Book Reviews

Olivier J. Blanchard , Rudiger Dornbusch , Paul Krugman , Richard Layard, Lawrence H. Summers, *Reform in Eastern Europe*

Richard Layard, Olivier J. Blanchard, Rudiger Dornbusch, Paul Krugman, *East-West-Migration*

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justified – but, on the other hand, the danger of private power exercised by individuals or groups, which arises from too strong a reliance on spontaneous evolution should not be underestimated."

In line with the previous comment it should further be noticed that most of the case studies stand out by their superficiality. Let me give a few examples. Lenel talks about three turnabouts in socioeconomic policy in West Germany, without being able to date or characterize the last two, and without saying even one word on the problems and consequences of the German unification. Flew gives an informative analysis of the shortcomings of the state maintained school system in the UK, but fails to go into the relationship with the independent schools (what about the freedom to choose, private contributions, etc.), or to say anything about the role of the Thatcher administration, which is so highly praised at other places in the book. Sundberg's contribution on Sweden's tax system does not give any substantive analysis of its flaws or a thorough comparison to the ECHR criteria. And it remains undiscussed why the Swedish electorate has accepted the unbearable tax policy of the social democratic party over the years. The essay by Pejovich on Yugoslavia also begs the real question to what extent his analysis, that the full decentralization of government by the end of the 1980s ended in outright war, should be read as a plea for (a return to) a strong, centralized, undemocratic leadership.

Concluding, this book is a rather incoherent bundle of essays, which does not come up to the expectations it raised. It rightly questions the role of government and the working of democracy in modern society, but it has little to add in the way of answer.

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Blanchard, O., Dornbusch, R., Krugman, P., Layard, R., and Summers, L.: *Reform in Eastern Europe.* 120 pp. MIT Press, Cambridge, MA London, 1991. Softcover US $ 17.95.

Layard, R., Blanchard, O., Dornbusch, R., and Krugman, P.: *East-West-Migration.* 94 pp. MIT Press, Cambridge, MA London, 1992. Softcover US $ 19.95.

Currently hardly any topic in economics is more important than Eastern Europe's transition from communism to capitalism, and no event will challenge the stability of Western Europe more than the migration of capital, goods, and labor over what used to be the iron curtain. The two books by Olivier Blanchard, Rüdiger Dornbusch, Paul Krugman, Richard Layard, and Lawrence Summers (the latter participating only in one of them) are timely accounts of the theoretical and political problems involved, offering useful insight and convincing policy recommendations. This review comments briefly on some of the topics addressed.

Stabilization

Since some of the authors have been involved in treating Latin America's stabilization crises, it seemed natural for them to begin the discussion with the "monetary overhang" which raises an important stabilization problem for the East. The authors argue that, in communist times, people needed more money for transactions purposes than is required for a market economy. They had to carry more precautionary money to take advantage of opportunities, and they were forced to save cash because goods were rationed and borrowing for consumer durables was not possible.

Undoubtedly, the monetary overhang is to be eliminated when the market economy is established. One possibility is to exchange the overhang for interest bearing government bonds, but the authors reject this possibility on the grounds that it would sanction the wealth distribution of the communist state and burden the government budget with interest payments. They prefer a straightforward confiscation.

This recommendation seems debatable in the light of the huge capital overhang that also characterized the communist economy. The capital overhang is the excess of productive assets available in the economy over the financial claims owned by the people. By the very definition of a communist economy such a capital overhang must have existed, for if the private financial claims had equalled or exceeded the stock of real capital, this stock in effect would have been in private rather than *communist* ownership. In a communist economy, there was neither the possibility of privately owning the financial equivalent of productive assets, nor was there any need for it. Saving for one's old age, for one's children, or simply to enjoy a permanent interest income were no options, since the state was supposed to take care of the individuals' needs. Thus, the authors' somewhat indiscriminate view (Reform: p. 16) that there was an overhang of "purchasing power" is too simple. There was a monetary overhang over the amount of liquidity needed for mere transactions purposes, but at the same time there was a capital overhang in the sense described.

The policy of confiscating the money overhang enlarges the capital overhang, and it increases the problem of establishing reliable property rights. Absorbing the money overhang by selling some of the state's assets to the people and burning the money received would have been an alternative to confiscation.

The recent decision of the Yeltsin government simply to cancel old bank notes was in the spirit of the book's recommendations, but has created political turmoil which could have been avoided. True, the communist wealth distribution may not have been a just one. However, investigating the roots of capitalist wealth ownership also does not always reveal a pattern of fairness and justice. Anyway, respecting the (limited) property rights of wealth owners in the communist systems could have made the transition process a little easier and more efficient. It is unwise to combine the introduction of a market economy with the punishment of the nomenclatura, because this risks destroying the state and makes a rapid transition impossible. It may be better to prosecute the nomenclatura, where appropriate, through the criminal justice system.

Privatization

Regardless of how the monetary overhang is eliminated, there is always some capital overhang to be distributed, and this is the issue of privatization.

The authors argue convincingly for speed. Restructuring the economy is bound to be slow, but privatization can and should be fast. Given that people have no financial wealth to pay for the state assets, the only feasible privatization method is to give the assets away. Selling them is no option, and indeed the authors regard the arguments against distributing shares as "ill thought-out" (Reform: p. 37) and unconvincing. The people have already bought the state assets through their implicit saving in the form of wage retentions. They should not be made to buy them again.

The privatization plan the authors recommend involves the creation of a few nation-wide holding companies which keep well-diversified portfolios of firms and distribute their shares to everyone. The holding companies have the task of restructuring the firms, selling them to competent owners, and distributing the sales revenues to the shareholders in the form of dividends.

Selling the firms after the distribution of shares in the holding company is no problem, because people will then own the financial equivalent to the firms sold. Since the holding companies distribute all sales revenues to the shareholders, there is just enough liquidity around to buy the firms.

The idea is well thought out. It avoids the problems that have contributed to the failure of the German Treuhandanstalt to sell the assets inherited from the communist state. That agency tried to sell its assets, but it overlooked the fact that the East Germam people had not been given the financial equivalent of the Treuhand wealth (they just received transaction money). The agency had planned to collect a revenue of DM 600b., but in all likelihood it will not be able to collect more than one-tenth of this sum.

One problem with the holding company approach is that, by distributing the sales revenues to individuals, it gives the liquidity to the wrong people. This would not be a problem if there were a well functioning system of financial intermediation collecting the dividends and lending them to the buyers. However, in the absence of such a system there is a considerable risk that most of the funds received by the shareholders will go into consumption rather than financial savings. Note that *all* of these funds would have to be channeled into financial savings to enable potential buyers to pay for the firms sold.

The problem could be avoided if the holding company approach were combined with the fractional ownership method which has been proposed by Sinn and Sinn (1992) and is currently being applied by Bolivia. According to this approach the holding company does not sell its companies for cash but asks potential investors for restructuring bids. The investors contribute their own capital and know-how and they receive a substantial ownership fraction with management rights in return. The holding company, in turn, retains a silent (non-voting) fractional ownership in the firm which entitles it to participate in the firm's future dividends, but it does not collect any immediate cash from selling its firms. In effect, this method means that the cash revenue collected under the method proposed by Blanchard et al. is automatically rechanneled to the firm rather than being distributed to the community of shareholders. When the system of financial intermediation is imperfect, this privatization method will generate more aggregate saving and investment, and it will create a particular stimulus for undertaking the necessary restructuring of the communist firm. The method will also improve the economy's risk bearing potential since, via the share ownership in the holding companies, the population will, in effect, continue to hold well-diversified assets of the privatized firms.

Restructuring the Economy

Privatization is the prerequisite for a fundamental restructuring of the communist economies and for an economic upswing. The communist economies had developed internal structures that cannot survive fierce international competition. They had adapted to wrong price signals, had to cope with various scarcities, had to react to quantity constraints unknown in market economies, and were heavily distorted by massive fiscal interventions. The price distortions may be the worst problem of all. Energy prices in particular were not comparable to those in the West. To bind its empire together the Soviet Union had charged oil prices in terms of traded goods way below the world market level. The integration of the Eastern countries into the world energy market has changed this situation overnight. It has brought about an "oil shock" which dwarfs the shocks the Western countries had to cope with in the seventies. The restructuring of the former communist economies is a goal with high political priority, but one that will take generations to achieve.

Remarkably, the restructuring needs of the Eastern economies are not always as commonly perceived. It is often argued that the Eastern European countries had very inward-looking economies with low degrees of specialization and such a low quality of output that competition in Western markets was not possible. The authors – among them some of the world's best trade specialists – demonstrate convincingly that such an argument is simply wrong. For one thing, the degree of specialization and the extent of international trade among CMEA countries was significantly higher than among comparable market economies. For another, typically more than half of the countries' exports went to countries that were not members of the CMEA. These findings should not only be studied carefully by policy makers who tend to cover their own mistakes by pointing to the seeming impossibility of finding "markets" for Eastern products. They also make it clear that many of the current difficulties of the East European countries result from a mere change in the economic system rather than the non-competitiveness or desolate state of Eastern firms as such. Western firms would also have their difficulties had they been confronted overnight with the rules of the communist planning system.

The Eastern economies not only face difficulties, they also have opportunities. The greatest opportunities result from the low cost of labor. Currently the total wage cost is 1/15 of those in the US or 1/20 of those in West Germany. Such wages are likely to attract investment and enable the creation of competitive work places, but they will also induce emigration. The first book (on Eastern reform) ends with this conclusion, and it leaves a more detailed discussion to the second book (on East–West migration).

Migration and Factor Price Equalization

The main theme of the second book is the factor migration resulting from the abundance of labor and scarcity of capital in the East. Based on the US experience with Mexican immigration and on other observations, the authors argue that, over the next fifteen years, Western Europe will have to, and should indeed, accept the immigration of at least 4 million non-CIS Eastern Europeans, 6 million migrants from the CIS, and 3 million ethnic Germans, the latter including internal migration within Germany. In total this is about 4% of Western Europe's current population, or roughly 0.3% per year.

Such migration is small relative to historical examples. The authors argue that over the last few centuries, in a sense, half of Europe's population has migrated to the US, with annual immigration figures of between 0.5 and 1.0 percent of the US population, and they point to West Germany's post-war immigration of 13.5 million which was more than a quarter of its original population. With political turmoil and lack of stability in the East, they fear the migration figures could rise dramatically beyond the estimates they consider reasonable for a smooth development path.

Whatever the exact figures, there will be a significant impact on Western Europe, with a substantial regional concentration on West Germany. The mechanics of factor price equalization described in trade textbooks will be at work.

- There will be intense trade between the East and the West with concentration on labor and capital intensive products, respectively.
- Capital will move East.
- Labor will move West.

All of this will tend to narrow the gaps between the wages and the rates of return to capital with a new equilibrium being reached where transaction costs balance the gains from further migration.

The authors leave little doubt that, despite the structural adjustment problems, the increased trade in goods, capital, and labor will create significant welfare gains for all countries involved. However, they also point to the fact that the gains may be distributed unevenly. In fact, the change in the income distribution may be dramatic. While in the West profit earners and the suppliers of complementary labor will win, simple labor will definitely lose, even in absolute terms. Foreseeing that these losses are likely to cause political resistance against liberal immigration policies, the authors urge the Western European governments, and even the United States, to open their borders and allow for the above-mentioned immigration figures to be realized.

History has overtaken these recommendations as they were being written. In 1992, when the book was published, West Germany alone took in 600 thousand immigrants, mostly via the asylum law. This is one percent of its population or three times the number recommended by the authors.

Should Migration Be Restricted?

While the authors, not knowing about the actual immigration figures, press for more immigration, they also address the question of whether constraints on immigration are justified. In the current situation of massive immigration from the East, this is the most important policy question treated in the book.

Constraints on immigration can be justified by negative externalities which the migrants produce. The authors consider fiscal and cultural externalities. The latter is the negative perception of foreign cultural influence by the domestic population. While the economist may not share this perception, he has to respect this as a given aspect of people's preferences. The former refers to the redistributive functions of the state. A common view, shared by the authors, is that the migrants create negative externalities both in the West and the East. Since the immigrants tend to be poorer than average in the host country and richer than average in the home country, their move will mean that they are giving less in the East and receiving more in the West at the same time.

While the fiscal externality argument at first glance seems plausible, its validity can be doubted from the host country's view when the externalities that come through the social security system are taken into account. Young immigrants who bring their children with them will take care of their own old age pensions via the contributions that these children, when grown up, will make to the system. Their *gross* payments to the system during their working years are therefore a positive *net* externality for the host country. In Germany, with a contribution of nearly 20% of the wage, and with an annual income of DM 30,000 and a 30 years' work period up to retirement, the externality would be DM 180,000. It would be hard to believe that any other fiscal benefit which immigrants and their families might receive in return could match this figure.

In addition to efficiency arguments the authors also discuss an interesting paternalistic argument. The argument refers to future generations of descendants who will all benefit from the immigration decision of their ancestors. The authors argue that these benefits may not be taken into account adequately by the migrant, and that migration should therefore be encouraged by the government. They seem to believe that the government will take the preferences of future generations into account better than the parents or grandparents themselves would do. Such a paternalistic type of argument is not normally accepted by economists.

While the paternalistic argument works against limiting migration, the authors on balance nevertheless do recommend a mild restriction, tight enough to make the above mentioned numerical figures sound plausible.

A Theory of the Mezzogiorno

The main argument that seems to have contributed to the recommendation to restrict migration refers to the role of market size effects. These effects are frequently mentioned in the book, and there is a separate appendix that explains them in the context of an explicit formal model which is able to create a Mezzogiorno equilibrium. In the Mezzogiorno equilibrium there is a persistent disparity between the East and the West, and migration will increase rather than reduce this disparity, contrary to the prediction of factor price equalization theorems. The (majority of) authors argue that market size effects will, on balance, not dominate the traditional neoclassical effects. However, they consider them an important possibility worth discussing in a formal model.

Basically this model is driven by the unusual assumption that the marginal propensity to import out of income is negative, while the marginal propensity to consume and invest domestic goods is greater than one. The reason for the negative income effect on imports is the market size effect. The higher income and output, the larger the variety of products that can be produced and supplied at home, and the lower the need to buy imported goods. Because of the market size effect an income increase results in a current account surplus which then makes it possible to reduce the country's competitiveness by increasing the wage rate. The increase in the wage rate increases imports and reduces exports, thus compensating for the income effect on the current account. Domestic output, employment, and the wage rate are positively correlated with each other which means that, in a sense, the country's labor demand curve is upward sloping.

The upward sloping labor demand curve generates Mezzogiorno equilibria. Migration from the East to the West will reduce Eastern and increase Western wages, contrary to what a neoclassical model would predict.

While the Mezzogiorno model certainly offers a high intellectual stimulus, it is not really convincing. The model leaves many questions unanswered, is not well presented, and contains mathematical ambiguities that make it hard to understand. (For example, the rightward shift of the DD curve in Fig. 12 on p. 81 in "East-West Migration" does *not* follow from the assumptions. If Y and E were measured along the axes, the shift would be clear. However, an increase in w, given E/w, will have a strong positive effect on Y/w via the derivative $\partial\sigma/\partial E > 0$ which is neglected in the verbal discussion in the last paragraph of p. 80.) The model has a strong Keynesian flair with demand being the dominant determinant of output, but it does not satisfy Keynesian stability conditions. More demand for domestic products induces more output, but the increase in output generates an even bigger increase in demand; the multiplier is infinite. Perhaps it is this instability the authors were seeking. But if so, they should not have concentrated on the equilibrium properties of their model.

A serious problem with the Mezzogiorno model concerns its welfare implications. The authors frequently speak of a "vicious circle" and seem to assume that, judged by the model, migration should be restricted for welfare reasons. In fact, however, if the world of increasing returns to scale which the Mezzogiorno case assumes existed, then migration would indeed be a good thing. It would be optimal to concentrate the European population in Western Europe (or in a pin-head in Berlin) and use the East for agricultural and recreational purposes. Migration would be beneficial, just as in the neoclassical case.

Neglected Problems

While the authors discuss quite a number of important issues in the context of migration and reform in the East – many more than this review could address – there are two important problems that should not have been omitted or should at least have received more emphasis.

The first concerns the timing of migration in the context of adjustment and migration costs. If the world were fully neoclassical without such costs then migration would probably not go from East to West, but from West to East.

With land, labor, and capital as the major factors of production and identical technological knowledge, the density of cities or local agglomerations should even out over countries with similar climatic and geographical characteristics. Given the extremely low population density in the East, this implies that there will be an eastward rather than westward migration once fully functioning market economies will have been established in the East.

Of course, for the immediate future such a prediction would not seem plausible, but in the long run, say 50 years from now, it may well happen. It is true that currently wages in the East are 1/10 or 1/15 of those in the West. However, land prices are often even less. The abundance of land, untouched nature and natural resources, much of which being located in regions with favorable climatic conditions, may well attract waves of migrants as it did for centuries.

This seems particularly plausible in the light of the artificial relocation that characterized the history of this century. During and after the Second World War tens of millions of people, mostly of German descent, were expelled from Soviet ruled countries, flooding Western Europe. It is not unreasonable to assume that, at some stage, tens of millions of other people will move to the East to fill the vacancies and escape the congestion problems of the West.

The reason that the plain neoclassical result cannot be expected to emerge for the time being and that we are indeed currently looking ahead to a period of westward migration has to do with differences in the adjustment speed of capital and labor. Labor can migrate fairly quickly. In principle, large fractions of the population can cross the borders overnight. Real capital, however, is slow. Real capital will not migrate on a large scale to the East before stable political and economic conditions have been established, and this can be a question of decades rather than years. Also, of course, the putty clay-character of real capital makes it hard to shift existing assets. Only reinvestment and net investment can move. Even in East Germany, where the political situation has been stabilized at one stroke through unification, capital adjustment is expected to take 20 years. Population movements can be much faster.

Thus, the market solution will probably involve an initial period of westward migration which will later be followed by a reverse eastward migration (see Sinn and Sinn, 1992, for a related argument concerning Germany's internal migration). Abstracting from externalities, this two-sided migration pattern can be expected to be an efficient reaction to the dismantling of the iron curtain.

It might be tempting to argue that, in view of the eastward migration to be expected for the very long run, the current westward migration should be prohibited in order to minimize the avoidable migration costs. However, such an argument overlooks the fact that a temporary movement from unproductive to productive work places may create more output gains than migration losses. Just waiting for the capital to become invested in the East is an inferior strategy, if the time period during which labor cannot be productively employed is long enough. In the absence of externalities and with competitive labor markets there is no reason to mistrust the efficiency of private migration decisions, even if migration is going in both directions.

The second problem, which should have received more attention than it did, is the role of institutional reform. It is true that the authors discuss the need to attract foreign direct investment, to introduce an efficient banking system, and to establish unemployment insurance and other institutions. They also pay lip service to the notion of *Ordnungspolitik.* However, they are not very explicit on the necessary reforms of the legal system and the government sector. The reader should be told more about the introduction of appropriate civil and company laws, stock market regulations, trade chambers, and all the detailed regulatory constraints to private business that define the subtle rules of the market game. The school of "ordo liberalism" that paved the way for Germany's post-war economic miracle offers important policy advice that could have been given more attention.

Similarly, the discussion would have benefited from taking up some of the messages offered by the Public Finance literature. A functioning market economy needs a functioning government sector, and a functioning government sector needs an efficient set of taxes. Which taxes are appropriate for an economy in transition? Which economic functions should the government perform, what are the truly public goods that should not be privatized? Answers to questions like these would have further increased the value of the two important books on migration and economic reform in Eastern Europe.

Despite these shortcomings, the two books are very valuable contributions to the economics of systems transformation, indeed they are outstanding. Professional economists have offered advice which will not only stimulate more research in the area but will hopefully be followed by the political decision makers.

Reference

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Fair, D. E., and de Boissieu, C. (Eds.): *Fiscal Policy, Taxation and the Financial System in an Increasingly Integrated Europe.* (Financial and Monetary Studies, vol. 22.) XII, 440 pp. Kluwer, Boston Dordrecht London, 1992. Hardcover Dfl 235.00.

The book under review contains papers by some well-known authors in their fields of expertise, that is in the areas of finance, savings, investment, German unification, European integration, and European Monetary Union (EMU). As is now widely known, the prospect of currency union received serious setbacks in September 1992, when the United Kingdom and Italy exited from the Exchange Rate mechanism, and in July 1993 with the widening of exchange rate bands to 15% after the crises concerning the French Franc and Danish Kroner. The outgoing President of the German Bundesbank, Karl Otto Pöhl, in 1991 described the financial consequences of German unification as a disaster. He warned the German and other governments against taking hasty steps towards transition to EMU. German unification and the increased need for private and public capital transfers in favor of Eastern Europe provide the backdrop for this