by transition countries to balance the budget and to privatise the economy fast and effectively in order to achieve economic growth - in that order - is unfeasible. As the present paper will show, in opposite order the two policy goals are no longer in conflict. Hence, the egg comes before the chicken.31

Schröder (1998b) demonstrates, by means of a stylized dynamic model, how this apparent paradox follows from the interaction of the privatised sector and the public budget. The effect of a narrow budget limit can - within the model - impede the restructuring process or even result in an only partially restructured economy. Further, it is found that sufficient growth in the restructured sector can remedy the deadlock, or speed up privatisation.

4.2. The evidence one can point to

In this section I will try to collect evidence of the fiscal constraint to restructuring.32 To start with, it is important to realize that it is difficult to underpin the argument by direct evidence from Central and Eastern Europe. There is a underlying problem of non-identifyability. There are several reasons for this: Firstly, data is a problem. Even though some data on government deficits are available, it is quite difficult to define the degree and speed of restructuring - section 3 bears evidence of this. This is so because restructuring can take place in many dimensions and different industries, not all of which will strain the public budget. Secondly, and more importantly, governments do react. Given the conflicting demands of a small deficit and effective restructuring, other fiscal policy measures or incentives for firms may be applied. This in turn will relieve the pressure on the budget or improve the level of restructuring. Nonetheless, the fiscal constraint effect will still be underlying such system. According to these two problems the evidence presented will either concern behaviour that is indicative of a reaction to the fiscal constraint or evidence that concerns pre-requisites of the fiscal constraint mechanism. For example in the latter category it is important to establish whether or not transition governments do at all maintain strict budgetary policies.

Some evidence of transition governments reacting to a fiscal squeeze - reducing the extent of benefits - is given in Boeri et al (1998, p.74):

30. Revenue from privatisation has been negligible in transition economies for various reasons. A lack of private wealth, considerations of fairness, political constraints etc. have resulted in voucher privatisations and token payments being the main means of "selling" SOEs (World Bank, 1996).

31. There is a related argument on over employment in Shleifer and Vishny (1994), where a government bribes firms (pre- and post-privatization) into inefficient production (excess labor) in order to promote public acceptance. While Shleifer and Vishny's argument is based on political economy considerations, our argument is based on pure budget accounting and the micro structure of firms.

32. Some samples of this evidence are repeated in the introduction to Schröder (1998b).

"Yet it was [the] ongoing budgetary crises (...) which forced public authorities to tighten eligibility and reduce potential benefit duration. Maximum duration was halved in the Czech Republic, Slovakia and Hungary, and a maximum duration of one year was set in Poland (where it had previously been open-ended). Gross statutory replacement rates were cut in Bulgaria and in the former Czechoslovakia; in Poland, the earning-related system was turned into a flat rate scheme."

Also various tax rates were increased in response to the tightening fiscal constraint. In particular labour taxes and social security contributions were raised, since they are relatively easy to collect and not many other tax measures are in place during the early years of transition. For example, in Hungary social security contributions were raised from 42.3% of wages and salaries in 1991 to 50.2% by 1993.33

East Germany as a bench mark

Further evidence of the fiscal constraint to restructuring can be given by pointing to the immense costs associated with effective privatisation and restructuring. Consider the case of the former DDR. Usually the East German case is brushed away as special and different from that of all the other transition economies. There is no doubt that East Germany had a superior starting position in transition. However, if we now determine what the associated costs of transition were for the DDR, then we do have a best case scenario.

The real costs of restructuring at all levels, i.e. the total of West German funds that were pumped into East Germany from 1990 until 1996 are estimated at 1000 billion DM (Sinn and Weichenrieder, 1997, p.181;DIW, 1997; FT, 1997, p.1). This amounts to approximately 60% of East German GDP (and 5% of West German GDP) in that period.34

Despite such inflows and the fiscal transfers to the Länder budgets, the new Länder accumulated in only six years almost as much per capita public debt as the West German Länder. Also the average Länder deficit in 1996 is at 5% of the Local GDP in the East and at less than 1% in the West.

So, we have an explicit 5% deficit plus an implicit deficit consisting of the 1000 billion DM and the national fiscal transfers. It is obvious that the implicit deficit must be a double digit number, even when correcting for excessive compensation levels in East Germany and accounting for transfers that were not related to privatisation and restructuring. I would argue that the resulting total deficit can be found in the range of 15-20% of GDP. In any case it becomes obvious that a restrictive 3% budget deficit - as is aimed for in many transition economies - will put a country at a serious disadvantage.

Having argued that the implicit deficit of the DDR is in the range of 15-20% of GDP, let's compare this with the actual deficits of other transition economies. Table 4.1 provides an overview.

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33. For a further discussion see Boeri et al (1998) chapter 4.3, where they also address the effects of a growing underground economy. The Hungarian data comes from their note 24.

34. All percentages are author's calculations. National accounting and Länder deficit data comes from DIW (1996/97) several issues, but in particular Volkswirtschaftliche Gesamtrechnung.

Table 4.1 Government balances in Transition Economies (percent of GDP)

	1992	1994	1996	1998
Bulgaria	-5.2	-5.8	-10.4	-2.0
Czech Republic	-3.1	-1.2	-1.2	-2.4
Hungary	-6.8	-8.4	-3.1	-4.9
Poland	-6.7	-3.1	-3.3	-3.1
Romania	-4.6	-1.9	-4.0	-5.5
Slovak Republic	-7.0[1]	-1.3	-1.9	-4.0
Slovenia	0.2	-0.2	0.3	-1.0
Estonia	-0.3	1.3	-1.5	2.5
Latvia	-0.8	-4.1	-1.4	1.0
Lithuania	0.5	-5.5	-4.5	-3.6
Armenia	-13.9	-10.5	-9.3	-5.8
Georgia	-25.4	-7.4	-4.4	-2.5
Russia	-4.1	-9.0	-8.3	-8.0
Ukraine	-25.4	-9.1	-3.2	-3.0

Source: EBRD (1998), table 3.5.
Notes: Data form 1992 to 1996 are numbers provided by the national authorities, the IMF, the world Bank, OECD. Data for 1998 are EBRD projections.
1. 1993

Table 4.1 shows a surprising result: The government deficits for Central European countries are remarkably low. Some countries accomplish even budget surpluses in times of transition. Recall also that GDP over the observation period was generally contracting - biassing the deficit to grow in relative terms. For the former Soviet republics (excluding the Baltic republics) we observe that extreme deficit levels get stabilised, while the Baltic republics do relax on their budgets (1996 compared to 1992), yet overall staying in reach of the Maastricht 3% level. Hence, the condition of a low budget deficit - a crucial part of the 'fiscal constraint to restructuring' mechanism - is evident in the data. In any case, the current deficit levels of transition economies are far below the implicit deficit of Eastern Germany.

Tax levels

A central feature of the model in Schröder (1998b) is that the wage tax is higher than the profit tax.There are two elements in motivating this assumption. Firstly, as mentioned in section 4.1, the general reorientation of the incentive structure will typically include a lower than average tax on profits. This is intended to stimulate business activity and discourage tax evasion. Secondly, taxes on wages and income are relatively easy to administer. Since transition governments have few other tax tools in place, they rely disproportionately much on such taxes. In fact in 1995 the combined tax rate on employers and employees (payroll tax and income tax) was 58% in Hungary, 50% in Slovakia, 48% in Poland and 47% in the Czech Republic. The highest rates found among EU countries are Italy with 56% and Belgium with 47%.[35] Hence, transition countries rely quite heavily on wage taxes. This becomes also evident in table 4.2.

Actual Government revenues and expenditure

Having presented the above evidence there remains one overview to be given. Namely the actual data on government revenue (profit tax and wage tax) and expenditure (unemployment and social benefit). In a study on fiscal policy issues in 1996 the IMF has produced comparable budget data for a number of transition economies. The data are presented in table 4.2. The figures are given as percentages of GDP; hence, a constant absolute value would show as an increase relative value during the transitional recession. The IMF provides revenue and expenditures figures for a number of budget items, in table 4.2 only those associated with the fiscal constraint are shown.

Table 4.2 Revenue and Expenditure Items under Transition (percent of GDP)

	1989	1990	1991	1992	1993	1994
Bulgaria						
Profit tax	23.2	17.9	16.5	8.4	5.4	7.2
Wage tax	13.7	13.8	12.0	16.1	15.1	12.8
Social benefits	10.4	12.0	13.7	14.3	15.2	12.9
Subsidies	15.5	14.9	4.1	1.8	2.2	1.3
Czech Republic						
Profit tax	11.0	12.2	13.7	10.6	7.7	6.2
Wage tax	21.9	21.2	17.0	17.9	19.5	22.5

35 All data is quoted from Boeri et al (1998, p.48). Data on Eastern Europe in turn comes from Coricelli et al. (1996), Fiscal Policy in Transition, Economic Policy Initiative Report, No. 3, CEPR/IEWS, p.43.

Table 4.2 Revenue and Expenditure Items under Transition (percent of GDP)

Social benefits	13.6	13.6	16.1	14.0	13.8	13.7
Subsidies	25.0	16.2	7.7	5.0	3.9	3.4
Hungary						
Profit tax	8.1	8.2	5.6	2.5	2.0	2.0
Wage tax	19.8	19.8	19.9	21.0	21.9	20.7
Social benefits	14.4	15.7	18.2	18.3	18.1	17.6
Subsidies	12.1	9.5	7.4	5.5	4.3	4.5
Poland						
Profit tax	9.7	14.0	6.1	4.6	4.2	3.4
Wage tax	10.8	10.4	15.9	18.2	19.0	18.6
Social benefits	11.2	10.6	17.3	18.7	19.5	20.7
Subsidies	12.9	7.3	5.1	3.2	2.2	2.2
Romania						
Profit tax	-	7.3	5.0	5.3	3.8	3.8
Wage tax	13.0	13.2	17.6	19.7	17.3	15.7
Social benefits	9.5	10.6	10.1	9.1	8.9	10.5
Subsidies	5.7	7.9	8.1	12.9	5.5	3.8

Source: IMF (1996), Table 19 and 20.

Notes: The data is based on a mix of National statistics and IMF staff estimates. Wage tax includes social security contributions, and social benefits includes all types of social security benefits.

Table 4.2 indicates clearly the hardening of budget constraints. Subsidies have been reduced dramatically for all five countries. Note the initial surge in subsidies in Romania - an attempt to cushion the effects of the transitional recession. However, the evidence on the fiscal constraint is mixed. Consider first the government revenue from profit taxes. In table 4.2 for all countries the revenue generated with profit taxation falls. There are two possible reasons for this, either performance of firms is worsening in the initial years of transition, or the actual tax rate is reduced (possibly in order to encourage activity). In any case, in support of the fiscal constraint it is important to note that profit taxes are of restricted use as an improvement of the budget situation. Revenue from wage taxes has been generally increasing (even though often reduced for the last two observations). Again there are several possible explanations for this. Firstly, the tax rate can have been increased during the period - maybe exactly in order to avoid an extensive deficit. Secondly, the relative level of employment may have been growing. Recall that the data in table 4.2 is in percent of GDP, hence with a constant wage bill and a fall in output the government revenue from wage tax would rise in the above measure. This would in fact be the case if we are in a scenario of overmanning. In any case, the relative importance of wage taxes compared to profit taxes rises over time. It becomes clear that employment reductions - resulting from restructuring - would harm the budget. Finally, in such scenario consider the development in social benefits expenditure. Here we find a slight rise in the Czech Republic and Romania, a significant rise in Bulgaria and Hungary and almost a doubling in Poland. This gives again some support to the fiscal constraint mechanics, namely that the expenditure side of the government budget is strained by the increasing demands on social provisions. However, note that for almost all countries the reduction in subsidies more than compensates the increase in social expenditure. Hence table 4.2 exhibits in part what the IMF calls expenditure control (IMF, 1996, p.79) and in part support for the fiscal constraint to restructuring.

Still, the overall question remains unsolved: Is what we observe caused by governments reacting to the pressures of the fiscal constraint, or does the observed reflect that the envisaged mechanics of the fiscal constraint are not the underlying cause after all?

5. Conclusions -- The Importance of the Debate

A central characteristic of socialist economies was that almost all productive capacity was in the hands of the state. Hence, a core element of transition is privatisation. However, continuing delays in the privatisation process and schemes that are constraint by political objectives, create major holdups to the recovery of Central and Eastern Europe. Privatisation in itself - of course - is not a sufficient condition for economic transformation, the ultimate aim is the restructuring of firms. Both privatisation and restructuring have been examined in this essay.

While privatisation concerns the ownership of firms, does restructuring concern the efficiency of firms. The interrelation of privatisation, the resulting ownership and the new owners' *a priori* and actual restructuring behaviour have been described. Evidence from various sources has been presented and the topics have been addressed in both a descriptive and empirical manner. The paper relates closely to the formal analysis of Schröder (1997, 1998a, 1998b), and both motivated and supported these theoretical contributions.

The essay identified a slow progress in privatisation paired with an overweight of insider owners. Further, substantial evidence on sluggish restructuring was collected. Overmanning and excessive social assets prevail at the privatised firms. These inefficiencies can both be linked to the inheritance of socialist enterprises, and the role of insiders in the firms. Several surveys were presented that identify persistent inefficiencies, in part regardless of the new ownership structure.The only repeatedly outstanding ownership forms, in terms of restructuring, are *de novo* firms and firms with foreign participation.

Finally, the link to the government fiscal situation was drawn, the costs of restructuring to the government budget were identified. The so-called 'fiscal constraint to restructuring' was advocated. The government cannot afford to let firms restructure, because of the budgetary consequences. The paper provided accounts on budget data and governments' policy reactions to the fiscal squeeze.

Overall the focus on privatisation and restructuring is of continuing relevance. Firstly, many state owned assets remain to be privatised, and much restructuring remains to be done. Secondly, the role of restructuring - in connection with the competitiveness of the economy - has featured extensively in the recent debate on membership of Central and Eastern European Countries in the European Union.

The European connection

There are several aspects in which the content of this essay is related to questions of European integration. Dimensions that set the narrow discussion on privatisation and restructuring into a broader - more topical - context.

Firstly, the increasing trade with Central and Eastern European countries impose competitive pressures on the participating economies. This imported competition increases the demand for deep restructuring - hence, can be a motor for improved performance. On the other hand, can the restrictions and regulations of trade, in certain sectors, severely handicap the transition economies ability (need) to restructure in those sectors. Here I think in particular of the energy and steel sectors. Secondly, foreign direct investments into the region stems mostly from within the European Union, as the essay has shown, it is exactly this type of foreign participation that results in deep restructuring and significantly improves company performance. However, the level of foreign direct investment to Central and Eastern Europe has been disappointingly low. Both because the supply of such investments was wavering, but also because the demand from the East was hesitant. The implicit obstacles have to be removed. Thirdly - on a slightly different note - a necessary condition for deep restructuring is know-how. Inducing growth in human capital will be (and already is) a part of European Union activity. This has two elements, first, the import of human capital - via the mobility of labour - second, the import of training. Limiting the access to both sources, will ultimately reduce the transition economies' ability to conclude structural adjustment.

Further interaction of structural adjustment and the relation of Central and Eastern Europe with the European Union stems from the current enlargement negotiations. Within the criteria for membership, the conditions of being a market economy, being able to withstand competitive pressure and to pursue sound fiscal policy, have an immediate relation to the present essay. The condition of being a market economy is the clear statement that centrally-planned economies are excluded. Structural reform - as in the topic in this essay - is at the centre of this demand. For example the share of private sector production in GDP is frequently called upon, as an indicator of having reached market economy standards. The condition of being able to withstand competitive pressures is closely linked to deep restructuring. It is only this type of restructuring that gives lasting productivity gains, and enables sustainable growth. Easy gains - of reactive restructuring - will eventually be exhausted, rendering firms at a growing disadvantage as the rest of Europe continuously improves performance. Finally, the request of sound fiscal policy is clearly reflected in the low or positive government budgets of many applicant countries. That this policy has potential costs was the concern of the 'fiscal constraint to restructuring', introduced above.

This brief flagging of issues can only imperfectly illustrate the true magnitude of the problem at hand. Nevertheless, I conclude from it that the actual importance of privatisation and restructuring goes beyond the narrow discussion of the present essay.

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