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## PANEL 1. INDUSTRIAL RESTRUCTURING: CAUSES, CONTENTS AND MODALITIES

Topic 1. Industrial Restructuring as a Means of Enhancing National Competitiveness:  
Overview of the Problem**INDUSTRIAL RESTRUCTURING AS A MEANS OF ENHANCING NATIONAL  
COMPETITIVENESS: OVERVIEW OF THE PROBLEM\***by **Paul G. Hare**, Professor at Heriot-Watt University,  
Edinburgh, United Kingdom**1. Introduction: Setting the Scene**

The title of this first Topic for the *Workshop on Industrial Restructuring in European Transition Economies* already does two things: it identifies a problem, namely the need to enhance national competitiveness; and it offers a solution, namely industrial restructuring. Accordingly, part of my task in the present introductory overview paper is to define these terms clearly, to consider whether the “problem” has been correctly identified, and to examine how far the proposed “solution” is the appropriate one.

Standing back from these specific questions for a moment, it is important to recall that the conventional wisdom on the transition from a centrally planned to a market-type economy has consistently asserted that industrial restructuring must form a significant component of any viable transition strategy (along with macroeconomic stabilization, price and trade liberalization, privatization, and wide-ranging institutional reform). What this refers to, for most authors, is the issue of how to deal with the inherited stock of mostly very large and inefficient enterprises which, to survive in a market environment, must undergo some form of restructuring process. Thus in this context, the focus of restructuring is on existing firms, seeking to create the

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conditions in which they might survive and prosper. It was rare, at least in the early transition years, for much attention to be paid to new business formation, a point we return to below.

Industrial restructuring, in these early discussions, was also sometimes linked with efforts to improve competitiveness in transition economies, though competitiveness itself was also expected to benefit from other transition policies such as trade liberalization and other steps to promote economic opening to the world economy. Tax reform and a variety of institutional reforms were also supposed to help.

Since, in my view, this conventional wisdom is either incomplete or seriously misleading as a guide to effective policy-making for the transition economies, it is crucial to start this paper by clarifying terms and establishing some basic definitions. It will then be possible to derive a number of recommendations for policy based on reasonably sound foundations. Accordingly, this overview paper is structured in the following way. Section 2 introduces some definitions and explores the possible linkages between restructuring and competitiveness, finding them to be weaker, more subtle and more complex than usually assumed. Section 3 then sketches some features of the institutional environment particularly relevant for the present topic, drawing heavily on my recent UNECE paper (Hare, 2001b) in order to do this. Some empirical evidence is reviewed in Section 4, while Section 5 concludes the paper by developing a set of policy recommendations for the transition economies.

## 2. Definitions and Concepts

### *Industrial Restructuring*

At the *national (or economy-wide) level*, restructuring refers to the process whereby the shares of certain sectors in GDP, employment, exports, etc., increase, while the shares of other sectors fall. For instance, the familiar observation that the share of agriculture in GDP declines and the share of services in GDP rises, as per capita income levels increase, illustrates what we mean by national level restructuring. More concretely, an economy in which heavy industry is declining while consumer goods and electronics branches are expanding relatively rapidly is undergoing this type of restructuring. Restructuring can be stimulated either from the *demand side* - such as the usual changes in the pattern of demand that accompany increases in per capita income; or from the *supply side* - due to large changes in cost structure (e.g. impact of energy price increases) or significant changes in key technologies (development of plastics, development of electronics).

In most of the former socialist countries embarking on transition, there is an additional factor underlying the need for extensive, national-level restructuring, which can be summed up in the term, *initial conditions*. What this signifies is the presence of many firms and branches developed under the socialist planning system which, for diverse reasons, suddenly became uneconomic once the early stages of transition brought about substantial price and market liberalization. These might sometimes be in heavy industry, or in other sectors where location decisions were not soundly based, or where technologies and/or markets have moved on. For some countries, how to deal with branches facing such difficult conditions is perhaps the greatest challenge of the whole transition process, one that is politically highly sensitive.

In a normally functioning economy, national level restructuring is going on all the time, regardless of government policies. However, as we shall see below, it is possible for deliberate policy intervention either to inhibit restructuring, or to accelerate it. Among other things, we shall need to consider carefully the circumstances under which such interventions might be desirable.

*Sectoral restructuring* occurs when, due to changes in the structure or level of demand, or changes in cost conditions, a sector of the economy finds itself producing the wrong mix of products, or producing the right products with the wrong technology. In that case, unprofitable products must quickly cease production

or be modernised, new products have to be designed and introduced, and the technology used to produce the better products must itself be modernised. Again, governments can intervene to assist or to inhibit such adjustments, or they can simply elect to provide a suitable environment of rules and incentives within which “normal” market forces can bring about any needed adjustment.

*Regional restructuring* refers to the somewhat parallel situation when a town, province or larger region finds itself in severe economic decline, usually due to an economic structure in which declining sectors/activities are significantly over-represented as compared with the national average economic structure. Russia, for instance, has many one-firm towns (e.g. Vorkuta - coal) for which problems in that one firm can spell economic and social disaster for the area concerned. In such circumstances, it is no help to know that elsewhere in the country, there might be other regions where new businesses are taking root, and where economic activity is increasing strongly. For the badly affected areas, the key questions are: (a) how to manage a process of decline; (b) how to find alternative, viable economic activities for the area or for the local people. As has been observed in several transition economies, restructuring at this level is unavoidably political, and extremely sensitive as we noted above in the context of national level restructuring.

*Enterprise-level restructuring* is, of course, the key to everything, since whatever form of restructuring we care to discuss, what actually happens in the economy always takes place in individual enterprises. Taking a somewhat broader perspective than that often adopted in this field, and drawing on Hare (2001b), restructuring at this level can be thought of as composed of three components:

- The entry of new firms or the relative growth of high productivity firms;
- The restructuring and re-organization of existing firms; and
- Exit from the market by failing firms, or the decline of low productivity firms.

The balance between these components varies from country to country, and over time in any given country, but all are important. As far as new firms are concerned, for instance, it is vital to have high rates of entry since the experience of most countries is that up to 80 per cent of such firms fail within 3-5 years. Hence to find the successful firms of the future, the few that will become large enough to employ thousands of people, lots of entry is needed, accompanied by the rapid and orderly weeding out of those that cannot make money. Of course, many of these new firms will simply start small and survive by staying small, exploiting some local market niche to enable them to do so. In total, such small firms provide a large amount of employment in most developed economies as well as in the more successful transition economies. But in the less successful transition economies there are still far too few small businesses - we come back to this point below.

Most people - both economists, policy-makers, politicians and the general public - tend to limit their conception of restructuring to the second group of firms referred to above, namely those already in existence which - for diverse reasons - are facing difficulties in the market. This is why I place such strong emphasis here on the other two groups. Nevertheless, the second group does merit some discussion of its own.

According to Roland (2000, p234), the restructuring of an existing firm can take *defensive* or *strategic* forms. The former refers to restructuring that involves cutting out loss-making activities, measures to cut costs, shedding some labour, and so on. These are, in essence, survival tactics for a business under pressure. In contrast, the latter - strategic restructuring - refers to much more forward-looking measures to re-shape the business by introducing new products, modernising production processes, identifying new markets, and the like. It requires substantial entrepreneurial expertise as well as access to technology and finance.

Sometimes restructuring is interpreted in purely financial terms, such as when governments or banks choose to write off some or all of the accumulated debt of an enterprise, or convert debt into equity, as part of

a rescue plan. Such *financial restructuring* raises many practical difficulties that lie outside the scope of this paper, such as how to design schemes in such a way that the beneficiaries have strong incentives not to engage in further debt accumulation, but instead to undertake the needed *real restructuring* of their businesses. In practice, I would generally favour policies - both by banks and governments - that consistently and credibly harden the budget constraints faced by ailing enterprises, with financial rescue operations of the sort just referred to seen as an occasional, last resort option. Moreover, financial restructuring will rarely, if ever, serve as a substitute for real restructuring; more often, it will provide a means of financing the latter, or at least putting an ailing enterprise in a position where it can credibly seek new external finance.

Last, restructuring is frequently perceived as an issue precisely because there is a widely held presumption that where it is needed, *government intervention* is called for. In a sense this is bound to be so, in that government policies and the legal/institutional framework established by governments determine the environment within which all firms must function. It is a more open question, though, whether and when more active government intervention will be justified.

### ***National Competitiveness***

Competitiveness is a notion which policy-makers frequently discuss - and worry about - but which economists often find quite elusive, sometimes to the extent of arguing that any such concept is substantially meaningless. Our task, therefore, is to consider whether the concept can be given a real meaning that both makes economic sense and is capable of being deployed usefully in policy debates.

Intuitively (which is not always a reliable guide to sound thinking, however), the idea of (national) *competitiveness* suggests a situation where the economy in question produces a set of goods and services that can be sold profitably in external markets. Sometimes, it is also taken for granted that the same term can be used to refer to production for the domestic market, provided that the goods and services concerned are able to sell at a profit while successfully withstanding competition from imports.

Using the term “national competitiveness” strongly suggests that we are dealing with a property or characteristic of production in a given economy, whereas those economists who regard it as a non-concept would argue instead that it has nothing to do with the quality or structure of domestic production, but everything to do with the *exchange rate*. In other words, or so the argument goes, in any economy, however technologically backward its production, there must be some exchange rate at which its products would sell in external markets, and at which in its own domestic markets its products would compete effectively with imports. I would accept that there is always an exchange rate that allows a country to achieve balance of payments equilibrium, but this would often result not from trade flows alone, but from the capital flows and inter-state transactions (such as aid) needed to balance the balance of payments account. But at any remotely reasonable exchange rate, some countries can sell little abroad other than primary produce, and domestic firms have difficulty selling in the local market unless they are offered some protection from import competition. In many markets, the reality is that *regardless of the exchange rate*, many products simply cannot be sold - due to quality deficiencies, failure to meet certain technical requirements, shortcomings in non-price parameters such as credit availability, reliable delivery terms, and so on.

Hence when properly considered, the idea of competitiveness is not just a matter of exchange rate policy, but it is fundamentally linked with the structure and quality of production in the economy concerned. Now let us consider why competitiveness matters for an economy, and how it relates to the restructuring that was discussed above.

We start by sketching the examples of Russia and Ukraine. Russia has enjoyed large trade surpluses in recent years, usually exceeding USD 20 billion annually, mostly due to large exports of oil and gas, timber, diamonds and metals. Manufacturing trade remains quite modest, with imports greatly exceeding exports.

From the balance of payments standpoint, this situation is comfortably sustainable (assuming the oil price does not drop too far). But for its longer term economic development, Russia would like to improve the quality and range of manufactured products sold domestically, and in some sectors develop products that can be internationally competitive and sell successfully in various segments of the world market. For Ukraine, merchandise trade has been in deficit for most of the 1990s, with exports declining since the mid-1990s and imports declining even more, hence cutting the trade deficit. But to develop successfully, Ukraine clearly needs to see exports - most of which are industrial products rather than primary produce - expanding rapidly, becoming a key driver in the growth of the economy. For different reasons, therefore, both Russia and Ukraine would like to see their domestic production becoming much more competitive in the sense defined above. These examples (which could be multiplied many times over) establish our first proposition, that *competitiveness matters*.

Next, consider what has to happen in a country for its competitiveness to improve (while leaving until later a specification of the precise policy measures or policy environment that might be needed to achieve such a result - but see Hare, 2001a). Fundamentally, competitiveness improves when existing or new firms are able to offer better products onto the market, and sell them at competitive prices. Note that I have not insisted on "lower" prices here, since what really matters is the quality-adjusted prices. If the products in a given branch are improving in quality, the average nominal prices realised on exports to, say, the EU market may actually be rising while, due to accompanying productivity improvements, the properly measured quality-adjusted prices may be falling. Indeed one natural way of measuring export quality is to compare the prices achieved in the EU market by a selected transition economy exporting a given product (or product range) with the prices achieved in the same market by highly developed suppliers of the "same" product(s), such as the EU member states themselves. Studies of this sort, as reported for example in EBRD (1997), have shown that in at least some product groups, the export quality of certain Central and Eastern European countries was improving in the first half of the 1990s, while that for Russia had shown scarcely any change at all or even deteriorated.

Conceptually, there is an overlap between the notions of competitiveness and restructuring, in that part of what we think of as restructuring certainly contributes to improved competitiveness. But some aspects of restructuring are unlikely to have much bearing on competitiveness, and competitiveness itself is likely, also, to be influenced by factors other than restructuring. To save space, the basic ideas I wish to convey here are presented on Figure 1, below.

What Figure 1 shows is that strategic restructuring and the entry of new firms are likely to enhance competitiveness. To that extent there is indeed a positive connection between restructuring - broadly interpreted to include new entry - and competitiveness. However, this link is only likely to prove effective in the presence of other factors such as better marketing, substantial new investment and appropriate government policies.

The last point is especially critical, however, since there is evidence from many countries, especially those belonging to the CIS, that restructuring in a *turbulent policy environment* does not lead to productivity improvements. The environment in which firms find themselves must provide incentives that stimulate them to restructure in appropriate directions, and a major part of that environment is the market signals that firms perceive. To generate effective, productivity enhancing restructuring, *market signals* must both reflect the relative costs of different economic activities, and be reasonably stable. The role of government policies in achieving this can be decisive, as we discuss later.

By referring to *marketing*, what I have in mind is especially the international dimension of marketing, in other words efforts to find out what markets abroad really want, and to meet those requirements - in terms of the right products or services, acceptable quality and delivery terms, the availability of credit on normal terms, rapid response to customer problems, and so on. By *investment*, I refer not only to that domestically financed, but also to the diverse channels of foreign direct investment, all being means of modernising production, improving the range and quality of products that serve the domestic and export markets. Last, the remark about government policies covers two types of measure, both discussed in more depth later in the paper. These are: (a) measures to create a favourable, supportive environment for all businesses; and (b) specific measures directed towards particular activities, sectors, regions, or markets. To illustrate the significance of these links, let me simply remark that serious efforts to undertake strategic enterprise restructuring in the presence of bad government policies cannot be expected to yield noticeable improvements in competitiveness. In this sense, restructuring might be considered a necessary condition for improving competitiveness, but it is far from being a sufficient condition.

Further, note the other implication of Figure 1, namely that some forms of restructuring, notably defensive and financial restructuring, are not expected to improve competitiveness under any circumstances. They merely establish the conditions in which more fundamental restructuring can occur.

Hence the linkages between competitiveness and restructuring are more complex, and in some respects more subtle than has often been assumed in the literature on transition economies.

### **3. Institutional Framework: Competitiveness and Restructuring**

In the light of the preceding discussion, there are three aspects of the institutional framework that need to be examined here. These are: (a) institutions supporting restructuring of existing firms; (b) institutions supporting new entry and providing for orderly exit; and (c) political and institutional conditions that inhibit restructuring. The three topics are closely inter-related, of course, but it is convenient to discuss them separately in this section, while some of the linkages are brought out in the conclusions. In what follows, and largely for space reasons, I take for granted much of the discussion of economic institutions that can be found in Hare (2001b).

#### **(a) *Restructuring of existing firms***

In a well functioning market economy, market signals as reflected in business performance measures (sales, unit costs, profitability and the like) are the indicators that stimulate most restructuring in established firms, the process typically being initiated by senior managers or company boards of directors. Hence to get the right firms to restructure, and to do so in desirable directions, the prevailing institutional conditions must ensure that *market prices* meet the following conditions:

- There should be few or no direct *price subsidies* to producers, and those that remain for some well defined policy reason should be small, stable and time-limited.
- Those elements of the *tax system* that affect market prices - such as social security contributions related to wage payments, various forms of indirect tax, excise taxes, etc. - should be set for long periods. The taxes concerned should be administered reliably and with few exceptions or exemptions.
- The domestic economic environment should be as *competitive* as possible, with constraints on the unfair exploitation of monopoly power, no restrictions on market entry, no restrictions on commerce, and preferably - in the relevant sectors - free competition between imports and domestic production.
- Whatever prices are fixed in a given market, they should be *paid promptly, in money*. Failure to pay should always result in prompt cessation of supply, and legal action to recover unpaid bills. This rule applies both to private sector transactions, and to all transactions between the state and the private sector (so it includes, for instance, tax and social security payments).

The core principle is the view - enunciated many years ago by Mirrlees - that the role of market prices in an economy is not so much to balance supply and demand in current markets, but to provide the best available information regarding the prices that will prevail in the future. This point, essentially, highlights the crucial role of market prices in guiding *investment* decisions. If the wrong prices are in place, some very bad investment decisions will be taken, with long term, damaging consequences. And serious restructuring, as we have implied, is fundamentally about investment.

It is also vital, of course, that managers or company boards, on perceiving the relevant market signals, have the *incentives* to undertake the necessary restructuring. Other strategies, such as rent-seeking or asset stripping (which can often slip over into outright theft), must be made to appear unattractive, unrewarding.

(b) ***New entry and orderly exit***

Even with the right prices and incentives in place, some existing firms will be unwilling or unable to adjust. Inability in this context can refer to the competence of existing management, to their ability to access key resources needed for restructuring, or to issues of markets or technology. A few simple examples may serve to illustrate the last point:

- ° Producers of bricks, cement or aluminium, where the factories were built at a time when energy prices (specifically, the electricity price in the last case) were held artificially low;
- ° Producers of light industrial products located hundreds or thousands of kilometres from major markets, where the factories were built at a time when freight charges were negligible;
- ° Producers of poor quality, energy-using passenger aircraft, facing a collapsed domestic market and little external demand;
- ° Producers of computers incompatible with standard western designs and lacking adequate software.

Firms in such - and many other - areas will either restructure rapidly to produce wholly new lines (though this may not be technically feasible for some of the above examples), or they must rapidly decline and most likely shut down. Hence suitable institutional conditions must obtain to facilitate such exit, and to support the rapid reallocation of those assets that can be used profitably elsewhere to be re-assigned. There is no point in protecting such firms and resisting the inevitable - policy must provide *for orderly exit* from the market.

For this to work, *new entry* must be encouraged to provide new employment opportunities for those displaced by closures, as well as to supply goods and services not previously available, or available only in limited varieties. Entry must be quick and easy, free from the plethora of bureaucratic controls that slow it down or drive firms underground in so many countries.

(c) ***Conditions that inhibit restructuring***

The principles of restructuring outlined under headings (a) and (b) above are fairly simple and make good sense economically. Despite that, they frequently fail to work in practice. This is because in many of the transition economies there are important factors that prevent the core principles from taking effect, and in various ways therefore constrain the restructuring process - sometimes for good reasons, usually for poor reasons. Let me merely list some of these factors:

***Entry***

- Complex rules and regulations governing new firm formation;
- Lack of business premises and other infrastructure for new businesses;
- Business networks based on barter and other forms of non-monetary transaction are extremely anti-competitive; among other defects, they deter entry;
- Regional and local constraints on trade in certain products limit competition and deter new entry.

***Restructuring***

- Soft budget constraints reduce pressure on managers to introduce change and also inhibit the development of effective, well functioning commercial credit markets;
- In certain countries, much of the social welfare system is delivered through enterprises. This is known to inhibit restructuring since it raises the apparent social cost of downsizing or closure. In most instances, social services should be delivered through local authorities (in some countries, this requires the reform of local government financing to be completed);
- Ownership structures dominated by workers and managers often result in resistance to major restructuring;
- Trade restrictions sometimes keep businesses alive for longer, but at quite high cost. More open international competition strengthens the incentives/pressure towards restructuring, and might also encourage some of the foreign investment needed to finance it.

***Exit***



- Political factors have kept firms going in many places, e.g. Russia's many one-company towns; in general, political factors have come into play whenever high local or regional unemployment is perceived as politically threatening;
- All the factors listed above that discourage restructuring also, as a by-product, delay the exit of failing firms.

#### **4. Experience of Restructuring and its links to Competitiveness**

The available empirical evidence on restructuring in the transition economies (some of which is referred to in Hare, 2001b), shows that a great deal is going on - in some countries far more than many casual observers have supposed - but that the effectiveness of restructuring in terms of yielding solid and sustained productivity improvements is rather uneven. Not only privatized firms, but also those still in majority state ownership, have taken a variety of steps towards restructuring. Interestingly, ownership structures are not as closely linked to subsequent restructuring effort as had been supposed. While there is substantial evidence that a significant foreign element in the post-privatization ownership structure of a firm is conducive to many aspects of restructuring - additional investment, modernization, access to new markets, improved management, and so on - the picture is less clear cut for other ownership forms. In particular, the widespread negative assessments of worker/manager owned firms that can be found in the literature are not always borne out by the empirical experience. And many state-owned firms have also been observed to undertake some restructuring.

The experience of restructuring, as well as its impact upon competitiveness, differs considerably across countries, and the differences suggest some more general lessons and policy conclusions that are elaborated in the concluding section of the paper.

*Hungary* is an interesting instance of successful restructuring, strongly oriented towards improving competitiveness, from which several important points can be highlighted:

- Early stabilization, inflation never exceeding 35%;
- Trade deficits and government deficits finally resulted in a tough supplementary stabilization package in the mid-1990s;
- At the microeconomic level, the legal environment for new business was already very favourable as early as 1990 and rates of entry of new firms quickly rose to normal, Western European levels;
- In 1992, an exceptionally tough bankruptcy law was introduced and strictly enforced. The country was criticized by some for being too tough, but the outcome was an unmistakable message to all firms that budget constraints would be hard;
- Hungary adopted a policy of gradual privatization by sale, with only a limited role for vouchers (mostly linked to restitution);
- Non-price transactions and deferred payments to the government (e.g. of taxes and social security contributions) were scarcely tolerated - with a few exceptions when political factors influenced the government to support specific sectors/regions. But this was not a widespread practice;
- Very few price distortions were maintained after 1991, especially as regards prices relevant for tradeable products; hence market signals were able to operate effectively and reliably from an early date;

- Right from the start of transition, Hungary created favourable conditions for foreign investors, among other things by undertaking a commitment to service its own high debt rather than defaulting as other countries did. The rapid growth of exports made this commitment increasingly credible, and for some years Hungary attracted far more FDI than any other country in the region (in per capita terms, the stock of FDI is more than ten times that attracted to Russia during the 1990s);
- Much of Hungary's restructuring has been motivated by and oriented towards eventual EU membership for the country, which is likely to occur in 2004 according to the European Commission's most recent reports on the enlargement process. This orientation has, at times, helped to overcome domestic political resistance to certain reforms. It has also ensured that much of the restructuring of industrial sectors has expanded export capacity, as one would in any case expect in a small and necessarily highly open economy.

**Poland** experienced the shallowest post-communist recession, resumed growth soonest, and was the first transition country to surpass its 1989 GDP level. By 2000, Poland's GDP stood at 127% of the 1989 level, way ahead of all other transition economies (in contrast, the corresponding figure for Hungary was just 104%) (Source: EBRD, 2001). Many of the points listed above for Hungary also apply to Poland, but with some notable differences.

- Drastic stabilization and liberalization measures were applied from January 1st 1990, the so called Balcerowicz Plan. This was necessary both to rein in inflation which had reached an annual rate of nearly 600% briefly in late 1989, and restore stability to public finances and the external accounts. The policy was very successful.
- Bankruptcy laws were, on paper, much weaker than in Hungary, but they were applied with increasing vigour. Moreover, one channel for privatization was privatization by liquidation, which, in effect, allowed the newly created private firms to benefit from some initial financial restructuring, while withdrawing from production hopelessly loss-making capacity.
- Poland was one of the first countries to propose "mass privatization" but in practice this proceeded very slowly and most privatization occurred through sales and worker/ management buyouts.
- Some large firms were protected for some years by state subventions. For instance the Gdansk shipyard received state support in the early 1990s - but eventually went into liquidation; in contrast, the Szczecin shipyard received virtually no support, was forced - under new management - to restructure rapidly to survive, and is now a highly competitive, specialist shipyard.
- Poland was initially less friendly to foreign investors than Hungary, and had defaulted on its foreign debts. Hence it received little FDI until the second half of the 1990s, by which time it had reached agreements with creditors (in both the Paris and the London Clubs) cancelling a portion of the debt and agreeing new payment arrangements for what remained. Only in the last few years has Poland attracted very large FDI inflows.

**Russia**, in common with virtually all members of the CIS, had a very different experience during the 1990s. The post-communist recession proved to be deeper and far more enduring than in most of Central and Eastern Europe, with the result that by 2000, Russia's GDP stood at only 63% of the estimated 1989 level - though since the 1998 finance and currency crisis, the economy had finally resumed quite rapid growth (above 5% p.a.) (Source: EBRD, 2001). Complex political factors, weak central institutions, and widespread lack of understanding of the workings of a market economy all conspired to make effective stabilization in Russia hard to achieve and even harder to sustain. Hence the Gaidar reforms implemented from January 1st 1992, involving price liberalization and stabilization measures, proved far less successful than the corresponding

policies in Poland had been. The initial monetary overhang in Russia was evidently more severe, and monetary indiscipline across the Rouble zone resulted in inflation of 1500% in 1992, almost 900% in 1993, with a rapid decline thereafter.

Consequently, almost uniquely amongst the transition economies, Russia found itself in 1994/1995 undertaking a massive privatization programme - mostly based on worker-management buyouts at nominal prices and the issue of vouchers to the population (so effectively, a large-scale giveaway of state assets) - while the macro-economy was far from stabilized. Over 40,000 SOEs were privatized extremely rapidly, but the results in terms of improved productivity and competitiveness have been patchy to say the least. Let us simply list here a few of the principal factors that have influenced restructuring in Russia:

- Slow stabilization, not really effective until after the 1998 crisis;
- Poor legal and regulatory environment for business, together with rampant commercial crime (the so called “mafia” problem), strongly discouraged entry of new businesses - the rate of entry has rarely exceeded a tenth of the rate that one would expect in a well functioning, adaptive, competitive economy;
- No effective bankruptcy law in place, very few firms forced out of business regardless of their poor performance. For many firms, therefore, budget constraints remained very soft;
- In the mid- to late 1990s, there was widespread toleration of non-payment, use of monetary substitutes (e.g. “vechsels”), barter deals, etc. Such de-monetisation of the economy confined transactions to established business networks, hence restricting competition and further limiting new entry;
- Important price distortions have persisted, notably energy prices and urban land prices, which have remained far too low. Many prices continue to be fixed by local or national authorities. Some potentially important markets have still not been permitted to function, e.g. a market for agricultural land;
- Taxes and other price forming factors have changed frequently and been implemented inconsistently, with frequent exemptions and reliefs. Hence prices have not provided the reliable guides to the profitability of future investment that they should.

**Ukraine** was slow to stabilize - with the result that in 1993 inflation exceeded 4500% - and was even slower to privatize. Due to supply disruptions across the CIS (see Bevan *et al.*, 2001), difficult adjustments entailed by Ukraine’s dependence on energy imported from other CIS member states (notably Kazakhstan and Russia), and the slow pace of institution building and microeconomic reforms, Ukraine’s production fell even further than Russia’s: in 2000, Ukraine’s officially reported GDP was only 42% of the level it had achieved in 1989. Moreover, even by the end of the 1990s, enormous parts of production remained in state hands and the country had experienced very strong resistance to serious restructuring, especially when that might have entailed closing down major enterprises.

The points made above for Russia are therefore substantially echoed for Ukraine, with one key difference. Whereas Russia is energy-rich and has run large trade surpluses throughout the 1990s - mostly based on energy exports as noted above - Ukraine’s independence was accompanied by trade deficits and the need for enormous energy imports that the country could barely afford. The result is that the Rouble exchange rate (in real terms, not merely nominal) is likely to be subject to upwards pressure of the sort that could make even those manufactured goods that could be exported appear relatively uncompetitive. In contrast, the exchange rate of the Hrivnia (again in real terms) will experience downwards pressure tending to make manufactures appear more competitive. In this sense, Ukraine’s lack of energy resources could prove a competitive advantage in the longer term (cf. the example of Japan). For both countries, though, these remarks

only hold good if manufacturing itself is undergoing the sorts of restructuring likely to improve considerably the range and quality of products on offer.

## 5. Conclusions and Lessons

In the transition economies we not only expect to see a good deal of restructuring going on, but the process should, ideally, result in widespread productivity gains and improvements in competitiveness (exploiting the links shown in Figure 1). At the micro-level, the latter will be associated with improvements in the prices achieved in developed economy markets for various products (reflecting improvements in product quality and variety, as well as less tangible factors like delivery conditions, reliability, availability of credit, etc.). At the macro-level, significant improvements in competitiveness are likely to find expression in large increases in the ratios of exports to GDP, imports to GDP (reflecting the sheer capacity of the given country to sell its products successfully in external markets).

A great deal of the necessary restructuring will take place through the normal operation of market forces - including here the processes of entry and exit emphasised above. However, as we have also argued earlier, for market forces to work some conditions must be in place. Further, we have seen that restructuring can be and often is inhibited by many factors, including deliberate, politically motivated constraints. Hence it is important to examine the role of the state in promoting restructuring, and to review the conditions under which desirable restructuring will take place within a reasonable timescale. All these elements of the restructuring process are outlined in this section, in order to yield a set of concrete, policy-oriented conclusions. Many of the issues referred to below are also discussed in Hare and Davis (1997).

### *Market forces*

According to the standard textbook story, we would like markets to be perfectly competitive, with uniform prices prevailing in a given market, and identical, accurate market information available to all market participants. But the real world departs from this ideal due to the presence of numerous forms of monopoly, many other market imperfections, and often very imperfect and diverse information available to potential transactors (many examples of such imperfections, and their implications for market behaviour, can be found in Stiglitz, 1994). Given this, it is sometimes tempting to argue that markets should be superseded by centralised (usually state) controls of some sort - this, after all, was one of the old arguments for central planning. It is preferable, in my view, to acknowledge that although markets frequently work pretty poorly, they nearly always work better than any known alternative method of resource allocation. Consequently, thinking in terms of public policy, our focus should be on those measures that can enable markets to function well. For brevity, I list a few such measures to illustrate my approach.

- Measures to ensure that, as far as possible, market signals (i.e. prices, for the most part) truly reflect the real, medium- to long-run relative costs of different economic activities.
- Measures to encourage high rates of entry into the market in response to the prevailing price signals, and to facilitate orderly exit. It is important for the signals to be sufficiently reliable that *the right firms exit*, and that new entrants are relatively productive (cf. the approach outlined in the Technical Annex, below). Note that entry and exit do not merely depend on the formal, legal position surrounding the business sector - effectiveness can only be measured by collecting data on outcomes, i.e. the numbers of new firms being established, the numbers that exit (voluntary liquidation or bankruptcy).
- For established firms, predominantly *hard budget constraints*. Again, this is best assessed not through official policy statements, but through a careful study of the channels through which enterprise subsidies continue to be granted in a given economy.

- Ideally, *information* about potential market opportunities should not be monopolised by a single market agent; but, contrary to elementary market theory, neither should it be universally available at zero cost. Some degree of imperfection in information flows is conducive to efficient investment - but how to ensure this institutionally is exceptionally challenging (for discussion of this issue, see Loasby, 1973, 1999).
- Surrounding the enterprise sector, both the labour market, banks and other financial institutions need to be functioning properly - to provide incentives for people to learn the skills needed in the economy, to move to other places when that is efficient, to provide funds for new investment, and so on. The detailed design of appropriate labour market and financial sector institutions, and their effective regulation, lie beyond the limited scope of this short paper, and are well known to present many practical difficulties.
- Likewise, markets generally function best when the economic infrastructure is in good shape, referring here to transport links, telecommunications, distribution and logistics, as well as the basic transactions technology, credit and payment arrangements, and the like. At times, of course, such structures can be double-edged - for instance, opening a new road to a remote area can just as easily kill off local businesses through the suddenly strengthened competition, as support it by offering access to a wider market. Hence measures in this field need to be approached with careful coordination and a degree of sensitivity. This point is another aspect of the imperfect information issue mentioned above.

### ***Overcoming political and other constraints***

Quite aside from familiar market imperfections, political interests and economic interest groups (such as large monopolies) can resist reforms and, especially in the presence of a weak or indecisive government, demand favourable exceptions to the normal economic “rules of the game” like tax favours, special subsidies, etc. Further, some firms can use their position in the economy as a bargaining counter with government. Here I think of one-company towns in Russia, where the firms survive, at times despite horrendous inefficiency and an almost complete loss of their original markets, because the government is afraid to permit them to close. Another example is a sector such as the coal industry where, on the one hand the workers are traditionally well organized and militant; and on the other, governments can often be shockingly slow to revise downwards their projections of likely future demand, and hence conspire with workers to resist restructuring that entails substantial reductions in capacity. In almost all cases, these pressures and alliances are inefficient and economically damaging, despite the short term political relief that can come from acceding to them. Hence in designing policy, the key is to devise ways of making tough decisions appear less politically costly, and hence more palatable, than was often the case during the 1990s. It is then increasingly feasible for weak governments to gain strength through taking decisions that are better in a longer term perspective. Some examples of how one might proceed in this area now follow (taking as given the steps listed in the previous sub-section, to support markets):

- Social benefits that have traditionally been provided through enterprises should be delivered through local government, financed by regional or national taxes (and specifically not by very local taxes).
- Where subsidies are still employed they should be applied conditionally, subject to defined and agreed criteria of enterprise performance - and in this context, credibility is immeasurably enhanced if the government concerned is able to take a few tough, perhaps even harsh decisions, early in the process. Subsidies should never go to activities that are strongly loss-making in the sense of the Technical Annex.

- Further, subsidies should never simply cover an accrued deficit, but should be designed to provide incentives for desirable restructuring. For instance, subsidies linked to sales revenue mean that a firm earning little revenue cannot - and should not - be subsidised. And a firm that manages to identify and enter new markets, hence boosting its revenues, will receive more subsidy in the given period.
- Such subsidies, especially related to tradeable sectors, might not fit comfortably with WTO principles of free and open trading. Hence to get suitable subsidies agreed, care might be needed either to fit into the limited categories accepted by the WTO as grounds for subsidy, or to announce strictly time limited subsidies - say extending for a maximum of five years.
- Exemptions to tax rules and other economic regulations granted to specific firms should be open and public, temporary, and subject to review in the light of prevailing competition policy rules. Such transparency in itself should help to generate pressure opposing special treatment for certain firms.

### ***Role of the state in promoting restructuring***

Wherever possible, the state's responsibility is to set the economic "rules of the game", including the establishment of suitable courts to deal with business disputes, regulatory authorities to constrain the undue exploitation of monopoly power, and the establishment of the institutions required to support well functioning markets. The latter is especially important since, as argued in Hare (2001b), operating markets is far from costless, and many important markets require a great deal of associated infrastructure to enable them to function at all. The most obvious instance of this is the establishment of markets for land and productive assets (fixed capital, such as buildings) which rarely work properly without some procedure to register and protect titles. Setting up such registration is unavoidably costly and complex in societies, like Russia and Ukraine, where this practice does not already enjoy centuries of tradition.

Once the rules and authorities are in place, it is best for the state not to intervene directly into the affairs of a given enterprise, except under very special conditions. These conditions include cases such as the following:

- Many of the remaining SOEs are large, including the public utilities in many transition economies, especially those belonging to the CIS. Hence when that state wishes to privatize them, it is important to consider what industry structure would be most useful post-privatization, and to create the desired structure the state itself may at times have to undertake some *restructuring prior to privatization*. This will often entail splitting an existing integrated SOE into several companies, based on identifying those parts of the business where competition is possible, and those where, due to network externalities, it is probably not. It should be noted that designing industry structures is not easy, and UK experience, for instance, illustrates both successes (electricity and gas) and failures (the railways).
- Whether it likes it or not, the state will sometimes be called upon to *support enterprises in distress*, whether these are state-owned or already privatized. Hence it is vital for governments to be prepared for such requests in three ways:
  - First, supportive policies need to be in place to do with training, relocation, income support, etc.;
  - Second, vigorous policies must be in place to foster substantial entry of new businesses to provide new employment;
  - And third, the state must follow clear, publicly announced criteria when it decides to offer support to any business entity at all. A starting point in the development of such criteria is provided by the brief analysis of the Technical Annex to this paper.

- Sometimes the state can be drawn into *wider forms of industrial support*, such as supporting an investment and modernization programme for a given sector, e.g. the car industry in Russia, or supporting the development costs of a new aeroplane or computer. Experience in many countries suggests that such support usually fails to achieve its stated objectives. I would argue, therefore, that such state-sponsored modernization is usually to be avoided, except when the state is able to act in collaboration with large foreign investors or with substantial private sector funding from within the domestic economy.

Otherwise, the state's microeconomic role should be strictly confined to designing and implementing suitable policies in areas like: (a) the social safety net; (b) transfer of social benefit provision to local authorities; (c) support for training and relocation; (d) measures to improve information flows; (e) measures to improve infrastructure where the private sector alone is unable/unwilling to provide what is required; and (f) measures to strengthen the financial sector.

### Technical Annex: When is a Business or Production Process Viable?

In principle, we wish to see those businesses that are profitable expanding, those that are loss-making contracting (and in the worst cases, closing altogether). In this Annex we consider briefly how to classify firms into the right categories, based on accounting and business information that ought normally to be available. As we saw in Section 5 above, such a classification is important for the efficient design of certain elements of government policy towards enterprises.

Now, most businesses are multi-product enterprises, and their costs are partly product-specific, partly general business costs (often referred to as business overheads), partly capital costs.

Consider a firm producing and selling  $n$  products in amounts  $x_1, x_2, \dots, x_n$ . Suppose the corresponding factory gate prices (net of taxes) are:  $p_1, p_2, \dots, p_n$ . Then the firm's revenue,  $R = p \cdot x$ , in a natural notation. Suppose the product-specific costs involve  $m$  produced inputs and an  $m \times n$  matrix  $A$  of (intermediate) input coefficients. Let the  $m$ -vector,  $q$ , define the corresponding input prices. Let unit labour input coefficients be given by the vector,  $a_0$ , and the wage rate be  $w$ . Then unit product specific costs,  $c = q \cdot A + w \cdot a_0$ .

Suppose overheads are  $H$  (including labour costs not attributable to individual products), depreciation charges  $D$  and the (market-) required return on capital,  $K$ .

Then even without more detailed data, a few cases can usefully be distinguished.

- (i) For product  $j$ ,  $p_j < c_j$

Then production of product  $j$  should be reduced (possibly to zero) since it is not earning enough even to cover its directly attributable unit costs.

- (ii) For the enterprise,  $p_j > c_j$  for all  $j$ , and  $p \cdot x > q \cdot A \cdot x + w \cdot a_0 \cdot x + H + D + K$

Then each product is covering its directly attributable costs, and the enterprise as a whole is covering all costs, including the normal return on capital employed. Hence in this case the enterprise does not need to eliminate any products from its production line, and ought to be thinking seriously about expansion in one or more of its markets.

- (iii) In all other cases, some degree of *restructuring* is required. This might include measures to cut overhead costs ( $H$ ), write off some existing capital (cut  $K$ ), change the technology of producing existing products (modify the coefficients  $A$  and  $a_0$ ), introduce new products (add new columns to  $A$  and  $a_0$ ), etc.

**Note** that the inequalities defined in (i) and (ii) do not quite correspond to standard concepts of value added. At the enterprise level, the usual *value added* concept would take the form:

$$V = R - q.A.x - H_I = w.a_0.x + H_0 + D + K + II,$$

where  $H = H_0 + H_I$ ,  $H_I$  is the part of overheads not involving labour costs,  $H_0$  is the part comprising labour costs (e.g. marketing staff, managers, finance staff, and the like),  $II$  is residual profits.

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