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PANEL 1. INDUSTRIAL RESTRUCTURING: CAUSES, CONTENTS AND MODALITIES

Topic 2. Stages and Modalities of Industrial Restructuring

STAGES AND MODALITIES OF INDUSTRIAL RESTRUCTURING IN EUROPEAN ECONOMIES IN TRANSITION*

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Background

Overall, the problems of industrial restructuring worldwide have been and continue to be extremely complex and varying between countries and regions. Heavy industry especially in the ECE countries has been characterized in general by over capacity, inefficient and oversized labor forces, obsolete facilities, and a pronounced lack of viability in financial, economic and environmental terms. The situation has been further complicated, particularly in Eastern and Central Europe, by drastic declines in domestic consumption and limitations in export opportunities. In particular, trade restrictions and barriers have been raised by other producers, interested in protecting their own domestic markets. Markets for the Western European countries and other more dynamic areas, which appeared until recently more buoyant, have also been seriously effected by the recent economic downturns. Funds to sustain employment and for even basic social welfare programs

* This paper is presented as received from the author. Any remarks should be sent by e-mail to: edmangan@aol.com.

are seriously lacking. It is against this rather bleak background that industrial restructuring efforts in the ECE countries have to be examined.

This paper focuses mainly on the issues of restructuring that are part of the transition of former centrally controlled economies to market oriented ones. The task has been historically unprecedented, combining an intricate network of economic, social and political relations. The collapse of the previous economic and political order did not leave behind a clean slate on which to draw the new economic and political relations. Remnants of the old power structure as well as new economic, political and social realities determine the number and character of options available in constructing the new set of relationships. This, in turn, establishes the ratio of desired and realistically achievable restructuring goals. Many transition economies have made great progress in the direction of establishing a democratic society coupled with a competitive, market economy, based predominantly on private property. Institutional and policy changes have reshaped these societies in a relatively short time. After the economic depression and output collapse at the beginning of transition, many countries are now registering economic growth.

The Challenges of Restructuring

Unfortunately, the main challenges dealing with restructuring in the industrial sector still appear to be unanswered. This is not just the typical, modernization restructuring, of the type that Western industry undertook in the 80s. The task here was and still is enormous and unprecedented, requiring a total overhaul (ownership and financial, plus technical and labor) at a time when the supply response to the economic changes has lagged well behind. Real restructuring in the area of heavy industry is still for the most part a process under discussion with real results yet to be accomplished. The emphasis, both internally and by external donors and advisors, has been on the creation of an enabling environment. As far as restructuring was concerned, the enabling environment was to induce it by creating competitive pressures, hardening the financial conditions of enterprises' operations, through budget constraints and transforming state enterprises into private ownership.

This approach has so far produced limited results. It relies critically on the strong assumption that privatization can be carried out quickly and an even stronger assumption that the new owners will immediately be capable of the necessary corporate governance needed to quickly translate into efficiency improvements. Implicit, also, is the assumption that every type of state ownership is undesirable, regardless of possible increases in efficiency of management. Till now this process appears much slower and less focused toward efficiency than was initially expected. Furthermore, many large enterprises, in fact whole sectors, have failed to respond to the emerging enabling environment or to privatization initiatives.

The absence of active and powerful shareholders, monitoring the operations of such enterprises, creates an environment with very little constraints to discipline the company managers. In addition, the absence of adequate and developed financial, capital and labor markets offer little opportunity for meaningful restructuring even when enterprise managers do have an interest to restructure. In some sectors management and labor have utilized their bargaining strength to resist carrying out the necessary adjustment measures. This was possible because of the institutional limbo, which was created when the governments collapsed as a controlling agent for enterprises.

The Approach of Government Involvement

A reassessment is warranted if the industrial sector as a whole is really to become viable. The process of restructuring would need to be complementary to the enabling environment approach, but also would need to recognize the reality that there are two types of industrial groups remaining. Those that will act of their own free will, to the creation of the enabling environment, or can be made to do so without adverse social and political effect. And those, which make up the heavy industrial sector, with considerable political clout, but also with larger and more pressing restructuring problems, where a unified strategy would be needed to overcome the objective and subjective obstacles.

Although there are several options, it should be made clear that, based on theoretical grounds and the experience of developed countries in restructuring, government involvement in restructuring is the best option. The problem has been, and still is, one of government's choices between a reactive and a pro-active strategy for the industrial sector. ECE governments appear to be conducting some "after the fact" industrial policy, or micro-management, by taking creeping and discreet decisions to keep alive an outdated industrial structure. These are weak reactions, rather then strong actions to set a strategy on a course toward efficiency. These reactions worsen the problems by suspending exit in the industries in question, and impeding entry into other sectors inasmuch as bank credit and other financial sources are channeled toward refinancing the existing obsolete industry structure.

Western experience in restructuring and privatizing industrial sub-sectors, plus the more recent experience in the former Eastern Germany, clearly show that pre-privatization restructuring makes strong economic sense. The problem, then, is not in the fact that this activity is intrinsically wasteful and resembles the old centrally planned economy, but in making sure that the right institutional conditions and motives of stakeholders prevail to direct the restructuring toward greater efficiency and ultimate privatization. This strategy is not about "picking winners," but rather would be an attempt to provide an institutional framework during transition in which the private sector adjustment is facilitated. The intervention is only in the case of a limited array of heavy industry subsectors, all others being left to market pressures without such strategic guidance. The role of government has to be seen as catalytic and proactive rather than reactive and should be clearly defined as supplementary and temporary.

Government led restructuring has the advantage of being sector oriented, rather then enterprise based. This integrated approach allows for the internalization of sector costs and benefits and a better economic and political framework for developing a long-term solution. The integrated strategy would include a time-dependent analysis, providing for a definite but realistic time frame in which the minimal initial restructuring is to be completed, and the non-viable enterprises are to be shut down. The balance of the qualitative restructuring could be enterprise based and left to the new owners to decide on. The strategy should be based on overall analysis, aided by foreign experts, on current and prospective sector characteristics. This would enable the identification of necessary enterprise closures and the needed actions and policies to make the rest competitive enough to be viable. The carrying out of the strategy would ideally require a temporary centralized turnaround institution with sufficient resources and clout to implement the chosen strategy.

To be successfully implemented, this strategy would have to include measures and policies that would reduce conflict and build consensus and a stronger commitment for action, based on a clear recognition of the self-interest of the stakeholders. The strategy would have to demonstrate to the winners the expected benefits they would receive by implementing it. It must also convince the losers that accepting the strategy is beneficial in the long term, or at least that this is the best of the bad options available to them, and that the compensations included in the strategy are worthwhile.

The design and execution of such an integrated strategy would rely heavily on the support of international and foreign participants. External technical assistance would be very important in designing the path to privatization, while the active role of the international financial institutions in designing and execution of the strategy suggests to potential investors that process will lead to viability.

There is an interesting discrepancy between the faith that the international community places in the governments in transition as being capable of creating an enabling environment and the lack of trust which they enjoy when it comes to making restructuring decisions. Though there are some historical reasons to justify this discrepancy, there is also a need to recognize that governments are transforming into far more responsible entities and should be relied on, as well as helped, in taking on their responsibilities in restructuring for privatization.

The International Development Institutions, already committed to aid in economic transition, are in an excellent position to encourage and support the integral approach to industrial restructuring. Without additional financial commitments, they could supply the necessary prestige, both internationally and domestically, contributing the "political capital" necessary to negotiate among the stakeholders, and to generate sufficient interest among prospective foreign investors. These organizations have the experience, knowledge and technical expertise necessary in the various steps of designing and implementing an integrated turn-around strategy. Furthermore, they could offer financial assistance to the integrated sector restructuring since some elements of such a strategy fall within the accepted framework of financial support, such as the creation of a social safety net, environmental protection and preservation, financial structural adjustment loans, etc. Accepting the idea of moving forward with support for the integrated approach would, no doubt, uncover new ways in which they could be useful and helpful in the effort, either in the design or the implementation stage.

The Enterprise Led Option

Industry management in the former command economies had the reputation of focusing on large investments in plant and equipment related to technological and production improvement rather than financial returns. More recently, without government assistance and control, and with severe problems in the development of market mechanisms, management has been left with the burden of “trying to make it on their own.” This has delayed significant overall actions dealing with the key restructuring issues pertaining to capacity reduction and labor redundancy, and has left individual managers free to act in their own best interests. These actions, in general, have discouraged both domestic and foreign investment as potential investors’ look to short term returns in industries that require a long-term perspective.

Experience in other parts of the world clearly favors government led, sector based work as the most successful means of restructuring. Unfortunately, time is slipping away, along with the opportunity, to take this sector view which is felt to be the key to implementing more rapid and successful change. If the government does not take a central role in the development and implementation of a sector based program, then a new paradigm would have to be developed or the promise of restructuring benefits foregone.

One possibility lies with an industry led program that would recognize individual plant restructuring that in some cases is already underway, but replace a government developed subsector plan with one created by the industry itself. This structure would require the sharing of resources by plants that are to continue and be modernized with those that are to be closed. In this way, the industry itself, acting through its managers as a group, rather than government or outside agencies, would determine the desired final configuration for the industry.

The key issue in such a self-funding proposition would be the determination of managers to take a longer term view regarding investment, including the benefits of one plant investing directly in the closure cost of another. This model, although in a very different market environment, might be similar to the programs carried out in the United States independently by companies, which had multiplant operations, wherein the costs of closure of several plants was borne by the surviving facilities.

The author believes that industrial managers within the ECE are sufficiently knowledgeable about their industry as a whole and with proper leadership and limited outside help, could develop a viable industry structure that would work in the long term. The major problem would be a change in thinking, passing up the short term benefits currently sought by managers, in favor of the longer term view of an overall healthy domestic industrial sector. Coupled with this change in view, an internal industry based organization would have to be created that could be trusted by the stakeholders to oversee the process of resource sharing to cover the costs of restructuring.

Conclusions

Successful industrial restructuring has been and will continue to be a difficult and expensive process that requires all stakeholders, public and private, including owners, lenders, managers and employees to loose something in the process. That loss has to be understood to be necessary to accomplish a future gain, which must be establishing a competitive position in the market to be served. Given the present state of world economy and the limited success of market reforms in the ECE countries, it is likely that industrial restructuring will be even more difficult in these countries. Due to many factors, long term direct investment in the industrial sector will probably not come from outside. International development and lending institutions have already drastically limited direct lending to any subsector of industry, and recently, external support of overall economic reforms has also declined.

Therefore, it is felt that industrial restructuring in the ECE will have to be done from inside the country and likely inside the industry. One alternative is a reversal of government policy and establishment of decisive sector leadership with direction and support in order to implement overall industrial restructuring programs. The ingredients for such a program have been discussed here in general but the details are well known, with ample previous work and examples available for guidance.

The alternative is for the industry itself to take control and for its managers to act on behalf of the overall sector. There is little history to support such a program and its success would depend on the managers themselves. In order to gain support both within and outside their industry, there would have to be a change in the perception that managers are acting only in their own best interest. Only the managers themselves can change this perspective. One suggestion to aid them would be the transparent use of foreign trade earnings to fund widespread internal restructuring.

It is felt that without an attempt at either of the above alternatives industrial restructuring in the ECE countries will continue as it is now, addressing ad hoc enterprise level problems. This approach will continue to delay real efforts on a subsector level to bring about the overall benefits of restructuring.

Ideas presented in this short paper are discussed and explained in greater length in the attached essay. Though completed several years ago, the main problems that the essay addresses have not gone away. It is, in large part, due to the fact that policies critically examined at the time have not changed. If the applied policies have not given the desired result, maybe it is time to reconsider and change these policies toward industrial restructuring.

ANNEX I

Enterprise Restructuring and Development in Former Command Economies

The Case of Heavy Residuals

Effectiveness of enterprise adjustment holds the key to a successful transition
(Kornai, **The Road To a Free Economy**)

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A. Purpose of Paper

This paper focuses on problems and difficulties which have emerged during the transition in carrying out the massive reallocation of resources in former command economies (FCEs) through enterprise restructuring and development. It looks at both the positive and negative supply response of a specified class of enterprises and sectors, a class which has so far shown most resistance to change, restructuring and adjustment attempts to isolate and classify the reasons for the lack of their response. Finally, some suggestions are made regarding the possibilities of improving the methods and pace of restructuring and development of these enterprises and sectors.

The view taken here is eclectic and principally addresses the question: what is holding up the process of enterprise transformation and adjustment? Is it a matter of wrong expectations? Is there a way to speed up the process which is taking its objective time? Alternatively, if enterprise adjustment is not on an optimal path1, are there correctable reasons for the delay, what corrections in outlook, approach and policy recommendations would be warranted?

The decisions made by enterprises and their behavior during transition are not viewed in terms of abstract models of possible rational economic behavior, but in terms of an eclectic appraisal of legacies of communism, limited market resources, distorted industrial structures and poor institutional conditions.

The question of time as an endogenous variable is also addressed. Everyone, of course, accepts the statement that transition takes time. Yet too often time is treated as condensed and compressed, and the transition ends up being viewed as an exercise in comparative statistics, rather then dynamic flows. A phenomenon at the beginning of transition is confronted with an ideal situation toward which it should be headed, while the time in between is reduced almost to an instant, or at least to "as brief as possible" by true, but simplifying propositions like: competition will increase effectiveness, privatization is the way to increase motivation, the emergence of capital markets will channel resources in an efficient way, etc.

The paper first states the key elements of the now predominant macroeconomic enabling environment approach. Then turns to privatization and corporate governance as the main leverage on which the expectations of enterprise restructuring rest. Some problems with privatization which have appeared in FCEs are reviewed and the strong hypothesis of quick changes in corporate governance examined. The paper addresses the question of enterprise restructuring in practice: what is taking place, and what ought to be happening under the assumptions of the enabling environment. The concept of "enterprise drift" is introduced to indicate the unsettled question of direction, and the concept of "heavy residuals" helps to define the sectors most affected by the drift.

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[1] But was wrongly, before, believed to be possible at a faster pace.

A short discussion on the changing role of the government is followed by an attempt to expand the concept of the enabling environment including pro-active policies with the direct purpose of speeding up the restructuring and adjustment of enterprises, sub-sectors and sectors. A list of possible policies to complement the enabling environment approach, in a time limited fashion, and only during transition, concludes the paper and leads to a short list of recommendations for further study and research, with the view of possibly modifying and expanding the structural adjustment approach to lending in FCEs.

B. General Background - Dynamics of Transition

The ongoing attempts in Eastern Europe to transform former command economies (FCE), previously based on state ownership and central planning, into market economies based on private property is, without question, the most ambitious attempt at economic reform in modern times. It is without precedent in terms of sheer magnitude and the number of societal changes that need to be accomplished in what is, after all, a relatively short period of time.

Though the countries which make up the group of FCEs have somewhat different historical backgrounds, and have entered the process of transition from somewhat different starting points, certain general characteristics of the task to be accomplished are common to all. These include:

a) The need to carry out a complete institutional overhaul, so that the institutions of a command economy will be replaced by a legal and institutional framework conducive to generating interests, motives and behavior in line with a market economy. In this regard defining clear ownership and changing the ownership from state to corporate to private is a high priority.

b) The need to replace the entire signal structure in the economy away from administered prices and allocation, to liberalized prices, interest rates, foreign exchange rates, etc. which will be reflective of supply, demand and comparative advantages.

c) The need to maintain macro-economic stability and control the macro-economic environment by a reasonably tight monetary policy and the elimination of budget deficit-generating activities.

d) The need for enterprises to adjust to the new and emerging opportunities and constraints in a way which will correspond to competitiveness and enterprise viability in a market context, which can be termed the positive supply response.

e) Associated with the process of enterprise adjustment is the problem of what to do and how to deal with enterprises which cannot adjust, cannot become viable and will, therefore, have to be liquidated through a negative supply response.

f) The need to choose and combine measures and policies to make the transition as effective as possible, and to be inventive and innovative about these policy choices and mixes, as there are no precedents for such far-reaching reforms from which to derive clear lessons on transition program design.

g) The need to monitor and balance the political economy of transition, i.e. the interaction of economic changes, on the one hand, and the enormous political and social changes that are taking place at the same time, on the other. These sets of changes are taking place simultaneously and they are intricately interrelated. The difficulty is in finding the policies which will minimize the overall socio-economic cost of transition, and will not create a major negative political backlash.

This is an imposing list of tasks to be accomplished in order to overcome the command economy legacy. The Eastern European countries have moved into their respective transitions with varying speeds and with differing levels of political commitment. Progress has been quite uneven in accomplishing the above mentioned complex tasks. In the last five years much greater policy emphasis has been placed on liberalizing markets and trade, on introducing stabilizing macro-economic policies, and on privatization, than it has been on the creation of factor markets and restructuring of the economy. The chosen tasks have also been easier to accomplish, for reasons that will be pointed out later.

It is widely accepted that the least progress has been achieved in restructuring of the productive enterprise sector. Due to a specific and lopsided development model applied during the period of central planning, all of the FCEs are stuck with industrial structures and productive facilities which are distorted from the point of view of their inclusion into the world economy. The supply response to changes in demand has been disappointing so far and restructuring is proceeding very slowly. It is widely recognized that, unless enterprises become efficient and profitable, even the best designed and vigorously implemented macroeconomic reforms will not result in a successful transition into a market economy.

The overall process of transition so far has not fulfilled the widely held, rather optimistic expectations as to the speed and possible pace of change. Since the transition is an ongoing process, the accumulated experience to date gives us an opportunity to review the past record, examine the policies applied as well as the propositions on which these policies rested at the time of application, assess the effectiveness of such policies and, if need be, to suggest and to implement new measures which might make the process more effective.

After five years the fundamental principles of economic transformation and political change, as well as the ultimate goals to be reached, evoke little or no disagreement among mainstream economists. There is no disagreement on the need to liberalize the economy, to make it more transparent and responsive to market shocks, to create competition (internal and domestic), to improve corporate governance, shift ownership from exclusively state to overwhelmingly private, or the need to achieve and maintain reasonable macro-economic balances. Nor is there disagreement about the necessity of democracy, political transparency and the creation of a civil society. The issues that do cause debate are related much more to the matters of timing, sequencing, emphasis, the choice of specific policies and the way they interact.

Many of the recommendations derived from the neo-liberal mainstream view, are fundamentally correct, but are practically either too difficult to attain or too far removed from the immediate issues at hand. Take, for example, the following randomly picked policy recommendations,(with comments in *italics*): "The success of an industrial reorientation strategy depends heavily on the development of an independent, efficient, and dynamic financial sector". *Quite true but unhelpful since these condition cannot be developed overnight and will, thus, not be a strong determining factor which will facilitate restructuring.* "Access to foreign capital is crucial to secure the funds needed for restructuring". *Again, no arguing that this is true, but experience shows these funds not to be forthcoming because of a host of still unsolved or partially solved problems in transiting economies who are, at the same time, facing stiff competition by NICs.* "Wage flexibility, along with productivity improvements should be the guiding principles, and wage rates should be brought in line with marginal productivity". *After the heavy pounding wage rates have taken so far, and after a marked decrease in the standard of living, it is difficult to see how any government could proceed with a policy as if there was no wage floor, i.e. indefinite downward flexibility.*

With respect to enterprise restructuring, the main topic of this paper[2], the transition of FCEs is far from complete. In many countries a number of prescribed actions have been initiated, laws passed, institutions created,

2 A growing literature on FCSs highlights macroeconomic stabilization, liberalization, privatization and institutional reform as the foundations of successful transition. There is comparatively much less literature on how the reforms have impacted the economic behavior and choices of enterprises, and their responses to the gradually emerging market environment.

policies put in place, with the view of generating enterprise adjustment and restructuring. Still the enterprise response is very slow.

Looking at the supply side, at the moment, these economies resemble neither a command nor a market economy. They are somewhere in between, some still quite close to the originating, other further advanced toward the destination pole. The state no longer directly commands the industrial enterprises as it used to. Yet the full set of institutions and networks vital for the normal functioning of a market economy are not fully in place. The enterprises are still not facing the conditions which will lead them, by carrot or stick, to restructure and adjust.
By and large, they also lack the resources which are necessary and required to accomplish the adjustment to emerging market conditions.

C. The Enabling Environment Approach

The mainstream strategic view that has emerged early on in the transition and that the reforming governments have tried to (are have been advised to) implement has earned the name "creating an enabling environment". It rests on two assumptions:

a) macroeconomic[3] reform and enterprise restructuring are interdependent and should proceed in parallel;

b) ownership restructuring is the most important aspect of enterprise restructuring and development, since all other forms of restructuring such as physical, financial, and organizational - depend crucially for effectiveness on the right motives, incentives and behavior of the new, private owners. The theory, then, is that if the economic environment (including the ownership) is right, the enterprises will, on their own, take the kinds of measures which will make them efficient.

Though the first assumption posits an interdependence, in practice much more attention has been given to the impact of macroeconomic reform on enterprise restructuring, than on the reverse mutual relation. The elements of macroeconomic reform are expected to impact enterprise decisions, and increase their efficiency, in the following ways:

a) Removal of price policy distortions, such as the elimination of protective trade policies and administrative price setting, will reflect demand and supply and expose enterprise to international competition, thus forcing the enterprises to base their decisions on market signals and comparative advantages.

b) The elimination of unconditional subsidies to loss-making enterprises through tight budget constraints, will determine enterprise profitability through the market and not through government decisions, also threatening unresponsive enterprises with bankruptcy and/or liquidatio n.

c) Macroeconomic stabilization, based on a consistent monetary and a responsible fiscal policy, will create a conducive entrepreneurial environment by elimination unpredictable changes in price levels and relative prices.

d) Financial system reforms and market-determined real interest rates will impose additional financial discipline on enterprises, reduce excessive investment in equipment and stock, allocate financial resources to most productive uses and make investment decisions dependent on the real cost of financial resources.

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3 Strictly speaking, not all of the following are macroeconomic reforms; a number of them are institutional, market building. But for brevity sake they are treated and lumped with macroeconomic policies and reforms to indicate their exogenous nature and impact on enterprise behavior.

e) Labor market reform will link labor compensation to productivity, enable layoffs of excessive labor, provide incentive for training and skill development in sectors that are expanding.

f) Coupled with the labor market reform, is the provision of a social safety net which will increase labor mobility, dampen the social costs of layoffs and remove the provision of social needs at the enterprise level.

g) Promotion of competition, demonopolization and improvements in the regulatory framework of an overly-regulated economy will further contribute to efficiency gains.

The sum total of these pressures and enabling conditions should give the right signals and the right motives for the enterprises to adjust, to restructure and develop according to efficiency oriented criteria.

D. The Importance of Privatization

But the rapid development of the private sector is seen as **central** to the economic reforms of FCEs. This is a direct consequence of the finding that the main source of enormous inefficiencies in FCE lay in public (state) ownership. The shift to private ownership, as the dominant form, proceeds through two ways:

a) the development of completely new privately owned enterprises, something that was barely tolerated in some countries and directly prohibited in most others; and

b) the privatization of State Owned Enterprises (SOEs).

It is generally accepted that the extend of privatization in FCEs is far greater then anything else attempted anywhere else in the world. It is also well known that the institutional framework needs an almost complete overhaul and that the industrial structure was concentrated like nowhere else in the world. But to those not sufficiently experienced in the region it may not be immediately evident that deeply irrational incentives, administered prices and directed investment have generated an enormous cumulative effect in industrial structures over 40 years in Central Eastern Europe, and over 70 years in the Former Soviet Union. The resulting patterns of production and capital stock are immeasurably further from an "equilibrium" than in any middle-income developing country contemplating liberalization and privatization.

Privatization is seen as the most important and effective way to eliminate the principal - agent problem that was so endemic to socialist enterprises. It will increase the sense of responsibility to owners, and will install a motive which will protect capital. Privatization, with its new set of incentives and motives, is expected to accelerate the pace of liquidation and downsizing, thus contributing to the needed restructuring of enterprises into competitive economic units, as well as to accelerate the inflow of investments for enterprise development.

But privatization is a complex and difficult process which can have many, sometimes competing objectives. The ultimate objective is clear and beyond major dispute: the promotion of a dynamic private sector that is subject to competitive market discipline. But the problem is how to get to that point from the inherited legacy which was so far away from this objective, and which created behavioral patterns and expectations quite different from those prevailing in a private, competitive economy.

As far as enterprise restructuring and development is concerned, the overriding objective of privatization is to achieve an ownership system that will improve efficiency and productivity. If this objective is to be accomplished, a privatization process (program) must meet the following criteria:

a) it should be accomplished quickly; and

b) it should lead directly to better management, either directly by new owners or indirectly, from hiring new managers[4].

We see, then, that the way in which privatization of SOEs impacts on improved efficiency depends on focus, speed and efficient governance. The situation on the ground in the FCEs during the past five years shows that the link between these three components was not as strong and direct as was initially expected. This link, which should have led to a quicker result in increasing efficiency, was considerably weakened by other intervening factors. In some cases the establishment of such a link proved to be impossible in all this time.

Regarding the focus on an ownership system which will improve efficiency, some states have blurred their efforts by adding as an objective the raising of state revenues to confront the tight budgetary situation. Foreign advisers have also tended to over-emphasize privatization as an instrument of stabilization, i.e. the states quickly getting rid of loss-making enterprises to reduce macro-economic pressures on public finance[5]. This did provide the element of speed but not the necessary focus and the desired governance effects.

Other states have been very concerned with the question of equity and fairness in privatization and have employed widespread distribution of ownership for a nominal charge. This also blurred the focus, was not as speedy as expected, and has shown no immediate or quick changes in corporate governance.

Yet others have resorted to "in-house" privatization, again as a way of meeting the speed requirement, but have compromised the other two. With all the legal requirements of a functioning market and private property still not in place, this also turned out to be the basis for the emergence of all kinds of "spontaneous privatization", asset striping, and development of new, informal links between the government and "privatizing" enterprise. Essentially, the portion of short-term rent seeking turned out to be much greater then expected (and desired), while the focus and the better governance has yet to show up.

The new private sector development has proceeded with great speed ever since the changes in the institutional framework have allowed private ownership. For example, in Poland the private sector's share of total sales of industrial products (in current prices) rose from 13.4 percent in 1990 to 26.6 percent in the first three months of 1992[6], doubling in less then two years. The situation is similar in other countries and the rate of growth is accelerating.

The privatization of SOEs has been disappointingly slow. But there were, and still are, those who point to the fact that privatization is a problem of major social transformation, therefore an inherently slow, evolutionary process[7].

A very rapid privatization of state industrial enterprises is theoretically possible if the new owners are free to shut down as much of the enterprise as they wish, while the state retains all financial liabilities and the responsibility toward previous workers and managers. But this is very unlikely to happen in practice. Indeed, in no country has the pressure on enterprises been introduced in this way.

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4 The issue of corporate governance will be dealt with in the next section.

5 The best known early champions of this view are Vaclav Klaus...; and David Lipton & Jeffrey Sachs, "Creating a Market in Eastern Europe: The Case of Poland".

6 Source: M. Belka et.al., p.35.

7 The best known exponent of this type of view is Janos Kornai (1990a), (1990b). See also Peter Murell.

According to recent reports, after 4-5 years only slightly over 50% of former SOEs have been privatized (or liquidated) in the best of transiting economies (Estonia, Poland, Czech Republic, Hungary and, arguably, Russia). It stands to reason that those were the ones that were also easier to privatize and that there still remains an uphill battle for the rest to be privatized, or liquidated.

This statistic also raises the following problem: what is meant by privatization? Typically we assume that privatization of an enterprise has gone all the way, creating the same type of reactions and motives as in a fully developed market with dominant private ownership. Often this is not the case. In their eagerness to report privatization as proceeding faster than it actually is, governments will combine the number of enterprises and the value of assets privatized in a way which will maximize the result, often hiding the fact that privatization was only partial, and that the government still retains a controlling package of shares in "privatized" enterprises.

The only quick privatization which led to massive restructuring was the one carried out in former East Germany. This represented the ultimate, and only full-fledged, case of shock therapy combined with speedy privatization. The industrial structure was exposed overnight to the standards of the world outside, revealing that much of its capital was worthless, that most of its output could not meet the test of competitive markets, that it lacked the workers habits and managerial skills to compete and respond effectively to the shock. In other words the enabling environment was introduced in former East Germany through the act of unification practically overnight.

The privatization was handled together with restructuring, and the government-sponsored Treuhand performed the function of the core financial and turnaround institution, changing the hands of some 8 000 enterprises, employing approximately 4 million people in exactly four years. This was possible only because of the huge inflow of resources and the safety net provided, in this case, by West Germany. In terms of general economic weight, the West German faucet was nine times bigger then the East German sink. Even so, the costs of transition and restructuring have proven to be staggering[8], affecting not only a slowdown in West Germany but all over the European Community.

This wholly focused and speedy method of privatization and enterprise adjustment is unavailable and out of the question in other FCEs. However, it is instructive about the mutual relation between focus, speed and corporate governance, and about the unrealistic expectations that something similar can be accomplished under vastly different, much less generous and compelling conditions.

Other instructive examples are offered by the privatization of "sunset industries" in Western Europe. The British privatization of the coal industry is, arguably, the most famous with its multiple layers of ideological, political and economic reasons. This privatization has cost the British Government over 12 billion pounds in the period 1985-1993, since it financed both the preparatory restructuring and the social cost of downsizing of the sector[9].

FCEs are not able to apply this method of privatization. Firstly, the needed restructuring is much more massive then that in the developed economies of Western Europe. Second, there are insufficient investment funds to do so, and even if there were, that would then completely crowd out the developing private sector. Third, the large flow of resources to state-led restructuring would also threaten the macro-stability which has been, or is being achieved, at a very high cost. But this case is instructive in showing that the privatization of "sunset industries" was carried out over a long period of time during which enterprises (and sectors) were prepared for privatization.

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8 Estimated to be around 400 billion DM over the last 5 years.

9 IEEC, p.1.

Both of these cases, though impossible to implement in FCEs, offer a lesson on what is needed to accomplish the objective of fast and focused privatization which will in turn lead to the desired effect of increased efficiency. And it is worth noting that in both cases, one of the necessary ingredients was a responsible government (or governmental institution) which would prepare, oversee, participate in, and generally facilitate the privatization process.

It was stated above, that despite a new wave of neo-liberalism in some of the FCEs10, privatization is not an end in itself, only a means of increasing competition and efficiency, albeit the most important one. There is a causal relation between privatization and efficiency, but not a total overlap. In other words, there can be increases in efficiency even without privatization, and there can be a lack of competition even in the presence of privatization, both of these being reported in FCEs11.

An interesting proposition is put forth by B.Ickes and R.Ryterman. They introduce the notion of a survival-oriented enterprise12 which typically places more emphasis on current cash flow than on the long-run value of their assets. This, coupled with the uncertainty generated by the economy wide and time-dependent upheaval that is created by transition, makes the link between ownership (managers and workers) and efficiency in survival oriented enterprises extremely weak, almost non-existent. They also make the important distinction between partial-equilibrium analysis of enterprise behavior, which leads to the strong conclusions on the existence of a strong link between privatization and restructuring, and a general equilibrium approach to restructuring, in which enterprises are faced with the problems of uncertainty of restructuring of others which, in turn, affects their own restructuring negatively.

This would seem to suggest that relying **exclusively** on privatization and the expected changes in enterprise governance to solve all the difficult problems of enterprise, sector and economy restructuring could forego benefits obtainable by a broader approach to restructuring. One line of support to privatization, with a view of increasing efficiency, is clearly in further fine-tuning the macro-economic policy measures13 which define the current enabling environment. Another would seek to shore up and make more resolute the institutional environment, particularly the bankruptcy and liquidation procedure. Yet another, explored in more detail in this paper, is to enhance the concept of an enabling environment by introducing pro-active policy which would combine restructuring and privatization **within** the privatization pipe-line, rather than as a fixed sequence in which privatization always has the lead.

Privatization as a method of enforcing efficiency increases and enterprise adjustment, through restructuring and development, is excellent as far as it goes, but it does not seem to go far enough and fast enough to solve some of the massive problems of transition. The standard argument, often heard, that there can be no progress in enterprise reform without privatization does not seem to be supported by micro-economic evidence in FCEs14.

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10 Vaclav Klaus actually proclaimed that privatization was so important for generating irreversibility and a pace toward the new system, that it has to be treated as an end in itself. While in former Czechoslovakia (he made the statement in 1991) this type of proclamation could have a political rallying value, few, if any, other FCEs can give political support to such an ideology.

11 See, for example, Brian Pinto et.al., and Inderjit Singh & Alan Gelb, p. 69.

12 Also, adding somewhat to the ambiguity, abbreviated as SOE as is the state-owned-enterprise. See. Ickes & Ryterman, p. 83.

13 Two opposite suggestion can be found in E. Green, who argues for relaxing constraints on enterprise viability by, for example, making the exchange rate "softer" (p.412-414), and in Singh and Gelb, o.cit. p. 67, who argue the tightening of the budget constraint. Though opposite in manner of proposed contribution to further efficiency increases, these recommendations are not incompatible in a policy framework which would be more sensitive to sectoral problems.

14 I. Singh & A. Gelb, o. cit., 69.

The main objective of increasing efficiency and the productivity of enterprises, sectors and the entire economy loose something in substance and some more in policy options if the discussion of the way forward is poised only through the question of whether or not to privatize. The added questions of when, by what means, and how fast, offer possibilities for establishing relations and added policy recommendations with a view of improving the performance in transition.

E. Corporate Governance - the Key to Changing Enterprise Behavior

Decisions to restructure are made by enterprise managers, based of their perception of opportunities and a number of constraints, both economic and legal. Since the main concern here is not with corporate governance in general, but with the impact of privatization on corporate governance, other aspects that constrain managerial decision making are ignored, even though their importance is fully recognized.

"Although shareholder monitoring is only one of numerous constraints on managerial behavior in advanced market economies, it is likely to be more important in an early stage of reform in FCEs to the extend that markets for products, capital, and managerial labor are still underdeveloped and thus do not yet exert strong competitive pressures on managers"15.

In cases where enterprises were taken over by single owners (typically the case with small scale privatization), by restitution, or were bought by domestic and foreign investors in well prepared commercial sales, the problem of translating ownership into control over the enterprise did not emerge. The logic of changed ownership leading in and of itself to greater efficiency played itself out fully. But this was the case with only a relatively small part of the economy.

In most cases, and particularly in enterprises to be considered later on in this paper, the majority of assets stayed in state hands. Even worse, because of ill defined property relations and withdrawing responsibility of the state16, assets ended up in a "free for all" free fall. In such cases changes in corporate governance will come rather slowly and much later.

The impact of ownership on corporate governance is much weaker in cases of hurried and ill prepared, as well as in mass and "in-house" privatization which have been applied in some countries. In Russia, for example, this type of privatization has affected a great volume of assets in former SOEs. As yet, the jury is out regarding the impact of this type of privatization on the desired changes in corporate governance which should lead to the necessary restructuring. "Russia's mass privatization program has seen an enormous number of firms, employing perhaps half the total labor force, change hands. But for many observers the speed of privatization has been bought at the price of sub-optimal ownership structures, which may have serious implications for future enterprise restructuring"17. "Russia's privatization is impressive and unique...(it) is the one bright spot in the generally bleak Russian economic landscape"18.

The traditional analysis suggests that the problem of creating corporate governance in transition economies should be addressed by giving or selling stocks to the public at large (give-aways exclude foreigners), by nurturing the growth of active and influential stockholders, by promoting the development of efficient securities

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15 Cheryl Gray and Rebecca Hanson, p.1, italics added.

16 A topic to be discussed in a later section of this paper.

17 John Earle, Saul Estrin and Larisa Leschenko, p. i.

18 John Nellis and Ira Liberman, p. 1.

markets, and by legislating corporate laws which will ensure stockholders a controlling position on corporate boards.

The evidence of the past five years suggests that matters on the ground are not so simple 19. Again, things appear different in a conceptual framework that looks at the process in an evolutionary, i.e. time dependent way. "The legacies of socialism, the increased autonomy of managers of state owned enterprises in the last phase of the communist regime, and the strong political powers of the workers in many transitional economies, including Russia, Poland and China, seem to have left strong constraints on the privatization process of the succeeding transitional economies and the nature of the evolving corporate control structure. In many transitional economies the phenomena of insider control are becoming evident"20.

Another problem is in shareholder dispersal, a large number of new owners with only a few shares. This makes them poor monitors of enterprise behavior because they find it difficult to justify the expense of monitoring the activities of management. Their real incentive is to act as a free rider, leave it to other (equally small) shareholders to impose corporate governance. It is really difficult to see thousands of equally small shareholders impacting on the decision to restructure a giant steel-mill. While the shareholder concept has a permanent value in that it brings capitalism and dividends to the population at large, its influence on corporate governance will be extremely limited in the intermediary time period.

To overcome the problem of shareholder dispersion some countries have created investment funds as intermediary financial institutions. Eventually, investment funds will acquire significant control over firms privatized in exchange for vouchers, but that will also take time before it is translated into an increase in efficiency through improvements in corporate governance, restructuring and development.

Even in the Czech Republic, the country most advanced in mass- privatization-coupled-with-investment-funds, there are still very serious obstacles and problems on the way of affecting major and serious restructuring of enterprises through the influence of funds as shareholders e.g. legal limits of 20% maximum involvement by a fund in an enterprise often does not give sufficient leverage and authority; fund's priority could easily divert toward portfolio management rather than acting as strategic investors; bank involvement as shareholders tends to favor debt roll-overs rather then liquidation, in an effort to minimize loan losses; political pressure not to push for harsh restructuring measures before the elections in 199621.

In most of the privatized enterprises there is a marked absence of a strong link between ownership and management. Therefore there is the danger that, left on their own, managers may run companies to their own advantage. The markets are still not developed enough to prevent, through competition, the managers' diversion from profit-maximizing. Since the bankruptcy procedures in most countries, besides being underdeveloped, are designed to protect creditors rather than shareholders, the managers could, conceivably, erode any amount of shareholders wealth before a threat of a shut-down became effective.

The mainstream argument posits that a number of these problems will be solved as institutions of the market mechanism develop and as a tighter legal framework is imposed. However, as noted earlier, this will take some time and, as recent studies of enterprise behavior in FCEs show, have yet to deliver the desired results on a massive scale. So there is reason to pose the question: Is it realistic to expect in the short and intermediate team

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19 See, for example, the collection of papers on corporate governance in transitional economies edited by Aoki and Kim, in particular the introductory essay.

20 Aoki and Kim, o.cit. p.xii.

21 Source: Oxford Analytica, *Czech Republic: Corporate Governance*, August 16, 1995.

improvement in corporate governance and enterprise adjustment, by tightening the legal framework and making sure that it is strictly observed?

Furthermore, there is also the question in which direction to tighten and form the new corporate law. Starting from scratch is a drawback, but also offers possibilities to move in new directions. Currently there is an interesting debate in developed, Western economies on how to improve corporate governance. One of the proposals is to change Western company law to reflect the fact that corporate managers are not only agents of shareholders but also trustees of the company's assets. Therefore the duty of directors would be to balance the claims of investors, customers, suppliers and employees[22].

This line of thought might serve as a good starting point to look again at the shareholder - manager relationship in FCEs as well. Is it necessary for the FCEs to make the quantum leap from government enterprise governance to shareholder dominated corporate governance, only then to get involved in the type of governance fine-tuning discussed in the above proposal? Maybe it would make sense to look at the issue of corporate control in a broader way which would offer additional means to improve the mechanism of enterprise adjustment and restructuring[23].

Even if we assume for the moment that privatization which allows strong inside control (by managers and workers) establishes a firmer bond between principal and agent, there still remains the problem of obtaining outside capital which is badly needed for restructuring and development. Outsiders would anticipate substantial agency costs to investing in insider-controlled enterprises. Therefore, the funds necessary for restructuring former SOEs would be difficult to obtain from the capital market. Furthermore, since the securities markets are thin and the managers (and workers) have strong attachments to their firms, market signals of corporate valuation would be badly distorted.

On the one hand, the logic of the enabling environment and the privatization-for-efficiency require an important, even decisive influence of shareholders on managers so that the value of their capital will be preserved and enhanced. On the other hand, the experience so far in non-commercial privatization does not seem to generate the necessary principal - agent relation. The disturbing thing is that in a number of observed cases the privatized enterprises have gone on behaving in the same way as state owned enterprises. This is generally explained by the lack of a strategic investor, interested and capable of preserving the value of assets.

If neither the shareholders nor the still weak markets have the real power of influence on managers, it would appear that there is a lot of concentrated power in the hands of the managers. Weather they will choose to use this power in a way which will increase efficiency of the firm, and the value of its assets, is to a large extend a matter of luck, i.e. weather the right man happened to be in the right spot at the right time to lead his enterprise in a way which will benefit the enterprise, the shareholders, workers and the society at large.

This observation would seem to be corroborated by the "Tale of Two Shipyards", both in Poland and both starting at about the same time, from almost identical starting positions. The Szczecin Shipyard has undergone remarkable restructuring efforts and accomplished phenomenal results in streamlining the labor force, improving operations and raising efficiency. The credit goes largely to Krzystof Piotrowski, the managing director. Enjoying the full support of workers, not the shareholders (there weren't any), he accomplished the phenomenal turnaround.

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22 A proposal made by John Kay and Aubrey Silberston, according to *Financial Times*, Editorial, August 22, 1995.

23 Another interesting issue is the relationship of new enterprises, shareholders and financial institutions. The prevailing, American view suggests the exclusion of financial institutions in corporate governance so as to preserve financial soundness. On the other hand the Japanese and German (in fact most West European) experience allows for a major voice for banks in corporate governance.

At the same time, the Gdansk Shipyard, (famous for its Solidarity movement) which went through an unsuccessful attempt at commercial privatization24, an attempt made even before the Solidarity-led government implemented its own plan to privatize SOEs, was at the same time doing worse than it was during communism. The only evident sign of "restructuring" was the dropping of Lenin's name from the name of the shipyard. Like his counterpart at the Szczecin Yard the managing director Hans Szyc came to the top owing primarily to the broad based support among the shipyard's employee unions25.

While good corporate governance is a key to the sound functioning of any private enterprise, the establishment of good corporate governance is much more difficult to accomplish in fact then in principle. Furthermore, "the need for massive enterprise restructuring in reforming socialist economies arguably heightens the importance of effective corporate governance and may change the nature of governance issues in those settings"26.

F. Restructuring - the Major Task Still Ahead27

The command economic system has left behind a disastrous situation in the industrial sector. A few facts will illustrate the magnitude of restructuring necessary at the level of the economy.

In CPEs competition was viewed as wasteful and monopolies were seen as the most efficient industrial structure so monopolization was pursued as far as possible. 6.000 enterprises in the former Soviet Union, producing basic industrial products, enjoyed total monopolies in their respective "markets" i.e. regions which they were assigned to supply.

The priority of large-scale production led to a historically unprecedented concentration of economic assets. The average plant size was extraordinarily large. For example, in Czechoslovakia, only 1.4% of manufacturing workers in 1988 were employed in enterprises with fewer than 500 employees.

The "socialist model" of accumulation heavily favored industry (manufacturing) and, within that, heavy industry at the expense of other sectors and services. This was a lasting consequence of the Stalinist industrialization model. Quantity was stressed, quality neglected.

The command economy and the industrialization model based on it, were largely insensitive to cost which led to high energy and capital consumption. In 1987, for instance, the energy consumption in Czechoslovakia was 12% greater than it was in West Germany despite the fact that gross domestic product per capital was significantly greater in West Germany. In 1990, the consumption of oil in Ukraine was equal to that of Japan despite an even larger gap in output28. The CMEA (Council for Mutual Economic Assistance) countries used on average twice as much energy per unit of output as did advanced Western countries.

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24 The bid came from Barbara Johnson, a native Pole, and heiress to the Johnson & Johnson fortune. She offered $6.5 million for a 55% stake, while the yard itself estimated the sale value at $100 million.

25 The "Tale of Two Shipyards" is documented well in the two Harvard Business School Studies cited in the bibliography.

26 See Cheryl Gray and Rebecca Hanson, p. 1.

27 A growing literature on former centrally planned economies highlights macroeconomic stabilization, liberalization, privatization and institutional reform as the foundations of successful transition. There is comparatively much less literature on how the reforms have impacted the economic behavior and choices of enterprises, and their responses to the gradually emerging market environment.

28 Both figures quoted from Myant, p. 11.

Emphasis on heavy industry, the wasteful use of energy and a lack of concern toward environment have resulted in wide-spread environmental damage. The level of airborne sulfur pollutants in Poland and Czechoslovakia was 2.7 and 4.8 times greater, respectively, than it was in West Germany.

Another way of looking at the same picture, from the perspective of international comparative advantages, again shows the magnitude of the restructuring that needs to be accomplished if there are to be efficiency gains. Table 1 illustrates this. In the three FCE countries considered to be most advanced, one fifth to a quarter of manufacturing is not contributing to GNP while two thirds of manufacturing has no comparative advantages in international trade.

Table 1: The Index of Comparative Advantage

% of manufacturing output	CA index	Hungary	Poland	Czechoslovakia
with negative value added	CA < 0	24	24	19
with comparative disadvantage	0 < CA < 1	69	65	59
With comparative advantage	CA > 1	7	11	22

Source: G. Huges & P. Hare (1991)

The structure of the economy is the legacy of the communist development model. The need for economy wide, sectoral and enterprise restructuring was further prompted by the following, almost simultaneous, occurrences during the early stage of transition:

a) the collapse of the trading area and a substantial drop in demand for products;

b) the breaking down of the command-economy network (supply, demand, finance, etc.) and the need to establish these functions on an enterprise level;

c) the liberalization of prices and the need to adjust the input to output ratio;

d) substantial reduction of subsidies and the general hardening of the budget constraint;

e) the introduction of competition, in particular foreign competition (better quality products and more cost effective), etc.

f) stringent monetary policy and the increase in the price of credit.

Never before has anything like this been attempted, nor was there a need for such massive changes[29]. It certainly differs dramatically from structural adjustments and enterprise restructuring that regularly occur in a market economy, more or less frequently during the different phases of a business cycle.

So are the enterprises restructuring in response to these pressures and challenges? Are they turning into efficient, profitable companies that can compete in the international markets? Which enterprises are

29 Even the restructuring for, and after the major world wars, does not come anywhere close to the restructuring needed in FCEs.

restructuring? And if they are, what is causing the restructuring? What follows is a brief review of some of the major empirical studies which attempted to find answers to these questions.

An early study of the behavior of Russian firms, based on a small survey of 41 firms, found that the surveyed firms largely used their market position by rapidly adjusting their prices to responses of input price increases. Firms' profits remained "remarkably buoyant in real terms". No evidence was found of decapitalization, at least not through greatly enhanced borrowing or predatory wage settlements. Though output fell significantly, employment adjustments were limited. The study concludes that enterprises "adjusted" in such a way as to roll over their problems into the macro-environment driving up inflation[30].

A more recent study of restructuring in Russian enterprises, conducted during the summer of 1994 and based on a sample of 439 randomly selected industrial enterprises, found the following:

a) Majority of enterprises (65%) changed their product mix in some form or another and many (72%) responded that they had introduced some new products. But this response must be assessed together with the response that the participation of the first major product in the product mix has increased on average from 55% (in 1990) to 64% (1994).

b) Enterprises expanded their direct market connections by acquiring over 90% of their inputs through new market links, of which about 45% from privatized enterprises. Furthermore, the percentage of sales to non-government and non-budgetary customers almost doubled from 22% (1990) to 39% (1994).

c) Full-time employment declined by 10%, much less then the fall in output, and the average monthly monetary wages in constant prices decreased by about 30%, eliminating the downward rigidity. A significant part of this decline came from blue-collar workers, much less from white-collar workers while managers gained a little.

d) The extent of restructuring is extremely uneven among different industries. While almost all industries have experienced a decline in output, not all industries have reduced employment or wages. In half of the 15 industry branches, total employment either had a small decrease or actually increased. In the other half, decreases in employment ranged between 10% and 46%.

e) The level of employment and wages moved in the same direction in most industries, indicating that wages have not been cut to save employment, or *vice versa*.

f) In examining the factors which influenced the extent of enterprise restructuring the study finds that: an enterprise's initial conditions and a deliberate restructuring strategy have had a positive effect, while government financial assistance seems to have delayed restructuring. Ownership structure did not yet show much of an impact[31].

A widely cited study of Polish firms in transition[32] offers the following findings:

a) SOEs have been much more responsive to the changing environment then was initially expected.

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30 See Commander et.al. The sample deliberately avoided the very large firms, the military industrial complex and the uni-firm towns.

31 See Quimiao Fan and Bingsong Fang.

32 See Pinto, Belka and Krajewski for an initial interpretation of results. A further amplification of the main findings is offered in Pinto and van Wijnbergen, and in Pinto's article in *Transition*. The sample consisted of 75 enterprises drawn from the list of the 500 biggest in Poland. They are representative of the core of the manufacturing establishment that accounts for 40 to 60 percent of Polish manufacturing. However, the largest and politically sensitive enterprises were deliberately excluded from the study.

b) Factors which explained this responsiveness and the ensuing enterprise adjustment, are: "the consistency of government's "no bailout" signal; trade liberalization and elimination of subsidies; the shift of banks from supporting bad to supporting good enterprises; and management motivation influenced by the certainty of privatization.

c) Substantial labor shedding occurred, despite workers councils, but it was still smaller then the fall in output so there was a fall in productivity.

d) There was an effort across the board to reduce material and energy costs and some reductions have actually been recorded.

e) Managerial attitudes toward sequencing were overwhelmingly in favor of commercializing enterprises and restructuring before privatization. "A restructuring phase is all but essential prior to privatization"33.

f) Hard budget constraints and competition as elements of the enabling environment stimulate SOEs to restructure even before privatization.

A cross-country study, based on a case study project, describes how 43 SOEs in the Czechoslovak Federal Republic, Poland and Hungary reacted to systemic changes and an enabling environment between 1990 and 199234. Some relevant findings:

a) Almost all firms pointed to the decline in demand, an increase in input prices, the cost of borrowing and the rupture of domestic and intra-CMEA links as the major causes for adjustment. Almost nobody mentioned managerial or financial autonomy as the starting point of adjustment.

b) There were a few examples of purely passive responses, while in the short term about 40 percent of firms displayed active responses and about 45 percent showed production responses. There is little evidence of a sectoral pattern underlying the degree of short term responsiveness.

c) A high proportion, around 60%, responded that they had a long run strategy in place though this finding was considerably weakened by the fact that managers were asked only if they are thinking longer term, rather then if they had the necessary means to accomplish the desired long term strategy.

d) Only 7% of non-viable firms had active short run responses as against 60% of viable ones. Almost every viable and potentially viable firm had a long run strategy while the absence of a long run strategy was concentrated in non-viable firms.

e) There is a strong correlation between privatization and the establishment of a long run company strategy with the causality typically running from the former to the latter. The process of formulating a strategy toward privatization is the most significant way in which firms have been formulating a long term approach to the market place.

f) The cases indicate a pivotal role of western involvement in enterprise restructuring but it is viewed as a sufficient, rather then a necessary component of successful transformation.

A study of transition and enterprise reform in China, Czech Republic and Poland found that:

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33 Pinto, "Why Polish State Firms Are Restructuring", *Transition,* Vol 4, # 7, September 1993, p. 4.

34 See Estrin, Gelb and Singh.

a) Top-down restructuring, by direct government intervention sub-sector by subsector, has not been a major aspect of reform in the sample countries. It is not clear if the countries have the expertise, or the political authority, to attempt top down restructuring.

b) Unit labor costs have risen and labor productivity has generally fallen in Poland and CSFR.

c) Labor markets are, generally speaking, working better then financial markets in the transition. The major issue seems to concern the buildup of bad SOE debt in the banking sector and the implied need to accelerate exit mechanisms.

d) There is a growing differentiation between more and less successful firms within industrial branches.

e) Changes in corporate governance has brought in more motivated managers, but there is little evidence of a major impact on firm performance in isolation from other factors.

f) It is possible to substantially "privatize privatization" through inviting competing plans for enterprises as this focuses attention on possibilities of restructuring.

g) The standard argument that there can be no progress possible without privatization is clearly wrong35.

A recent study of 150 enterprises in Russia tested the firms decision to adjust as a function of managerial, enterprise, industry, market and ownership characteristics36. Some of the important findings include:

a) Dependence on trading partners as well as intense competition both decrease the likelihood that an enterprise decides to adjust, while membership in enterprise associations increases the likelihood of adjustment.

b) Larger enterprise are less likely to decide to adjust than smaller enterprises.

c) Privatized enterprises are less likely to decide to adjust than SOEs. This surprising finding is explained by the length of time needed for privatization to bear fruit in terms of an adjustment strategy; and the possibility that SOEs still have more and better access to important resources than do privatized enterprises.

Finally, a cross-sectoral study of industrial restructuring and enterprise adjustment in Poland carried out case studies in a number of firms in three sectors: 1. iron & steel; 2. electronics; 3. consumer durable white goods. The findings:

a) Differences between sectors are minimal and the adjustment, such as it has occurred, was very similar in all of them.

b) Only a few subsidiaries have been privatized.

c) In the iron and steel industry the level of competition on the world market, the decline of CMEA and the collapse of domestic demand make restructuring difficult and privatization only a long term prospect.

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35 See Inderjit Singh and Alan Gelb

36 See Barry Ickes, Randi Ryterman and Stoyan Tenev

d) There is surprisingly little evidence of any long-term adjustment planning in any of the firms.

e) The shortage of capital, even working credits, has severely restricted the ability of firms to embark on restructuring.

f) Absence of clear ownership rights has hampered the development of long run thinking. For the most part, the existing managerial elite has remained in place with skills oriented toward engineering, rather than finance, strategy or marketing.

g) For most firms, in all three sectors, long-run adjustment will be difficult because access to new capital, technology and managerial know-how is restricted 37.

The above studies did not deal with the budding "pure" private sector. New enterprises are emerging in great numbers, particularly in the sectors starved during communism such as services, wholesale and retail trade, transportation. By offering goods and services for which there is a market, and by productively employing resources, they are contributing significantly to the restructuring of the economy and increasing its overall efficiency. But their growth so far has been unable to absorb the redundant work force emerging, and yet to emerge, from the SOEs and recently privatized enterprises.

So what is to be made of the above mentioned findings? Certainly, the most obvious finding is that the majority of firms that did react, reacted in a short-term fashion to an economic tidal wave that hit them. Large groups of enterprises have adopted various short-term and reactive restructuring strategies and have carried out a certain degree of restructuring in input purchases, product mix, marketing, employment and wages, and sources of finance. Strategic restructuring has been much less in evidence.

One of the themes that runs common in all the studies points to the conclusion stated earlier: restructuring has not occurred as fast as expected, nor as fast as necessary to reduce the negative impact of the FCE structural legacy on current economic performance. There is an unavoidable incongruence caused by the time lag between macro-economic transformation and the micro-economic conditions under which the enterprises operate. Until the institutions of the market economy start biting, the SOEs do not respond as they should or as expected. They are not, as economic theory would have it, "well behaved". The reasons are structural and institutional.

Considering that enterprises in most of the countries had no marketing functions at all, the linking with suppliers and purchasers through new, market type links is certainly a major and important accomplishment. So is the restructuring to accommodate the new, financial autonomy, which most enterprises have also adjusted to in some measure in the short run. Furthermore, the broadening of the product-mix, also a favorite response in the short run, shows the technical expertise of most incumbent managers. Due to technological backwardness and inefficiencies in the process, the product-mix adjustment will not go very far without a more fundamental technological overhaul that has been largely lacking in enterprise restructuring.

Labor shedding has also been way below what was expected for a thorough restructuring. The socialist legacy of full employment and entitlement to work still has a strong hold. On the other hand, during the current processes of privatization no authority has yet emerged which will deal with the labor input purely on efficiency grounds. But the least progress has occurred in enterprise closures. The creation of a market economy has suddenly open up the question of enterprise viability, something that was totally irrelevant in the former command economy. Enterprises came into existence, usually with great pomp and celebration of "yet another success of socialism". Once in existence they kept going regardless of performance, never closing down. The exit and liquidation of enterprises was a practice almost unheard of, since it could cast a shadow on the previously mentioned successes of socialism.

37 See Xavier Richet and Saul Estrin.

Most of the evidence supports the enabling environment approach in suggesting the importance of liberalization, competition and hardening the budget constraints. Furthermore, there is a strong correlation between privatization and restructuring but the evidence in almost all cases shows that the linkage is far more nuanced and complex than just the simple proposition: privatize what can be privatized as soon as possible and the road to restructuring will be wide open.

An interesting observation that derives from a number of the above mentioned studies is in that there is, so far, no marked and substantial difference in the behavior of privatized (as opposed to new private) and state owned firms. The responses, particularly in Russia and Poland, have given little support so far to the hypothesis that the privatized firms will outperform the state owned ones in terms of efficiency gains. This intuitively very strong hypothesis, has not been empirically confirmed yet38. The main pressure to adjust and restructure has come from the hard budget constraint, rather than the type of ownership.

Generally, the extent of restructuring has not been in line with the significant decline in output. But the recommendation to the all important question - how to increase the pace of restructuring - is much less clear.

The viability of enterprises is the key variable to look at when determining their adjustment and behavior. Though extremely important, enterprise viability is not a very precise concept when applied to transition of FCEs. While in developed market economies, from which this concept has emerged, it is fairly straightforward - enterprises can either sink or swim - in transitional economies the situation is much more complex. There is a third, gray category of "drifters".

"The future of the Hungarian industry depends on the drifters. If most of them were to disappear in one year or two, this would imply a considerable de-industrialization for Hungary. If most of them were to survive, there would be no significant structural change in Hungarian industry. A middle scenario, in which 30-50 percent of the drifting enterprises are not long-term survivors, seems the most likely. This would imply a sizable structural cleanup of the Hungarian economy"39.

The trap which the drifters are in and which they, with their very existence then reproduce, slows down the emergence of markets and affects market behavior in an adverse way, slowing the entire process of building up entrepreneurial capabilities.

Indeed, it could be argued that on the supply side the drifters actually define transition. Mass enterprise drifting is not a steady-state phenomenon, it is present only in transition. When this category disappears the transition will be over. However, during transition it has a large-scale presence as a behavioral pattern among industrial firms and a significant impact on overall economic performance.

F. Heavy Residuals - A Special Case of Enterprises

Not all "drifters" and survivors are the same. Some sub-sectors and enterprises, because of their rather specific economic and market position and because of their socio-political stature in the society at large, has yet to get involved in serious restructuring at the sectoral and enterprise level. These enterprises and sectors are not responding adequately to the creation of an enabling environment and privatization.

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38 Elsewhere, a case has been made that the scope for productivity gains from privatized SOEs may be relatively small, so that the productivity increases and innovation in FCEs are likely to depend greatly on the emergence of new, initially small private enterprises. See Edward Green.

39 Adam Torok, p. 77.

Two groups of reasons stand behind the lack of restructuring on their part: (i). they are using their existing market and political power to resist it as much as possible, to preserve the status quo and to extend their survival at the expense of others; (ii) their economic situation is also more difficult and the restructuring needed is typically larger than in the small, medium and large firms in other sectors. These enterprises and sub-sectors are faced with more than a "fair share" of restructuring problems and adjustment needs.

There is an "objective component" to the difficulties of their restructuring which makes the process that much complex and the resistance at least a little more understandable. As the privatization and enterprise restructuring proceed through the riddle of the enabling environment in the rest of the economy this residue, still in state hands, creates a heavy burden on the process of further enterprise and economy restructuring. Thus the "heavy residuals".

The experience of the last five years has shown that the privatization process and the creation of an enabling environment have had a different impact on enterprises of different size. Today we clearly see something that was largely hidden by the enthusiasm of early views on transition: time is needed to turn a lot of the "drifters" around, to make some of them viable and sellable, and to increase their efficiency which is the ultimate goal. It is also clear that a considerable number of existing large SOEs, or parts thereof, will have to be phased out, but cannot be closed in a manner of "sudden death".

In terms of their readiness for privatization, the easiest was the case of small and medium scale enterprises. Since most of the new private sector development also occurred by creating firms of up to 200 employed, this segment of the restructuring of the economy is firmly set on course. On the other extreme are the enterprises and, in some cases whole sub-sectors, which are still either not privatized or are privatized through "in house" privatization, thus making it unlikely that it will lead to any meaningful restructuring and increased efficiency in the foreseeable future.

Enterprises in these sectors are typically capital intensive producers of tradable goods (e.g. steel producers, heavy machinery, armament production, fertilizers, coal production, petrochemicals). Though the evidence is not conclusive in all countries and is not necessarily the same in all of them, there is a high correlation between the concept of "heavy residual" and the older concept of "heavy industries" i.e. industrial sector belonging to the production of the means of production[40]. Very often a part of the problem lies in the fact that the enterprises are set up as integrated plants.

They are facing rapidly declining demand due to the collapse of the regional trading block and the deep recession which has followed in the wake of the beginning of transition. The decrease in their demand is larger then the average for the economy. Furthermore, as transition and restructuring of other sectors proceeds, they will have been left behind because of further relative reduction of demand for their products (due to increased capital and energy efficiency of others). In other words, with the exception of a few products, they are not likely to benefit much from a cyclical upswing.

This has had as a consequence a huge over-capacity and a major drop in their market position, due to circumstances entirely beyond their control. Some examples: In Czechoslovakia, general engineering and heavy industries (other then chemistry) lost 40-60 percent of their markets in 1990/91[41]. In Hungary the decline in the volume of output during 1988-1991 was 28.3 percent in mining, 40.6 percent in metallurgy in general, 52.1

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40 There have also been reports of massive problems in sectors which do not, typically, belong to the capital producing sector. Examples: consumer electronics in Poland, the glass industry in Czechoslovakia, etc. They have felt the same kind of shock as the "heavy residuals" but are distinguishable from them by an easier restructuring response.

41 Source: Jana Matesova, p. 27.

percent in iron and steel, 45.3 percent in engineering, 62.4 percent in the fertilizer industry[42]. In Romania, oil refining was reduced by 45 percent and fertilizer production by 61.3 percent in 90/91[43]. In Russia the decrease in the production of main steel products fell on average by 30-35%[44].

These excess capacities are huge, non-marginal discontinuities of such magnitude that they defy regular text-book policy recommendations on adjustment and restructuring.

The core consists of very large enterprises and important sub-sectors which, even with a dramatic drop in demand and output, represent significant, non-marginal contributors to the Gross Domestic Product, to industrial production and to employment. These enterprises are massive employers, often providing the sole or most important source of employment in a town or a region.

Enterprises in these sub-sectors are still state-owned and have been highly regulated in the command economy. They have very poorly defined company boundaries, assuming the normal usage of the word company. Having been created and run by state ministries who operated as the "decision makers", many of the enterprises have in place managerial groups which have been both loyal and highly effective (if not efficient) in running the enterprises in the command economy framework, but have insufficient capacity needed for independent and qualified decision-making in a market oriented economy. The principal - agent relationship is practically non-existent and the enterprises are, in many ways, on their own, in spite of the fact that the state is still the principal nominal stake-holder. The weak position of the state toward their own enterprises has made them prey to rent seeking.

The work force is often highly unionized or by other institutional arrangements, like self-management, placed into a position where it can be very protective of both the level of wages and the redundant segment of the work force at the same time. These enterprises find it extremely difficult to economize on labor, either in terms of price or in terms of numbers of employed.

In the past these enterprises, indeed entire sub-sectors, have been designated as "flagships of growth". They were the pride of socialist industrialization. The several decade long insistence on the extraordinary importance of these sectors and enterprises is hard to erase overnight. Therefore they still enjoy a very high political profile. The social and political implications of "flagships of growth" turning into "white elephants" are huge and in a way add to the objective inability of these sectors and enterprises to respond to the pressures of an emerging market and an enabling environment.

Typically, these sectors possess technologies which create high entry barriers in terms of capital cost, technology and management skills. Therefore their market position is not immediately endangered as it seems highly unlikely that new, more efficient companies will enter these sectors. This is important inasmuch as the only way to combat their monopoly position is then by means of competing imports, a strategy which is not always available because of the hard currency crunch.

Exit barriers to active restructuring are much more important. They are extremely high in the case of heavy residuals and are very difficult to overcome. In fact the high economic, social and political costs that exit would entail constitute the main plank in the current resistance platform to more radical restructuring and quicker adjustment. There are no well prepared end-game strategies in sight. Furthermore, in a number of cases the mop-up environmental costs are extremely high.

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42 Source: Adam Torok, pp. 69-69.

43 Source: World Bank, Europe & Central Asia - Country Department I.

44 S.Z. Afonin, "Future of the Russian Iron and Steel Industry", *Presentation*, Brussels, May 1995, p. 2.

Financially, these sectors and enterprises within them offer a bleak picture. They generate a lot of losses. It has been estimated that they burden the economy with their losses by about 4-8% of GDP[45]. The heavy residual sectors have a much higher than average number of enterprises that do not contribute to the GNP, enterprises with negative present value which, therefore, need to be phased out.

On the other hand, they are tied to the emerging financial market sector through commercial banks which have too little leverage over them and who are hedging their risks by revolving loans outstanding, rather than acting as decisive liquidators. By their sheer size and importance these enterprises manage to socialize the bad debt through the financial system which is a direct cost to the rest of the economy.

With the exception of a few strategic industries and utilities, the governments in FCEs still hold onto the heavy residuals, not because they are the "crown jewels" in the economy, but because they are the most difficult to dispose of either by privatization or a shut down. In fact it is more appropriate to assume that a reverse crowding out effect is taking place, i.e. that the most attractive firms are being privatized easily while the government is left with the loss makers on its hands.

The enabling environment-cum-privatization approach is reaching these sectors and the majority of enterprise within them very slowly and, so far, with insufficient impact. They have been caught up between insufficient guidance by the market which is yet to emerge in many important ways (capital markets, stock-markets, markets for managerial know-how, etc.) and the failure of the state as their previous guiding hand.

And while this ambiguity and duality also touches on other enterprises which have in the meantime successfully transformed themselves into private enterprises, the heavy residuals are by their structural, technological and socio-political characteristics caught up in the neither-nor situation. They are economically costly to close down, and costly to operate. An apparent no-win situation.

Studies of restructuring done so far have either neglected the sectoral angle, or else have looked at individual sectors (coal, steel, refining, etc.) without attempting to generalize the problems as endemic to the heavy residuals. Some examples of sectoral situation descriptions include:

a) The case of the Russian iron and steel industry. Together with the dramatic fall in demand, the sub-sector faces a host of other restructuring problems. Replacement of obsolete and worn-out equipment. 60 percent of steel and 50 percent of rolled products are produced on obsolete equipment. Labor redundancies are such that half the work force should be shed. Other input costs should be shaved by at least 25 percent for the sub-sector to be competitive. The technological mix has to be changed away from open-heart to converter steel and to continuous casting[46].

b) The Rumanian oil refining industry, other then facing an almost 50% drop in demand and capacity utilization, also faces a 60 percent reduction in labor force, obsolete technology, insufficient working capital, environmental pollution, over-regulation, inefficient distribution, processing losses which are three times the size of average in the West, and a financial loss of over 200 mil US dollars in 1993 alone[47].

45 The estimate originates from country operations and the IEMIN division of the World Bank. The estimate has been made for Poland, Hungary and Romania. Except for Slovenia and the Czech Republic, the financial burden of heavy residuals in other countries, particularly those from the former Soviet Union, is likely to be even higher.

46 See S.Z. Afonin, o.cit.

47 According to a report prepared in World Bank's Europe and Central Asia - Country Department I.

These short descriptions are listed here mostly to offer the background for a discussion, to follow in a later section of this paper, of what is being done about these sub-sectors.

No formal definition of the heavy residual is to be attempted here. The argument presented is intuitive, on the one hand, and pragmatic on the other, without sufficient empirical support nor a formal theoretical model to back it up. For a more precise pin-pointing of the sub-sector a study would have to be conducted which would distinguish restructuring behavior and adjustment in enterprises according to:

- technical criteria: product, technology, size of output, etc.
- economic criteria: financial position, employment, market position, etc.
- political criteria: the web of relations among stake-holders such as the state, regional
- powers, management, workers, suppliers, banks, etc.

The rare cross-sectoral study of enterprise adjustment mentioned earlier48 finds little by way of difference in the behavior of steel, electronics and white goods enterprises in Poland immediately after the introduction of the Baltzerowitc Plan. The main conclusion is that the shortage of capital and an absence of clear property rights represent the dominant factors determining enterprise behavior and these were same or similar across the three sectors. It would be interesting to conduct the same survey of the same enterprises three years later to see if there was any variation in their responses then and now, i.e. if some sectors managed to adjust and restructure more readily than others in the meantime.

Both intuitively and from the patchy empirical evidence available from studies of certain sectors (rather than across-sector), there seems to be a need to look at the difference in the rate of adjustment by sector, with an attempt to isolate the particular problems of the heavy residuals and their slower than average restructuring and adjustment.

If a problem of heavy residuals can be clearly isolated and identified, it would seem necessary also to look at the policy recommendations in light of the different transition path of heavy residuals. Clear property rights, a harder budget constraint and the need of governments to fill in the present institutional vacuum would be the logical choices for further action.

Since the hard budget constraint and the clarification of property rights are at the core of the current enabling environment approach, there is no need to elaborate any further on these methods of prompting greater efficiency increases. The government and the state, and their role in transition, particularly their role in restructuring, have been much more controversial. There is a need to look critically at the possible ways in which the government could fill the vacuum in SOEs in the transition period, and conditions under which it's role could be most effective.

G. The Changing Role of the State and Government

Since the beginning of the dramatic changes which have occurred in former CPEs it has been difficult to argue the case for a specific role for the government in restructuring as one of the areas in which it could contribute during transition. The notion of government activism of this type was too highly charged with associations of the past in communist countries. Hence it was seen, and in certain quarters it is still seen as anathema in any transition towards a Western-style marketeconomy.

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48 Xavier Richet and Saul Estrin.

There are very strong views that the state (government) should stay out or the restructuring process during transition. Gomulka, for example, maintains that an active industrial policy is unrealistic because governments have neither the financial nor human resources for it[49]. While largely true, this argument does not say much about the intrinsic worth of a pro-active approach, only about the realism of its application in view of government deficiencies.

But *during* transition the alternative to government deficiencies is not a full fledged and developed competitive market, but rather a market in creation. It is, therefore, equally unrealistic to expect the markets alone to solve the problems of restructuring of the heavy residuals since the markets are neither fully developed, nor sufficiently capital-deep to deal with the financial requirements of restructuring.

If the reason to adopt a government-hands-off approach is in that they have in the past demonstrated economic irresponsibility and bad economic judgment, the counter reason is in the contention that governments, just as enterprises and private investors, are learning during the process of transition to behave responsibly. So one of the objectives of a successful transition should be to strengthen and shore up the responsibility of governments as agents of change and their decisive involvement in a greatly reduced economic domain.

Another argument against the involvement of government is that it is politically dangerous, since it could not only slow down the pace of transition to a market economy but could, in an unfavorable set of circumstances, lead to a reversal. This argument has a lot of weight, and should be taken very seriously. It also leads to the whole debate of government accountability and democratization during the process of transition as *an end in itself*. To the extend that this end is being accomplished during transition, there is no reason not to benefit from it in bringing the increased government transparency and responsibility to solving the problem of heavy residuals.

The governments in FCEs have come a long way from the commanding heights which they held as completely unchallenged, exclusive and omnipotent enterprise governors. The previous system got the label of a **command economy** for good reasons. The governments largely commanded the allocation of resources, distribution of income, job availability and security, prices and trade regimes, in fact every important aspect of economic behavior. Governments were decision-makers while enterprises were there to execute these decisions with very limited freedom of choice. Even in countries that experimented with enterprise independence (Yugoslavia, Hungary, Poland) ultimately it was the state and the government that ultimately called the shots.

The failure of the communist political system and the command economy suddenly changed the position and the role of the state and government in economic life. From a dominant role in all aspects of economic life, the state (government) was now pushed by events into a different role, one which it was not accustomed to, nor sufficiently equipped for. Some governments (Czech Republic, Estonia, Slovenia and Hungary) were quick and quite efficient in adapting to their new role in transition, a role of maintaining political stability and a reasonable pace of economic reform thorough macro-economic management. But many others, particularly from the former USSR, drifted into transition, pulling with them into the drift mode the enterprises they were once in full control of.

An argument could be made that in abolishing the practice of the command economy governments have come too long a way (or that they have exited too quickly), that they have shed more of their responsibilities than was opportune, that they have thus contributed to the rather chaotic transition process. This is often referred to as "government failure", and it has taken on several forms:

a) For the most part, state desertion in the name of laissez-faire has left the heavy residuals rudderless, without any guidance in a radically new and different environment.

49 See Gomulka, p. 11.

b) Slow and haphazard creation and enforcement of privatization mechanisms and institutions aimed at private sector development, an a lack of powerful turnaround agencies, like the German Treuhand, which would facilitate the transition from state to private control of enterprises.

c) The absence of a clear distinction among owners, management in SOEs, and regulatory functions, all in the context of nominally state-owned enterprises.

d) Lack of a well taught out and resolutely implemented plan of tightening the budget constraint and gradual abolishing of other non-market financial sources. As a result enterprises were not forced to take a tightening financial situation seriously since governments ultimately came with a bale-out.

e) The loss of state control has not been replaced by legal ownership control by others, and large enterprises became political battlefields for various stakeholders and vested interests.

f) These enterprises are characterized by poor and inadequate institutional setups even when governments are in control. However, it is weak governments who are often in nominal control, governments with an open ear for rent-seekers.

It is in this interface of rapid state disappearance in enterprise governance, on the one hand, and the non-appearance of an immediate, strong and alternative authority, imposed by the market, private property and the enabling conditions, on the other, that a larger number of enterprises than is necessary are struggling for their survival. Governments, in the meantime are showing at best a benign neglect, and at worst a total hands-off attitude toward enterprise restructuring and heavy residuals in particular.

The governments in FCES have concentrated on macro-economic management and institution building. Those with a clear view of transition did this to get the enabling environment in place as soon as possible. Those with a less clear view of transition objectives, dealt with macro economic issues, problems and balances either out of inertia or under external pressure and because of conditions for financial aid.

The transition strategies that have been adopted by post socialist governments generally bear a strong resemblance to the programs for structural adjustment that the IMF used in various developing countries during the 1970s and 1980s. This resemblance is not a mater of pure coincidence. The IMF, and the World Bank, have applied the same basic conditions for providing financial assistance to the FCEs in Europe as they did in these other countries.

But the influence did not go only through conditionality. The neo-liberal transition strategy was also accepted by a number of new governments which came in the place of communists. The Polish government, for example, willingly adopted the harshest program suggested by the IMF during 1989/1990 because the government firmly believed it to be the correct medicine. Likewise, the government of Czechoslovakia (now the Czech Republic) also endorsed a very radical approach, even though it was not seeking financial support from the IMF and World Bank.

The role of governments in restructuring, viewed through the prism of an enabling environment approach, is essentially seen in the following[50]:

a) remove subsidies and allow prices to clear markets, so that prices can perform their allocation signaling function;

b) credibly establish that, at those prices, budget constraints will have become truly hard;

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50 According to Olivier Blanchard et.al, p. 110.

c) put in place appropriate structures of ownership and control so firms will respond appropriately to these new incentives.

According to this view, there is no active role for government in restructuring, either at the sectoral or enterprise level. Governments have been urged to privatize quickly and to refrain from restructuring prior to privatization. This advice follows from the poor performance of governments as resource allocators in the old days of communism and the belief in the power of emerging market institutions and forces.

But the assumption that the enabling environment will, by itself, create sufficient motive and pressure to cause rapid restructuring and/or closure of the heavy residual enterprises is proving to be unrealistic. Other then the passive adjustment of output, caused by the deep depression, the heavy residuals have hardly touched the surface of a meaningful restructuring.

Experience of the past five years suggests that the development of the market and competitive forces should be supplemented by actions of governments *as stake-holders* in seeking a more effective way to restructure and/or liquidate the heavy residuals. One set of reasons has to do with the emerging market, the other with the changing role of government.

Firstly, time is needed to create and develop markets so that they can perform the necessary allocative and distributive functions [51]. The emerging markets in FCEs have neither the breath in terms of *market* availability of resources, nor the *depth* in terms of established market norms and conducts of behavior. The capital market can serve as an illustration of the first, and the human resource market for the second.

Capital, even working capital, is scarce and difficult to come by. Heavy residual enterprises by their very nature as capital intensive, and because of the state of obsolescence they find themselves in, will need much more capital to accomplish the type of restructuring needed to make some of them viable and competitive. Experience has shown that foreign investors are rarely interested in the ownership of these firms, unless they are previously sufficiently restructured. Foreign savings to finance investment is likely to remain limited. The inflow of total foreign direct investment has been way below expectations with the possible exception of Hungary, the Check Republic and Slovenia, and the foreign direct investment in enterprises making up the core of heavy residuals are practically unheard of. Therefore the private, commercial component of capital inflow seems rather unrealistic as a source of meeting the capital requirements.

The shortage of domestic capital for long-term financing makes the restructuring of large businesses extremely difficult. Enterprises that do not need any urgent, comprehensive, and capital-demanding restructuring are mostly able to find successful survival strategies and a financial structure to go with it. Many, however, will need long term capital for upgrading the efficiency and environmental standard of production. In most cases mass or "in-house" privatization will bring a negligible flow of capital to enterprises. Other sources of domestic capital will be required and it is difficult to see how the weak capital markets will provide them. The sheer volume and the risks involved in enterprise development financing of large enterprises are still too much for the newly established financial institutions in FCEs.

The banking sector during transition is burdened by a growing stock of non-performing assets and is, generally, still relatively poorly equipped to allocate domestic savings efficiently. The stock markets are still to small and to weak to generate financing for much less problematic enterprises, let alone the heavy residuals.

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51 There is a large body of literature dealing with the concept of "market failure" as a justification for different forms of government/public intervention in developed market economies. But in the case of FCEs the main reason for government intervention is to be found in market weakness, rather than market failure.

The building up of new capacities and skills, as well as the reallocation of existing capacities which could be made viable, require substantial investment flows. Except in the case of former East Germany, such flows can be generated only gradually and incrementally, depending on domestic savings and the external flow of funds; neither of these promise a rapid increase in the investment flow which would help speed up the restructuring and adjustment of the capital stock.

To replace and modernize the capital stock which was accumulated over generations requires a sufficiently long period of cumulative new investment flows, to be used for new capacities and skills, but also for transforming old, potentially viable ones. This is, therefore, a necessarily long and gradual process. It is not a question of choice or preference, but of material restraints and constraints which the magnitude of the transition imposes. Thus the only realistic option to maintain a reasonably sustainable level of employment and a level of supplies to support the population, is to keep some of the existing capital stock in operation, even if it does not meet the strict market criteria.

On the other hand, viable strategies for restructuring are just as short, perhaps even in shorter supply than capital[52]. Market *oriented* managers, possessing the necessary skills in marketing, financing, quality control, accounting, business planning, etc. are in very scarce supply. And there is no alternative management elite, educated in the West and possessing MBA diplomas, waiting in the wings to take over the most problematic enterprises. If anything, the better trained, better educated and market-motivated managers tend to leave the heavy residuals in search of better rewards and easier paths to new opportunities and business glory. Turnaround experts and turnaround institutions, like the Treuhand in East Germany, could hardly be equipped with the necessary professional skills without significant aid from the West, with East Germany yet again giving a clear example.

Creating a sufficiently broad entrepreneurial class and a management strata which will competently approach and solve the myriad of problems faced by heavy residuals will also take time. Without them, the market approach to restructuring just cannot take off.

Second, the change in the position of governments in society offers possibilities to utilize their new role in a much more responsible manner than has hitherto been the case. The monumental political changes that have taken place in FCEs have made governments and the process of governance much more transparent and responsible. This is often overlooked, particularly when discussing the role of government in economic policy. Governments in countries in transition, when it comes to questions of their participation in the economic part of transition, are too often treated as if they were governments of the old times, running the show alone and with no responsibility toward anyone except the Communist Party Central Committee and the Politburo.

This is no longer the case. The state is no longer the omnipotent entity confronting the individuals of communist societies and the state enterprises through a government which is commanding and unresponsive to democratic choice. Though democracy and democratic political behavior are still in the making, the threshold to a new type of governance has been passed in most of the FCEs. By identifying the government in FCE *only* through its past powers and mistaken economic conduct, there is a tendency to overlook and neglect some of the responsibilities that governments can and should perform during transition, and could be made politically accountable for. In this case, responsibilities involving the speeding up of restructuring.

The economic changes occurring in transition are intricately connected with political and social changes. The first should not be considered in isolation, without some idea of impact on the other two. Governments, as stakeholders in heavy residual enterprises, should calculate the costs and benefits of all aspects of transition in making their economic decisions. A restructuring relying only on markets hides the fact that a substantial cost of restructuring must be born by the society at large. This cost has a private but also a social dimension to it, the

52 A point made by Matesova, p. 34.

loss of public welfare. Can the private propelled restructuring, with a narrower, private cost-benefit analysis, adequately guide the process if there are substantial social costs involved? The governments, as stake-holders, are in a unique position of encompassing both sets of costs and benefits. No other stake-holder in enterprises facing restructuring has a similar vantage point.

Making difficult and hard choices, like reducing the wage levels, increasing unemployment, reducing social benefits, etc. obviously has an impact on the electorate and therefore on the political processes. Too demanding a transition will reduce the level of acceptability toward radical changes and will slow down the process of transition. Poland in its first year of transition serves as a good example. Economic efficiency cannot be pursued outside of the framework of the politically possible and politically expedient, particularly since the initial political "window of opportunity"[53] has in the meantime been closed.

The assumption that in FCEs the restructuring of viable heavy residuals must be accomplished without the financial involvement of government should be revisited. It seems to be both unrealistic and overly restrictive for policy considerations and recommendations. After all, why would the restructuring in FCEs in this regard be any different then the restructuring experiences of developed countries, where financial support was an important aspect of restructuring the "sunset industries"?

Furthermore, governments much more then the financial sector, still have the financial means needed for an effective restructuring. Some of these means are being spent post-factum to salvage the social and political situation without at all impacting the needed economic change. The problem is how to utilize these financial means effectively so that the net result will be an expansion of efficiency, productivity *and* a quicker transition to a competitive market economy, based predominantly on private property.

The design and implementation of restructuring programs will call for strong political leadership and commitment from government. Bravery in politics is also a rather scarce resource. However, it should be encouraged and directed toward creative and constructive search for remedies, rather than suggesting governments should sit on their hands and concentrate only on creating those parts of an enabling environment - the legal framework, institution building, correct macro-economic policy - which will deal with the problem indirectly.

Another problem which is quite evident and will have to be remedied if governments are to take an active part in the restructuring process in heavy residuals, is the problem of government unity and clarity of focus. Governments are, and will be expected to espouse and defend clear and unambiguous positions in relation to their transition strategies and policies that they are implementing or plan to implement. Virtually in all cases it has been difficult for the post-communist governments to achieve such clarity and determination in practice. Conflicts and struggles within the governments have caused much uncertainty and inconsistency in the formation and implementation of policies. This in itself has been one of the major reasons for a poor restructuring record so far.

In most countries, the Ministry of Finance and the Ministry of Industry have represented and voiced the conflicting positions. While the Ministries of Finance are, typically, the proponents and representatives of the neoliberalist and structural adjustment approach, the Ministries of Industry, not surprisingly, generally favor a selective, industrial policy, or some other "activist" approach. The Ministries (or other institutions) in charge of Privatization generally support the Ministry of Finance and are in favor of rapid privatization, while ministries that are responsible for sectoral or other microeconomic problems tend to support the Ministry of Industry.

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53 A term coined by Leszek Baltzerowic, the first post-communist Minister of Finance in Poland. It indicates the political credit that a government has in the immediate post-communist period and which can be used to push through unpopular reforms which will, in the long run, benefit the entire society.

While there is general agreement that most enterprises will have to be restructured to survive in the emerging competitive, market conditions, there is much less agreement on the extent of restructuring that is needed prior to privatization. In the current hybrid economic environment, one which combines elements of the old and disappearing with elements of the new and emerging, it is generally difficult to determine which enterprises would ultimately survive under competitive conditions. The sectoral ministries typically protect the interests of the existing as inherited. The finance and privatization ministries argue the interest of the emerging. The latter point out the existence of an anti-privatization bias, even a privatization trap[54], and the danger this involves for the pace of transformation and privatization. The sectoral ministries point out that the initial phases of transforming the socialist planned economies were misguided by the optimistic belief that a transition to a market economy could easily be achieved by the privatization of state-owned enterprises, combined with the introduction of equity markets, which would also serve as the market for equity control[55].

In a way, both are right. But in a way, both are wrong also, since transition can only meaningfully be viewed as a combination of the two, as a process of gradual rather than immediate replacement. The transition of FCEs is clearly more complex and difficult then either of the reductionist views would allow. It cannot serve a useful purpose to reduce a complex phenomenon to an single-dimensional one. It narrows the choice of policy options .

This bifurcation in the attitude of various interest groups within government toward restructuring could be overcome by determining precise criteria of government involvement in restructuring and sectoral intervention. These criteria should be established in cooperation with international financial agencies involved in aiding the restructuring program. In principle, the criteria should be determined in a way which will help clarify the situation among heavy residuals, so that unjustified losers in the transition should be protected and helped. In fact two set of operating criteria would need to be developed: the concept of unjustified losers as an entry benchmark for restructuring aid, and justified losers as an exit benchmark for enterprises destined toward orderly closure.

In the event, most of the FCEs are actually conducting some kind of sectoral or enterprise intervention[56]. Faced with social and political implications of letting large state firms collapse, often in regions which are highly dependent on them for their livelihood, governments avoid and delay this by ex post intervention designed to keep them afloat[57]. This ex post intervention is strategically wrong because it is open-ended. It is also financially costly because it crowds out investment into clearly viable enterprises.

If the viability of enterprises in the emerging competitive environment is considered to be a serious problem, and it should, explicit recognition of this fact will improve the quality of the policy debate. Since governments are not able to liquidate immediately all enterprises that are clearly nonviable, a *de facto* form of industrial policy is being pursued retroactively, in stead of in advance[58]. It would be better to recognize this reality and start from it in an attempt to design a forward looking strategy, one which would develop a pro-active

54 A point summed up by Lawrence Summers in "A changing Course Toward Privatization".

55 See Masahiko Aoki & Hyuang-Ki Kim (Eds), particularly the "Overview".

56 See Alfandari, Fan and Freinkman for a discussion of the situation in Russia. They show that the total federal government transfers to enterprises amounted to 6-7% of GDP in 1994. These transfers were highly concentrated with 1.5% of enterprises within the survey sample receiving about half of total transfers.

57 The experience of Western European countries and their inability to close declining shipyards and mines without substantial state intervention comes to mind again.

58 See Sanjay Dhar on this point.

position of the state with a view and definite goal to enable the full functioning of a market and competition by gradually reducing the burden of the heavy residuals on the economy.

This approach will greatly reduce another dangerous temptation which the governments of FCEs face in their attempts to keep the heavy residuals alive. It derives from the pressures by non-viable enterprises to relax some of the constraints which are a package of the enabling environment. The temptation and/or pressure is particularly high to change the exchange rate or the interest rate, in such a way as to protect the domestic producers from too much competitive shock as well as to protect the heavily indebted firms with large capital requirements from paying too high a price for capital.

The challenge to policy makers is to create enough of an enabling environment which will promote the successful, without unduly and too harshly eliminating those who could possibly be successful. Adjustment is like investment - too much of it can reduce both the short-term and the long term viability of enterprises59.

The temptation to accommodate the heavy residuals by making the enabling environment "friendlier" and reducing the macro-economic pressures to allow for the viability of all endangered enterprises must be avoided. By adjusting to accommodate the less efficient, it would also lessen the incentives for adjustment of those who are fully capable of restructuring under competitive conditions. The problems of heavy residuals should not be addressed with general policy tools but should be isolated for specific treatment due to specific circumstances. And the government should take the lead in this effort.

"Governments have to intervene in the microeconomy. Thus, a hands-off policy during transition would be most inappropriate. The temptation to resort to the old mistakes under central planning may be strong - for example, in the process of restructuring - but that possibility should not be used as an argument against any government intervention during the transition period"60.

H. Policy Recommendations

The proposed policy recommendations are to be viewed as a *supplement*, not a *substitute* to the enabling environment approach. There is no alternative but to move decisively toward macro economic stabilization and a market, competitive economy based on private property. The widespread price distortions in the planned economy warrant a comprehensive, rather than a partial price liberalization. Trade liberalization complements domestic price liberalization to ensure that the domestic relative price structure is roughly in line with world prices. It also helps maintain domestic price discipline among the still prevailing domestic monopolistic producers. Stabilization is necessary to prevent liberalized prices from spiraling into hyperinflation, particularly in view of the monetary overhang and the financial distortions which emerged in the course of transition. Hardening the budget constraint on enterprises has the dual function of preventing inflationary pressures and serving as a tool of restructuring, inciting enterprises to respond internally to exogenously determined market signals. None of these broad policy targets should be dropped since they, each in their own way, create the building blocks of a more efficient economy, based on more efficient enterprises.

But in view of the slow pace of restructuring, particularly of the inertia in heavy residual sectors, something more should be done. The attempt to accelerate the pace and to make more pronounced the macro reform and enabling environment, often motivated by the frustration from lack of speed in enterprise reform, can lead to undesired outcomes: intolerable levels of financial distress, social unrest and political backlash. This has been clearly demonstrated over the last five years.

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59 A point made by Ickes, Ryterman and Tenev, p. 23.

60 Michael Bruno, pp. 46-47.

Furthermore, in a time-dependent analysis, the emergence of an enabling environment should not be viewed as a simple markets-supplant-state situation, but rather as a process in which their roles are changing and altering, providing a mix of signals and pressures on enterprise behavior, a mix which is nevertheless drastically different from what it was in FCEs.

In view of this time-dependent approach a pragmatic, practical and eclectic mix of *policies* ought to be sought, a mix which will accommodate the realities and ease and minimize the costs of transition. In such a pragmatic frame of reference the government activity in the restructuring of heavy residuals should not be considered as a return to state decision making on investment, the hallmark of the previous system, but rather as the government investing into *a specific dimension of creation of an enabling environment.*

The heavy residuals are not responding to the general emergence of the enabling environment. Yet they are an important part of the economy and their lack of response is directly influencing other sectors. Therefore the concept of an enabling environment should be expanded in a way that will directly address the problem of the heavy residuals, while at the same time leaving the rest of the economy to adjust and accommodate to the main thrust of the enabling environment.

This should be viewed, simply, as a *specific* transition cost of introducing a long term policy, that policy being the creation of an enabling environment itself. The enabling environment is a framework which will continue to operate *after* transition as well, i.e. it is the normal institutional and policy framework for a market economy. In order to get it fully operational as soon as possible, the problem of heavy residuals should be taken care of since it presents the single biggest constraint on the effectiveness of the enabling environment. To do so, a cost must be paid with specific aspects of that cost being the social provision for displaced workers, environmental protection and cleanup, expansion of working capital, etc.

The role of government during transition is to create and maintain a level field for competition. However, the heavy residuals with their specific problems and rigidities do not conform to this objective and constitute a net drain on the country's resources. Therefore, during transition, and while actively trying to restructure them, the governments should operate heavy residual enterprises at positive cash flow, not necessarily profitability, until they can be either privatized or phased out.

The enabling environment should, therefore, include some elements which it does not include at the moment: a set of micro-economic activities, to be discussed later, which are not going to be permanent features of government participation, but are only transition related and are really transition-enabling.

It must be emphasized here that the argument presented is not one for the permanent presence of government and the public sector in economic activity in the log run and a "dynamic equilibrium" once this post-transition equilibrium is reached. The argument is only for an increased role and increased *responsibility* of the government in the process of *transition*. At all times during transition the governments must generally strive toward the following:

a) the autonomy of SOE management during transition, in order to avoid the management of economies by political parties or pressure groups;

b) a meaningful compromise, in the short run, between the profit motive and the social goal of upholding employment, with a clearly established priority for profitability in the long run;

c) the clear contention that SOEs should be considered a temporary, transitory solution, with the objective of minimizing the costs of transition, and must be subject to periodical reassessment of their role.

Furthermore, the restructuring of heavy residuals, and in particular the segment which will have to be phased out, must at all times be considered within the broader policy framework for the creation of an enabling environment. Though the choice of policy intervention depends on individual country circumstances, some general principles regarding the nonviable enterprises do apply[61]:

a) subsidies on inputs must be removed to make the economic viability of enterprises more transparent and calculable;

b) bankruptcy and liquidation procedures must be improved and liquidation of enterprises should proceed with more determination when and where politically possible;

c) when immediate liquidation is not possible, governments should opt for explicit and transparent budgetary support, rather then the support through the banking sector, since this openness will maintain the pressure to liquidate.

Governments should not hold on to the assets of SOEs, i.e. they should not remain permanent owners. On the other hand, as previous owners and responsible for their current state and value, they should try to preserve the value of these assets until they are converted into private hands, and to device mechanisms which will speed up the transfer of assets in a meaningful way, rather then just passing the assets over through mass privatization.

The reason, then, for government participation in heavy residual restructuring is in that the state is both a policy maker and an enterprise owner. It must assume the dual responsibility of creating the environment for an increase in efficiency, as well as generating an adequate response on the supply side, *in cases in which the supply response is not forthcoming simply by the creation of an enabling environment*. Furthermore, most financial and other liabilities of concern to private investors are government liabilities. Finally, cost associated with labor shedding and other social expenses must be borne, and therefore addressed properly by the government.

To argue the need for government participation in pre-privatization restructuring is not to argue for the sector to keep on working, but to make it viable for privatization. This is doing what it takes to get the private investors, particularly foreign capital more interested in investing. The principal agent who can still do this for a large class of enterprises is the government.

The objective is for governments to design a rational strategy to make a sector viable under increasingly competitive circumstances, rather then to keep the sector alive in its present form. This will then shift the emphasis toward slimming and scaling down, rather then toward new investment which would develop the sector. To achieve this goal requires:

a) defining a *strategy* and an *institutional framework* for its execution;

b) reaching a workable *consensus among stake-holders* on when, how and what to privatize, as well as what to close.

The *strategy* for turning around the heavy residual sectors should be defined at the sectoral rather then the enterprise level. There are political and economic advantage to be had if governments apply an *integrated approach* to the problematic heavy residual sectors, in other words, if they were to treat the sector as a single multiple-plant firm, rather then to address the question of enterprise viability plant by plant. The integrated approach would deal with plant closure in the segment of the industry cost curve where the performance of plants is definitely non-competitive, and would at the same time restructure and prepare viable enterprises for their

61 Dhar, pp. 18-20.

future privatization. It would also allow the government to execute mergers and break-ups to eliminate the higher cost capacity.

Since the turnaround to be achieved by the integrated approach is to be designed to address head-on the potential private investors' concerns, a sectoral treatment offers additional advantages because it addresses the private investors concerns about hidden sectoral costs and inherited rigidities. Serious policy flaws, structural rigidities and market distortions which are currently discouraging private investors must be addressed up-front and cleared up initially or, at least, set into motion for clear and unambiguous solution during the restructuring for privatization phase.

The strategy should at a minimum address the rationalization of sectoral capacity, environmental cleanup problems, a safety net for redundant labor and human resource upgrading for those to remain employed, an adequate regulatory framework, the promotion of privatization and the provision of critical private investment necessary to increase efficiency and profitability. The strategy should lead to active promotion of privatization for surviving plants.

On the other end of the integrated approach, dealing with the non-viable segment of the sub-sector will involve closing of enterprises, assistance to the work force by creating new jobs, retraining staff, severance pay, etc. with the objective of assisting their transfer to the productive segments of the economy.

The strategy for sectoral restructuring would also entail all the measures needed to restructure the remaining and potentials viable enterprises and prepare them for privatization and possible joint ventures with external buyers.

This will involve, in the least, plans and programs of labor shedding, definition of the core business and the disposal of non-core assets either by selling immediately or by transferring the social assets to local governments, sufficient financial restructuring to enable a relatively solid financial position for the new ownership, a managerial reform during the process of restructuring and the clear definition of all environmental responsibilities.

In parallel with the actions to prepare the enterprises for privatization a search must be organized to find potential buyers. Convening of round tables and appropriate marketing for the enterprises in preparation for privatization could bring interested parties at an early stage into the process of restructuring for privatization.

Once the public-private link is made firmly in terms of commitments for investment into enterprises and their future development, the development of new products and new markets, new investments and the upgrading of the labor force could be contemplated. Financial restructuring should include working capital and critical investment for the surviving firms but only in the context of privatization commitments and guarantees.

To implement the above strategy there should be a core financial and turnaround *institutional framework* dealing with the specific sector. The most successful such institutional framework so far in accomplishing the rapid privatization *and* restructuring has been the German Treuhand. Though the Treuhand has had a mandate to turn around and liquidate thousands of enterprises from all sectors, its mode of operation and mandate could be replicated for the heavy residuals in other FCEs.

Wide scale restructuring requires a core of sound financial institutions and their depth to be able to cover the financial needs of restructuring capital-intensive industries and their debt burden. The heavy residual restructuring program partially offsets the thin financial market.

Restructuring of heavy residuals is impaired by difficulties in making business plans in the presence of policy distortions and dramatically changed market conditions. Enterprise managers lack the necessary business skills to be the only factors to accomplish turnarounds. The banks are also poorly equipped for this. Their access is severely impaired as they are unable to appraise viability and, with the bank decentralization, are often no longer in a position to adopt a sectoral approach to financial consolidation and restructuring. Again, a core turn-around institution which would bring together all interested and involved parties seems as the most effective way to deal with the problem.

For the strategy to be successfully implemented, it will be essential to design measures and policies that build *consensus or a winning coalition among the various stakeholders*. To begin with, in some cases the governments as stakeholders would need to be urged to take the lead and initiative. Though they are aware of the problem some governments have been reluctant to take action. They should be urged to take a hard look at the situation, with the possibility of launching a complex and well thought out integrated approach in which the International Development Institutions would be involved, before they decide to either to go ahead or to eliminate the option out of hand.

Governments should be both urged and helped to provide sectoral studies which would enable all parties involved to have a frame of reference for action. These road maps, benefiting from external support in their design, would play an important role since they would provide stakeholders and potential investors with a high degree of certainty that the strategies are viable and that strong support exists to implement it. Enterprises, banks, unions, creditors, etc. would better see the situation, and governments could then clearly see that there is a definite job for them in the process of restructuring. They should be helped in taking this in-depth look at the heavy residuals with adequate technical expertise.

The first step, therefore, would be addressed to the governments as key stake-holders with a suggestion to critically review their current position *vis-à-vis* those sectors which are impossible to privatize and difficult to close down.

In this initial effort the two fractions within the government, one in favor of a sectoral approach, and the other opposing it, should be brought to terms. A way should be found to support the rational and efficiency oriented position within governments. Often the international, impartial view could help lay out the options in a sensible and meaningful way. Such views are currently simply not available. The unification of the government position will be far easier to accomplish if it is to be related to a strategy which has the full support of the International Development Organizations and other external donors and financial institutions, then it is in the current situation of conflicting views and interests on how to address the problem of heavy residuals and at the same time minimize one's own responsibility.

Though governments might be fully committed to the creation of an enabling environment, when it comes to dealing with the heavy residual sub-sectors they face some very tough opposition. Rationalization is generally not very popular since it leads inevitably to labor and management shedding. Banks and other creditors see a potential loss due to financial restructuring and debt write-offs.

The current configuration of interests of stake-holders is partitioned and antagonistic. They feel that they are involved in a zero-sum game and that, therefore, any gain by one side can only be accomplished by sticking stubbornly to the claims, and outlasting the claims of the others. No broader picture and overall cost and benefit can be seen in the short-term as each stake-holder tries to maximize his respective position. The long-term is not even contemplated as the immediate concern is survival, rather then increasing economic benefit.

Politically, the scope and vigor of a pro-active integrated strategy toward the restructuring of heavy residuals will depend on the relative weight and influence of emerging political power, particularly power in the hands of various stakeholders: the administrative-bureaucratic structures, the managerial-entrepreneurial sector (in SOEs, among private and foreign investors), the labor unions and workers councils, as well as the public at large. The future patterns of government action will be influenced by the relative strength of conflicting groups as well as by the government's perception of voter preferences.

A strategy to restructure heavy residual enterprises must therefore take into account the balance of political forces. One way of seeking a workable strategy for restructuring would be to design measures and policies that generate sufficient support and commitment by the various stake-holders, while at the same time bringing the resistance to a minimum. Individuals and institutions have inherited special advantages, "situation rents" associated with their roles in the old system. If all such rents were eliminated simultaneously, the government would fall as soon as voters could get rid of it. This has clearly been demonstrated in Poland during the initial phase of economic stabilization.

Therefore, concerns of all stakeholders must be addressed and their willingness to participate must be secured through their strong conviction that they are participating in the best, or at least the least bad, plan under the circumstances. Securing the support of potential winners ought not to be a problem. It will be tougher to demonstrate to the losing groups that closure, labor shedding and their financial losses are inevitable and that any alternative is even worse.

What to do with unprivatizable plants? Whose judgment will it be to shut them down and lay off workers? This decision is difficult for the governments and managers to make, and the workers will hardly make it themselves. Governments as nominal owners and therefore the prime stake-holders must take the lead in formulating frameworks for coalition making, such that losers would be sufficiently compensated and winners would have an easier situation in which to make their decisions.

The acceptance of the strategy by the losers will depend critically on their enlightened self interest, i.e. on their conviction that the acceptance of a loss within the program is smaller and less painful then the future consequences of continuing to oppose the necessary restructuring and closures. For this to happen the integrated strategy must offer certain compensations within the time frame during which the turnaround is to be accomplished.

Politically, governments have to be able to share the decisions on closures and labor shedding to make them less unacceptable. The integrated approach to sectoral restructuring offers such a framework for sharing the responsibilities. In stead of drifting in an ill-defined situation of day-to-day survival in a framework of partial and diametrically conflicting interests, the stake-holders could rally around an internationally supported government strategy which offers scope, direction, spelled-out implications and an agreed mechanism for rewarding winners and compensating losers.

In Poland a sector specific program was adopted for the restructuring of the coal mining industry. Previously independent mines were put into a holding structure with the intention that efficient plants would help finance the restructuring or closing down of less efficient ones. However, the program was ill conceived and with no international support so it ended up delaying rather then encouraging restructuring. Profitable mines ceased paying taxes because their profits were now used to cover up the losses of inefficient ones. This was a typical case of strong interest groups, specifically managers and militant workers within the industry, exploiting a weak government and a poorly designed integrated approach.

In Rumania the government stands ready to apply the integrated sectoral approach to two sectors in deep trouble: the oil-refining industry and the fertilizer industry. However, mindful of the magnitude of the problem it is seeking international support in all aspects of conceiving and execution of such an integrated program. None has as yet been forthcoming.

In Russia the Committee of Metallurgy of the Russian Federation has worked out, with the Government's approval, "The Federal Program of technical re-equipment and development of the metallurgy of Russia in

1993-2000". The program calls for updating and replacing obsolete facilities but is not a comprehensive restructuring effort, resembling rather the old way of planning. It points to a deficit in resources to the tune of 35% of planned investment. Such ill-conceived programs will reproduce the old industrial structure as well as reproducing the old ways of doing things. If these methods of "restructuring" are not replaced by a full-fledged integrated approach, it is very likely that the transition will be prolonged and the costs of it will be far higher.

I. Where Are the International Development Organizations In All of This?

The International Development Organizations (IDOs), like the World Bank and European Bank for Reconstruction and Development, are fully committed to helping the FCEs pass through the transition period as effectively as quickly as possible. In a number of these countries (Poland, Hungary, Rumania) they have been active even before the transition began, offering financial assistance mostly through structural adjustment loans. With the start of the transition, involvement increased, in terms of: the number of countries, activities, financial commitment, and the range of economic issues being addressed.

With regard to restructuring and the privatization of heavy residuals the IDOs could have a positive impact and influence significantly the effectiveness of dealing with this difficult problem. Because they are regarded as very powerful and influential financial institutions, the IDOs involvement in an integrated approach to restructuring of heavy residuals would send a strong signal both domestically and internationally and would help focus attention, policy, determination and resources to the resolution of this sizable problem.

The IDOs have all the necessary ingredients to make a valuable and decisive contribution to quickening the turn-around of heavy residuals by means of an integrated approach. Firstly, they are deeply involved in the creation of the new enabling environment. Financial and technical assistance are provided for the development of the macro economic and institutional framework for a competitive, market economy. Together with the IMF, the IDOs also have an impact on governmental policies that create the economic conditions in which the heavy residuals currently operate and will be operating while their turnaround is carried out.

Therefore, the two sets of policies would not be divergent. One, focused through the structural adjustment loans, would help create the market, competitive dimension of the enabling environment. The other, offering an enabling environment through restructuring assistance for privatization, would jump start and assist the supply response of sectors that can hardly make it on their own. These two lines of action could converge to make a unified and unique set of policies to speed up the transition and the creation of an economy-wide enabling environment.

Second, the presence of the IDOs in a program of this kind, gives clout, prestige and a sense of determination and commitment, all of which are necessary to incite and draw the attention of potential foreign investors. Neither the governments nor the enterprises concerned, could generate the type of interest that the involvement of the IDOs can. Without a bigger inflow of foreign capital the restructuring and development of enterprises in heavy residual sectors is unlikely to take off.

With an active participation in an integrated turn-around approach to heavy residuals the IDOs essentially provide "political capital" which would encourage private investors to adopt a bolder approach toward the emerging markets. They could actively help catalyze and even organize financial and other assistance from private sources in the West. In the case of heavy residuals it is quite clear that the reforming countries need, and will continue to need, a lot of foreign capital involvement to accomplish the necessary restructuring of the heavy residual sectors.

Third, through its several decades of involvement and experience in industrial restructuring and enterprise development, the IDOs have amassed a considerable knowledge of the global industry, the markets, the key players, the costs and market opportunities, etc. They also have on hand, in a ready to apply and integrated form, a host of supporting types of needed expertise such as knowledge about closure and privatization, about environmental issues and environmental clean-up, about the social aspects and social policies needed to remedy massive enterprise closures, legal conditions and requirements for industry regulation, etc.

Domestically, the IDOs could capitalize on the fact that they are viewed as a powerful *and* objective third party among most of the stake-holders. With active involvement in the integrated approach, they could help in defining the sub-sector cost-benefit analysis. This would demonstrate the overall benefits of an integrated program and in particular the benefits of acting *as soon as possible*, given that the continuation of the current situation only worsens the future possible solution.

The IDOs should support the governments in their capacity as stake-holders, in bolstering the confidence, trust and the new, emerging ownership patterns, so that all stakeholders are convinced that the proposed plan of action has no better alternative. They would act as a "catalyst" of authority which in turn would contribute to serious consideration and responsible behavior of all stake-holders during the preparation and the execution of the turn-around of heavy residuals. It would also put the governments into a role of greater responsibility, while offering them more opportunities to deal with the heavy residual problem. An understanding with governments should be reached along the following lines: to facilitate their decisions to close some enterprises and shed labor; the IDOs will help finance a part of the restructuring, and will seek to mobilize other private capital.

The IDOs should urge all those governments which have asked for assistance in restructuring, to broaden the policy dialogue with all stakeholders to include the specific problem of heavy residuals and the passing of a policy statement which would define the broad overall orientation. In this context, their independent view and guidance could be helpful in identifying the strategic issues and the choice of priorities, in defining the overall orientation of the integrated approach, its organizational and financial programs and the preparing of various stakeholders for the process of privatization.

In sum, the IDOs could be ideally positioned to help the government's turnaround institution by its ability to contribute to the formulation and then the execution of an integrated approach, by its ability to relate the turnaround process to the overall client country economic agenda, and last but not least, to mobilize, focus and blend donor assistance and new private investment. The catalyst role deriving from their endorsement could bring in money and investment which otherwise would not be forthcoming, as well as serious rallying of internal stakeholders which in their absence, not forthcoming. These two are key considerations in assessing the benefit of IDO involvement in restructuring heavy residuals.

Over an above that, their involvement could include technical assistance in privatization and joint venture preparation, business plan creation, the convening of investor round tables, securing and providing financial guarantees, technical assistance and financial support in passive restructuring, as well as technical assistance and financial support in active restructuring.

The integrated sectoral restructuring programs would also include certain components and activities that they are already involved in, such as the creation of and the functioning of a safety net, as well as short-term environmental clean-up and reclamation. In both of these cases, their support to the integrated restructuring effort could take the form of technical assistance or financial assistance, or both.

Earlier it was noted that the human, managerial resources needed to carry out the restructuring of heavy residuals is critically deficient. The IDOs could help by technical assistance and financial support for human capital upgrading, for the education and training of managers in order to develop business and marketing plans and to improve operating practices.

In this context, the involvement and financing by the IDOs could also help in preventing the brain drain from the government to the private sector. Governments are often losing their best and brightest to the private sector which makes for a less then competent public sector, and leaves the heavy residuals in an even more difficult situation. While this sector should be downsized and streamlined it should not be made weak and ineffective. Creative and innovative forms of financial support for managers should be introduced, while they are restructuring enterprises for privatization.

While the IDOs should not finance any sizable active restructuring, this best being left to the new owners, the fact that they are involved in streamlining sectors, in providing a framework for consensus building and stake-holder compensation, as well as in defining the business plans for remaining enterprises, will reduce the risk to private investors who would then bring the moneys needed for active restructuring and enterprise development.

Some active restructuring should not be excluded a priori. It is very likely that cases might arise such that a relatively small fresh investment will either have a significant contribution to preparing the enterprise for privatization or, else, will act to galvanize and solidify the support of doubtful and suspicious stake-holders. In such cases, to be determined and defined within the broader context of sectoral restructuring, the general principle of avoiding active restructuring should not be considered as cast in stone.

J. Conclusions

The transition of FCEs is a unprecedented, historic event combining an intricate network of economic, social and political relations and feedback. The collapse of the previous economic and political order did not leave behind a clean slate on which to draw the new economic and political relations. Remnants of the old power structure as well as new economic, political and social realities, determine the number and character of options realistically available in constructing the new set of relationships which will promote the desired goal: *an increase in efficiency.*

Over the past five years many FCEs have made great progress in the direction of a democratic society coupled with a competitive, market economy based predominantly on private property. Institutional and policy changes have reshaped these societies. After the great economic depression and output collapse at the beginning of transition, many countries are now registering economic growth.

One of the main challenges facing the FCEs in the last five years was in how to deal with the problems of massive industrial restructuring. The task was enormous and unprecedented. It still is, since the supply response to the economic changes has lagged well behind. The restructuring, the closure and the development of viable SOEs is still a task to be accomplished.

In the past five years the emphasis, both internally and by external donors and advisors, was placed on the creation of an enabling environment. The enabling environment was to induce restructuring by creating competitive pressures, hardening the financial conditions of enterprises' operation (budget constraint) and transforming state into private ownership.

This approach has so far produced limited results. It relies critically on the strong assumption that privatization can be carried out quickly and an even stronger assumption that the new owners will immediately be capable of such corporate governance which will quickly translate into efficiency improvements. The last five years have shown that this process is much slower and less focused toward efficiency than was initially expected.

Furthermore, many large enterprises, in fact whole sectors, have failed to respond to the emerging enabling environment or to privatization initiatives. The absence of active and powerful shareholders, monitoring the operations of such enterprises, provide for an environment with very little constraints to discipline the company managers. The absence of adequate and developed financial, capital and labor markets offer little opportunity for meaningful restructuring even when enterprises (managers) do have an interest to restructure.

These sectors, termed "heavy residuals", have utilized their bargaining strength to resist carrying out the necessary adjustment measures. They could do so because of the institutional limbo which has occurred after the governments collapsed as a controlling agent for enterprises.

A new approach needs to be designed if the efficiency increases in FCEs are to get a significant boost. This approach should be complementary to the enabling environment approach, not a substitute for it. In effect, it recognizes the reality that there are two types of industrial sectors in FCEs: those which will either of their own free will react to the enabling environment, or can be made to do so without adverse social and political effect; and those sectors with considerable political clout, but also with larger and more pressing restructuring problems, where a government-led strategy will be needed to overcome the objective and subjective obstacles.

It should also be remarked that, both on theoretical grounds and by observing the past experience of the last 5 years and the experience of developed countries in restructuring, the "no-government-involvement-in-restructuring policy" is not a real option. The choice has been, and still is, between a reactive and a pro-active one.

Most of the FCEs are conducting some post factum industrial policy or micro-management by taking creeping and fait-accompli decisions to keep alive an outdated industrial structure. These are weak reactions rather then strong actions to set a strategy on a course toward efficiency. By these actions the governments suspend exit in the industries in question, but also impedes entry into other sectors inasmuch as bank credit and other financial sources are channeled toward refinancing the existing heavy residuals.

Western European experience in privatizing industrial sub-sectors, plus the experience of Treuhand, clearly show that pre-privatization restructuring makes strong economic sense. The problem, then, is not in the fact that this activity is intrinsically wasteful and resemblant of the centrally planned economy, but in making sure that the right institutional conditions and motives of stakeholders prevail to direct the restructuring toward greater efficiency and ultimate privatization.

This strategy is not to be associated with the "picking winners" approach but rather as an attempt to provide an institutional framework **during transition** in which the private sector adjustment is facilitated. The intervention is only in the case of a **limited** array of heavy residual sectors, all other sectors being left to market pressures without such strategic guidance. The role of the state has to be seen as catalytic and proactive rather than reactive. It must also clearly be defined as supplementary and temporary.

The government led restructuring for privatization should be sector, rather then enterprise based. The integrated approach allows for the internalization of sectoral costs and benefits and a better economic and political framework for plotting out a long-term solution. The integrated strategy should be based on a time-dependent analysis, providing for a definite but realistic time frame in which the minimal initial restructuring is to be completed, and the non-viable enterprises are to be shut down. The bulk of the qualitative restructuring would then be left to the new owners to decide on.

The strategy would be based on best expert analysis, aided by foreign experts, on current and prospective sectoral characteristics. This will enable the identification of necessary enterprise closures and the needed actions and policies to make the rest competitive enough to be privatized.

The carrying out of the strategy would ideally require a Treuhand type turnaround institution with sufficient resources and clout to implement the chosen strategy.

To be successfully implemented, the strategy will have to include measures and policies that will reduce conflicting interest, build consensus and a stronger commitment for action, based on a clear recognition of self-interest. The strategy must clearly show to the winners the expected benefits they can hope to get by implementing it. It must also convince the losers that accepting the strategy is tantamount to accepting minimal losses over a period of time, and that there are compensations included in the strategy which make it so.

The design and execution of an integrated strategy relies heavily on the support of international and foreign participants. Since the government-led restructuring is designed to take place *within* the privatization pipe-line, the eventual investors should be included from an early stage. External technical assistance would be very important in designing the road-map to privatization of heavy residuals, while the active role of the international financial institutions in designing and execution of the integral strategy suggests to potential investors that the road map not only exists but is viable.

There is a bit of a discrepancy between the faith that the international community places in the governments in transition as being capable of creating an enabling environment, and the lack of trust which they enjoy when it comes to making restructuring decisions. Though there are good historical reasons to justify this discrepancy, there is also the need to recognize that governments are transforming into more responsible entities and should be relied on, as well as helped, in taking on their responsibilities in restructuring for privatization.

The IDOs, being fully committed to the aid in transition of FCEs, are in an excellent position to encourage and support the integral approach to heavy residual restructuring. With their prestige, both internationally and domestically, they can contribute the "political capital" necessary to sway the balance of powers among the stake-holders, and to generate sufficient interest among prospective foreign investors.

The IDOs also have the experience, knowledge and technical expertise necessary in the various steps of designing and implementing an integrated turn-around strategy. Furthermore, they could offer financial assistance to the integrated sectoral restructuring as many of the ingredients within such a strategy fall within the accepted framework of financial support, such as the creation of a social safety net, environmental protection and preservation, financial structural adjustment loans. Accepting the idea of moving forward with support for the integrated approach would, no doubt, uncover new ways in which they could be useful and helpful in the effort, either in the design or the implementation stage.

The objective of this paper was not to plot a detailed menu of possible ways for IDOs to include themselves in the proposed integrated approach. Rather the objective was to demonstrate in a conceptual and eclectic framework, the need to reinforce the enabling environment approach and to suggest that the integrated strategy to restructuring a resilient segment of the economies in FCEs might be the way to go.

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