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Obstacles to enterprise restructuring in transition

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PREFACE

Five years since the fall of the Berlin Wall, and after an initial phase largely perceived as successful from the point of view of macroeconomic stabilisation and of the emergence of new private sectors, the transition process in central and eastern Europe is now facing a number of "structural" obstacles that stand in the way of more rapid and radical advances in the formation of a market economy.

This working paper collects the contributions made by the invited participants to a Panel Session organised by Philippe Aghion and Nicholas Stern at the 1994 Annual Congress of the European Economic Association held in Maastricht on 3-5 September 1994.

The panel members were:

Philippe Aghion, Senior Economist at the EBRD and Official Fellow of Nuffield College, Oxford.

Stanislaw Gomulka, London School of Economics and Policy Adviser to the Polish Finance Minister.

Hans-Werner Sinn, University of Munich, and Director of the Center for Economic Studies.

Nicholas Stern, Chief Economist of the EBRD and Sir John Hicks Professor of Economics at the London School of Economics.

Jan Svejnar, University of Pittsburgh and Chairman of CERGE-EI in Prague.

After a brief Introduction by Philippe Aghion and Nicholas Stern (of the Chief Economist's Office), the paper is organised as follows: In Section 1, Stanislaw Gomulka emphasises the scarcity of non-obsolete capital assets, mobilised savings and foreign direct investment as a major obstacle to the transformation and recovery of central and eastern European economies. In Section 2, Hans-Werner Sinn concentrates on the rigidities in the housing and labour markets and offers some suggestions on how to speed up the privatisation of housing assets. In Section 3, Jan Svejnar surveys some of the main obstacles to enterprise restructuring: (a) the problems which have slowed restructuring of the financial sector in Section 3; (b) the potential conflicts of interest between commercial banks and investment funds; (c) the budgetary and high tax problems induced by the early phase of transition; (d) the lack of corporate governance and managerial skills.

INTRODUCTION

Philippe Aghion and Nicholas Stern

OBSTACLES TO ENTERPRISE RESTRUCTURING IN TRANSITION: A BRIEF INTRODUCTION

1. MACROECONOMIC CONSTRAINTS

A key feature of eastern Europe's transition to a market economy is the interplay between *private sector development* and the *privatisation/restructuring* of existing (large) state-owned enterprises (SOEs). We use the term privatisation/restructuring to distinguish between pure ownership transfers and the necessary changes (in management methods, incentive systems, wage setting, scope of vertical and horizontal integration, financial structure, physical capital etc.) to make SOEs truly become the equivalent of (new) private sector firms.

The two processes, privatisation/restructuring and private sector development exert varied and sometimes conflicting influences on one another.

(a) On the one hand private sector growth should *unambiguously* favour the restructuring/privatisation of state enterprises: first, it creates new private jobs and thus reduces the expected cost of laying off state-firm employees; second, private sector growth opens career prospects for good managers of state-owned enterprises, thereby encouraging them to signal their managerial abilities by initiating appropriate restructuring policies; third, new private businesses should exert a positive influence on the management of state-owned enterprises which they use as suppliers or subcontractors. The Chinese experience provides positive evidence about such synergies between SOEs and new "private" businesses.

(b) On the other hand, the restructuring/privatisation of (large) SOEs appears to have mixed effects on private sector growth. The privatisation/restructuring of SOEs and State Banks may stimulate private sector growth by contributing to the emergence of a "critical mass" of private and/or better managed businesses and also by favouring the access of new private businesses to credit (the latter has so far been largely crowded out by the unrestructured SOEs). However, and especially if implemented too fast at an economy-wide level, the restructuring of SOEs may also exert negative effects on private sector growth. In particular, by inducing excessive unemployment, it may create political and/or social instability; or it may force governments either to increase taxes or to divert resources away from infrastructure and capital investments in order to finance new labour market policies (including unemployment benefits, subsidies to severance payments, pensions, etc.)[1] Both should have deterrent effects on new private investments.[2]

These potentially negative influences of overly rapid privatisation/restructuring are likely to be magnified if restructuring is to take place within firms where employees' control remains predominant (with their potential pressures for special treatment in the process) and/or within firms which do not benefit from new private funding. This in turn points to the role of privatisation in bringing both *adequate corporate governance* and *additional sources of funding*. Some economists have argued that these two positive effects of privatisation may have been sacrificed (so far) in mass privatisation schemes like the one recently implemented in Russia.

2. MICROECONOMIC CONSTRAINTS

The early debate about the transformation of the enterprise sector in central and eastern Europe was centred on the idea that the transfer of property rights to private agents was the key ingredient for achieving efficient restructuring. Several years into the transition process, the relationship between privatisation in the above sense of ownership transfer and restructuring is much less transparent than initially conjectured. First, mass privatisation that have left control rights in the hands of insiders (employees or managers, as in Russia) have so far generated only limited restructuring (as "measured" by the amount of labour shedding or divestitures of non-core activities or closures of non-profitable activities etc.). On the other hand, in countries like Poland where hard budget constraints have been increasingly enforced, even non-privatised enterprises have engaged in restructuring (as shown by Pinto et al, 1993).

As mentioned earlier, two conditions appear to be necessary for privatisations to effectively foster the restructuring of SOEs: they must provide the enterprise with a concentrated and stable governance structure and they must bring new sources of funding.[3] There is actually one case where privatisation has brought an immediate and unambiguous change in the firms' behaviour: namely, whenever privatisation has been achieved through foreign investment. Both, changes in management structures and new capital investments have indeed taken place in this case.

The *financial* dimension of privatisation appears to be important for achieving successful restructuring, one reason for this being the necessary compensations that must be made in order to secure minimum support from insiders, employees and managers, another reason being the reduced ability of governments to subsidise new capital investments, as argued above. The compensations issue is particularly acute in the absence of sufficiently developed credit markets and institutions that would allow firms to borrow against their future incomes (post-restructuring) in order to compensate the current losers (laid-off employees) from restructuring.[4]

The emergence of more concentrated authority structures in large state-owned enterprises not privatised through foreign direct investment appears, both in a country like Poland where mass privatisation has not taken place and in the Czech Republic where it has, to be greatly facilitated by the banks' involvement in the restructuring process.[5] Thus the involvement of banks can facilitate improved *governance*. This remark raises an immediate question concerning Russia, where the banking sector is still at an embryonic stage and where rapid mass privatisation has so far lead to widespread employee ownership. Can the new venture funds recently established in this country substitute for banks and act as monitors of the restructuring process in large "privatised" SOEs? The role of financial intermediaries in the restructuring of SOEs is likely to be crucial to the success of the process.

END NOTES

1 Such a diversion effect of increased unemployment has been markedly observed in Poland. See also Jan Svejnar's following remarks on the public finances.

2 This incidentally points to the importance of overcoming labour market rigidities. (See Section 2).

3 See Section 1 and 3.

4 See Section 3.

5 Although Jan Svejnar points to potential conflict of interests faced by the commercial banks that acquire majority stakes in Privatisation Funds.

1. OBSTACLES TO RECOVERY IN TRANSITION ECONOMIES

Stanislaw Gomulka

The purposes of my comments are twofold. One is to note the (likely) major sources of recovery, and the other is to identify transition-related obstacles to general, rapid and sustainable economic growth.

The largest and longest economy recovery so far has been in Poland. The monthly industrial output is now, in the middle of 1994, about 30 per cent higher than the bottom level reached three years earlier. There have been two features of this exceptionally large recovery which were unexpected and which may well be common to all transition economies.

Firstly, on the *demand side,* the recovery has been very much led by private consumption, and *not* as originally expected by investments and/or net exports, both of which were either stagnant or declining during 1991-93. The reallocation of capital assets between activities and enterprises, in particular the so-called asset privatisation, has proved to be a fairly powerful substitute for investment. Investment in fixed productive assets must begin to grow fast to sustain the recovery only at a later stage. Net exports need to be positive only initially, to improve quickly the usually poor external position, but at the later stage foreign direct investments and other capital inflows tend to supplement exports sufficiently to ensure a healthy growth of international reserves despite a trade deficit and the need to service foreign debt. What is required is a simultaneous rapid growth of both exports and imports over a long period.

Secondly, on the *supply side*, the key source of recovery has been the very fast growth of the original private sector, and *not* the expansion of state enterprises or the newly privatised state enterprises (Rostowski 1993, Gomulka and Jasinski 1994). This applies also to manufacturing.

Berg and Blanchard noted, in a paper written two years ago, that "the growth is mostly in very small firms, mostly in non-tradeables, and mostly outside of manufacturing" (1992, p.28). This is indeed the case, but not only in the initial stages of transition. Their view that "private sector growth cannot, in the short or medium term, substitute for the restructuring of state firms" (ibid) appears to be wrong as a general proposition; it has certainly been wrong in Poland.

The output of private manufacturing, net of any impact of the transfer of state firms to the private sector, has been expanding in Poland at about 25 per cent per year in the years 1992-93 (Gomulka and Jasinski, Table 4). It may be estimated to account for about 40 per cent of the total manufacturing output in 1994. At the same time, despite some considerable restructuring, the output of the state manufacturing sector has been stagnant.

A major obstacle to recovery in state firms appears to be not only an inferior incentive system associated with the state form of ownership. Possibly the main problem is that these state firms have typically also inherited outdated capital assets, large bank debts and excessive labour force to produce poor quality goods at high unit costs. In view of small own financial resources, the options for most of these firms are consequently often limited to small improvements and typically exclude the kind of radical departures in terms of products and methods of production which are really needed. The private entrepreneur is not only better motivated, but also has more freedom in selecting the right products and collecting the necessary inputs. The investment projects undertaken by the private sector are, on average, extremely capital-saving. Labour productivity, wages and (recorded) profit margins are about the same in both sectors, but the capital/output ratios, both average and marginal, are many times lower in the private sector. Consequently, the profitability of new investments is also many times higher in the private sector.

The restructuring of many state firms is severely hindered by the inadequate level of internally generated finance. The price liberalisation did benefit some enterprises, notably in the energy sector, but this has tended to result in higher wages and less employment shedding rather than in higher profits and larger investments. This behaviour has prompted some economists to regard state-owned or formerly state firms in transition economies as being largely "insider-controlled" (Fan and Schaffer, 1994). Such firms tend to respond to adverse external shocks just about sufficiently to keep themselves afloat. With some notable exceptions, their actions concerning restructuring are mainly defensive, designed to limit contraction rather than secure quickly large profits and fast growth.

The conclusions of this analysis of the Polish experience are the following:

(i) The size of the proper private sector at the start of transition and the (legal, human capital, financial capital etc.), conditions influencing its subsequent growth are likely to be the two most important factors differentiating transition economies in terms of the timing and the size of recovery.

(ii) The restructuring of state (or formerly state) enterprises is likely to be slow, with the notable exception of when such a restruction is conducted by outsiders and financed by large internal and external capital.

A particularly rapid growth of the private sector takes place in the category of very small and small businesses. In Poland alone, about one million of such businesses were set up during the last 5 years. Their growth is based in part on the transfer of capital assets from state firms, bought at very low prices, and on tax avoidance. Both sources of growth are likely to dry up, especially the former. To sustain rapid growth of new investment, the private sector will need to have access to larger bank credits at lower nominal interest rates than at present.

This leads me to note the macro-economic obstacles to sustained recovery: low proportion of national savings in GDP, large dis-saving by governments, large public expenditures on social transfers and wage subsidies, which in turn increase the scope for high taxation and inflationary financing. Consequently both the inflation rates and the interest rates are typically high or very high. (The Czech Republic is a well-known exception).

To remove these macroeconomic obstacles, the countries in transition need to establish new financial institutions, in particular private pension funds, health insurance funds and building societies. These institutions should help increase national savings and make public expenditures less of a burden and more of an instrument for economic development. But in the meantime, there is the need on the part of political authorities to arrest more or less immediately, the growth of social transfers and keep the budget deficits under stricter control.

2. HOUSING AND LABOUR MARKETS IN THE EAST

Hans-Werner Sinn

2.1 INTRODUCTION

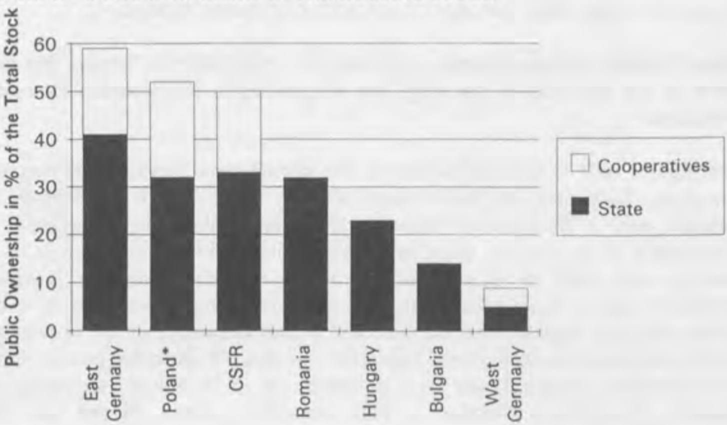
The establishment of market economies in the east is a fascinating experiment of history. However, the task is more difficult than was expected. The macro-economic problems on which the IMF focused, did not turn out to be the real problems. The real problems are of a micro-economic nature, and they concern the details rather than the principles, the single markets rather than the aggregate.

I have been asked to speak about housing and labour markets. The two markets are highly interrelated because the structural change taking place in the countries of the east requires mobility, and mobility typically involves changing jobs and dwellings. The labour and housing markets are, without a doubt, also the most important markets in the economy. In western economies, the trading volume in the labour markets is about two thirds of GNP, and the housing stock typically covers more than 50 per cent of a nation's wealth. In the east, housing capital often is about the only capital that will continue to be useful in a market environment.

2.2 THE HOUSING MARKETS

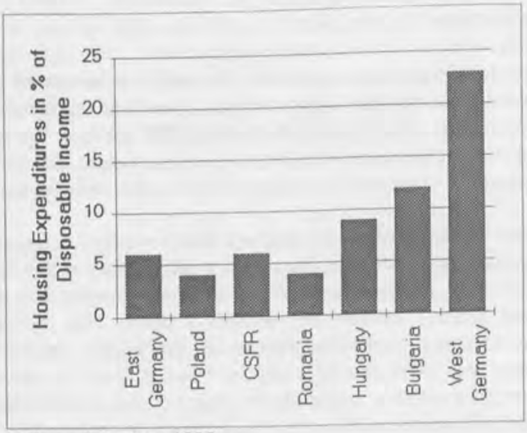
The two most important preconditions for a well-functioning housing market are private ownership and rents that are high enough to cover the construction costs. Comparing the situation in the east with that of a market economy such as West Germany, Figures 1 and 2 show that there is a long way to go before these conditions can be met.

FIGURE 1: PUBLIC OWNERSHIP IN THE HOUSING STOCK



All numbers late 1980s
** Urban*

FIGURE 2: HOUSING EXPENDITURES AS A SHARE OF DISPOSABLE INCOME



All numbers late 1980s

While Figure 1 shows that the fraction of public housing in West Germany is less than 10 per cent, the countries of the east typically have fractions of between 30 per cent and 40 per cent, not counting co-operative housing which in East Germany, Poland and the former CSFR amount to roughly 20 per cent of the total housing stock. The situation is better than average in Hungary and, in particular, in Bulgaria. In the latter the communists never attempted to expropriate private house owners on a large scale, and also did not build much public housing.

Figure 2 shows a similar situation. The share of income spent on housing was much lower in the east than in the west, but Bulgaria again came closest to western conditions.

Both figures refer to the time before the iron curtain came down. In the meantime things may have improved, but certainly not very much. Except for Hungary and Bulgaria, none of the countries mentioned has so far exhibited major success in the privatisation of the housing stock, either via restitution to previous owners or via sales to new ones. In Poland and the Czech Republic restitution is viewed sceptically since it would raise the question of returning the properties of the twelve million Germans expelled after the war, and in East Germany, which, in principle, returns the properties expropriated from 1949 onwards the restitution process suffers from numerous technical and legal problems yet to be solved. Currently, the fraction of properties restituted in East Germany is about 40 per cent. The government has established a programme according to which 15 per cent or about 350,000 housing units were to be sold. Although the programme is ambitious, the numbers sold are so far only about 60,000.

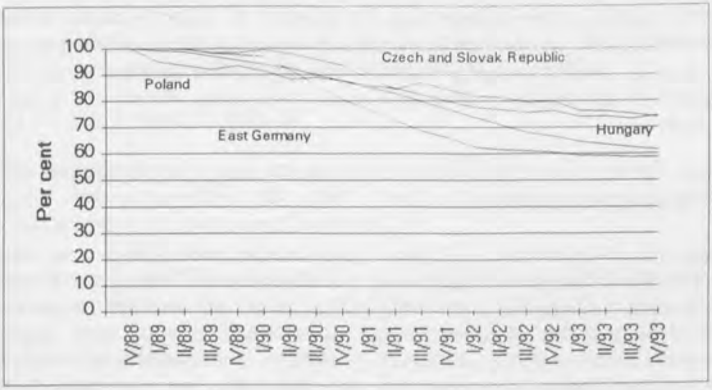
It is often taken as self-evident that privatisation of the housing stock is equivalent to selling this stock. In fact, however, such a strategy makes no sense since people possess too little financial wealth to be able to buy this stock. By the very definition of a communist state, people did not have private financial claims against the economy's stock of capital. They bought this stock collectively from withheld wages. It is both unfeasible and unjust to require them to buy it again.

Thus privatisation should mean giving the stock away. This can be done by giving apartments to tenants or by creating private housing companies and distributing shares. Whatever the method chosen, one of its advantages would be that people would have some wealth in their hands which they could use as equity or collateral for funds borrowed to invest in new firms. The creation of firms is the most important task in transition, and housing wealth could be the nucleus out of which a competitive business sector could grow.

2.3 THE LABOUR MARKETS

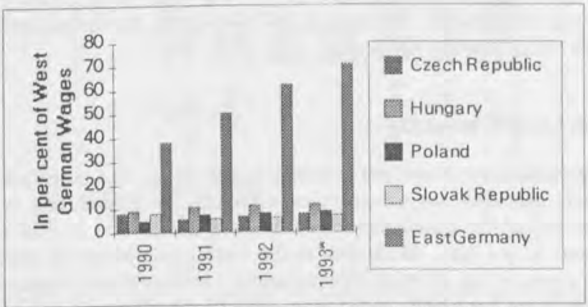
The labour markets in the east are generally in bad shape. The transformation crisis has hit many industries and caused massive lay-offs. In Poland, and in the Czech and Slovak Republics, employment declined by a quarter and in East Germany it fell by about 30 per cent, all relative to the 1988 level. Never in peace time has there been a greater rate of mass unemployment. The figures are comparable to, and are in some cases even larger than, those observed in the great depression of the twenties.

FIGURE 3: EMPLOYMENT IN EASTERN EUROPE



Surprisingly, East Germany has been most severely affected. Is this because the big brother helped speed up structural change or because he imposed more constraints on East Germany than other eastern countries are facing? The answer is not simple because both aspects may have been relevant. Nevertheless, the most important single reason for the East German unemployment problem is the fact that West German employers and trade unions had chosen the wage level for the east. Fearing a Korea in the backyard, the western proxy negotiators imposed West German wage levels on the East German economy, disposing of this threat for many years to come. There is a transition period for the wage adjustment until 1996. Figure 4 demonstrates how much of this transition has already taken place and to what extent the East German competitiveness may have been affected.

FIGURE 4: MONTHLY AVERAGE WAGES IN CENTRAL AND EASTERN EUROPE



** I-III for the Czech Republic, Hungary, Poland and the Slovak Republic*

It is sometimes argued that the East German adjustment is simply a big bang approach with a more brutal, but also more rapid, transition to prosperity. This argument is doubtful when account is taken of the fact that, so far, structural change seems to be slower in East Germany than, for example, the Czech Republic. While in the Czech Republic 2.2 per cent of the stock of laid-off people is returning to the work force each month, this figure is only 0.6 per cent in East Germany. This is in sharp contrast to the optimistic views that German government officials tend to hold on this issue.

2.4 CONCLUDING REMARKS

The discussion of the housing and labour markets should involve much more than can be included in this section. Hopefully, the discussion will also centre on the migration issue, because this is so closely related to the two markets. People are faster than capital. This speed asymmetry makes it wise to have many people migrate to the west where jobs are temporarily available in the period before enough capital has been invested in the east. They can return later, when the capital and new jobs are available. The two-sided migration pattern should not be left out of the discussion of adjustment strategies in the east when looking for optimal policy move.

3. OBSTACLES TO RESTRUCTURING POST PRIVATISATION

Jan Svejnar

3.1 INTRODUCTION

The first five years of the transition have witnessed a wide range of privatisation outcomes in the East. In virtually all the transitional economies there has been a significant growth of new small and medium sized enterprises (SMEs), a process that in some countries has been aided by restitution of property. In some countries, such as the Czech Republic, Estonia and Russia, most state owned enterprises (SOEs) have been or will soon be privatised. Others, such as Poland, Bulgaria and Romania, have placed less emphasis on privatising the SOEs so far. In the Polish case, the emphasis has recently been shifting from privatisation to commercialisation of SOEs.

As the early post-revolutionary euphoria has gradually evaporated and the societies in central and east Europe have settled into a new routine, it is becoming increasingly more difficult for politicians to secure consensus for major restructuring. There are of course differences across countries. The Czech government for instance faces a relatively co-operative population, whereas the Polish and Slovak societies display greater attitudinal heterogeneity. However, the new reality in the region is that pushing through restructuring is harder now than it was five years ago.

Let me now turn to individual sectors, institutions, actors and policies in addressing the issue of obstacles to restructuring. I will focus on issues related to the financial sector, public finance, management and corporate governance, and interaction with the European Union. Before starting, I would like to stress that many transitional economies have been very successful in carrying out the first phase of the transition process. In focusing on obstacles and problems, I am in no way denying the accomplishments to date. Rather, the paper is meant to be a critical review that will help in setting the policy agenda in the next phase of the transition.

3.2 THE FINANCIAL SECTOR

The underdeveloped nature and imperfect functioning of the financial sector is a major obstacle to efficient allocation of resources, inflow of foreign capital, and rapid growth in the transitional economies.

The first major problem encountered in many of these economies is that commercial banks have not been inducing restructuring as much as they were widely expected to do. In many countries the banks still lend heavily to long term clients (usually large SOEs) even if these are loss-making firms. There is hence a problem of recycling of bad loans as banks issue new loans in order to be serviced on the old ones. These practices reflect the fact that in many instances hard budget constraints have not yet been adequately enforced by the banking sector. Many banks have thus also built new bad portfolios of loans after the old stock of bad loans had been reduced or eliminated at the start of the transition.

Most loans issued by the banks in central and eastern Europe are of a short term nature, induced in some countries by the fact that banks are matching the maturity of loans with that of their deposits. There is hence an important element of myopic behaviour built into the system, with the result that it is difficult for firms to undertake long term investments on the basis of commercial credit.

In countries such as Slovakia and the Czech Republic, a problem of conflict of interest has also developed between the banks and the investment privatising funds. With some of the largest funds being owned by the large commercial banks, a bank's desire to initiate bankruptcy of firms may go counter to the interest of its investment fund that holds shares of these firms. The phenomenon may be serious enough to account in part for the lower volume of bankruptcies in Slovakia and the Czech Republic than for instance in Hungary and Poland.

In contrast to their lenience toward the large SOEs, the banks have in recent years been very strict with small businesses. After an initial period of easy lending to the small private sector in some countries, the banks have tightened up. Collateral requirements are high, often approaching 150-200 per cent of the value of the project when provided in real estate or fixed capital. The real interest rate has also been high in some of the transitional economies. This has especially been the case for export-oriented firms that face western inflation and fixed or only slowly adjusting exchange rates.

The situation of loan shortages is also partly brought about by the problem of asymmetric information between the banks and entrepreneurs. The banks often report that they have funds but cannot find good projects, while small and medium size firms claim not to be able to get financing for high expected return projects. A better provision of standardised information between the borrowers and lenders is clearly needed.

Some of the above mentioned obstacles are related to the problem that commercial banks in the transitional economies still do not have an adequate number of well trained and experienced loan officers and that the banks generally suffer from inefficient operations. This results in a limited ability to appraise and monitor projects. Yet, to lend funds to an enterprise whose liquidation value may be very low requires that the bank be able to control and monitor the operation. If this condition cannot be fulfilled, the banks do not lend or require very high collateral.

The problems are in part caused also by the fact that the banking sector in the transitional economies is still very highly concentrated and facing only limited foreign competition. In most central and east European economies, the core of three to six large commercial banks dominate the sector. Smaller banks hold a minor share and so far they have had limited impact. Many western banks have established branches or subsidiaries. However, even when the laws and regulations are permissive, western banks have until recently stayed on the fringe - focusing on financing activities involving western firms and joint ventures. Very recently, there has been an indication of an increase in direct lending by western banks to enterprises in these economies. It remains to be seen whether this is a start of a new trend.

A major obstacle faced by the transitional economies is the reluctance of foreign investors to enter the area. While the situation may be changing, with the notable exception of East Germany, the inflow of foreign direct investment over the first few years of the transition has been very low. Estimates and definitions vary, but it appears that over the 1990-93 period, the inflow of FDI was of the order of US$6 billion in Hungary, about US$2 billion in each Poland and the Czech Republic, and less in the smaller economies. This is a trickle in comparison to the annual FDI inflows in the rapidly growing Far Eastern economies. It is also very little in relation to the investment levels that are needed to restructure the transitional economies and get on a growth path that will enable them to start closing the wide income gap between them and the economically advanced countries.

The principal indication of the nature of this problem is the fact that western investors still do not think of the transitional economies as a natural place for investment. Perceived uncertainty is high, deriving in large part from uncertainty about the functioning of the legal framework within these economies and about future developments in Russia and other newly independent states. As the above figures indicate, the problem is a general one, affecting even the Czech Republic - the only transitional economy that has maintained a balanced budget, relatively low inflation, and Moody's and Standard and Poor's country ratings above those of Turkey and approaching those of Portugal. The clear lesson is that building up credibility is a difficult and long process.

The allocative role of the stock markets has also been minimal. Stock markets have been successfully established in most transitional countries but their trading volumes have been low. Transactions often take place outside of the stock markets, thus further reducing their effectiveness.

3.3 PROBLEMS OF PUBLIC FINANCE

In an attempt to avoid or ameliorate budgetary problems, many transitional economies have established high taxes. This has put a brake on investment and growth, and encouraged tax avoidance and corruption. The high tax problem is more acute in some countries than in others. Estonia has for instance succeeded to push through reforms while reducing taxes to a much greater extent than many other economies. The problem is of course linked to the expenditure side where one still observes large social transfers. Hungary is for instance a country with one of the highest public expenditures/GDP ratios and also one with a severe budget deficit problem.

As the governments in transitional economies have found after the first round of public expenditure cuts, it is politically and socially hard to reduce them much further. This has been especially the case in the areas of the provision of retirement benefits, health care, and unemployment compensation.

The provision of retirement benefits is a particularly difficult area. The central and east European countries have entered transition with a publicly funded, pay-as-you-go system of retirement. The system faces major problems as it is characterised by a virtually universal coverage of the population, low retirement age, high and growing dependency ratios, high expenditure and contribution levels, high statutory replacement rates, and perverse redistributions. The result of the high dependency ratio is the fact that the system is very costly and yet offering relatively low benefits to individual participants. With ageing population and a pay as you go system, the tax burden becomes increasingly heavier. Several countries have already moved to raise the retirement age and supplement the public retirement system with private schemes - clearly a step in the right direction but more will need to be done. Raising the retirement age is needed on fiscal as well as efficiency grounds, although the short-term effect may be an increase in the already high unemployment rates. Lowering the average wage replacement rate to the level of OECD countries would also be desirable, especially if part of the benefits of this restructuring could be channelled into a newly established system of private (supplementary) savings for retirement. Shifting the public pillar to a broader and less distorting tax base than payroll is also desirable on efficiency and distributional grounds. The health care problems are in many respects similar. Targeting health care better and providing alternatives to the state funded system is hence a high priority.

3.4 MANAGEMENT AND CORPORATE GOVERNANCE

Despite major changes that have unquestionably taken place since 1990, the transitional economies still suffer from a shortage of managerial skills. Managers of (former) SOEs still tend to underestimate the importance of key activities such as quality improvement, marketing, and accounting and audit. There are notable examples of western managers being brought in to transform enterprises but these are exceptional cases and not all turn out to be successful (e.g. the case Gerald Greenwald's team unsuccessfully attempting to turn around Tatra in the Czech Republic).

A major problem arises in the area of corporate governance. Insider power is often significant and neither government nor new private ownership has so far provided effective control. The Polish government for instance yielded significant control rights to workers and managers already in the 1980s and entered the transition with limited powers over enterprise affairs. In contrast, the Czech and Slovak governments have kept relatively tight control through the privatisation process. However, the new dispersed ownership has so far not been conducive to management control in many privatised firms. The financial problems discussed earlier and the lack of corporate control have had numerous effects, one of them being the accumulation of a significant inter-enterprise debt in many transitional economies.

An interesting issue arising in this context is whether the economic decline during the first phase of transition reflects a major, long term, structural change (as argued by Western observers and policy makers), or whether it is a more temporary, cyclical problem, stemming from the fact that there is a need to penetrate new markets that are in a recession (as argued by many managers in central and eastern Europe). In assessing the validity of the two views, it is important to note that many central and east European managers have succeeded in reorientating trade from the east to the west. With most trade now taking place with the western European economies and with a boom starting in western Europe, it is possible that exports from central and eastern Europe will grow rapidly as well. As this discussion indicates, the question of how much restructuring is needed during the transition is not a simple one. Moreover, as the above example demonstrates, the situation in the European Union plays a crucial part in the transition in central and east Europe.

3.5 THE EUROPEAN UNION

While western Europe is the major partner and provides a great promise for the transitional economies, existing safeguard restrictions and anti-dumping procedures represent a significant hindrance to growth in central and east Europe. As various economists have indicated, the impact of exports from central and east Europe to the Union is limited, albeit focused. There is hence relatively little cause for alarm in the Union and hence an acute need to find a more harmonious accommodation between the two sets of economies.

3.6 OTHER PROBLEM AREAS

Since other problem areas are dealt with in detail by the other participants at this panel, I would like to conclude by mentioning that I see the deregulation of the remaining regulated markets (e.g. labour and housing) as a priority area in the next phase of the transition. Most central and east European countries display wide geographic dispersion in unemployment and low mobility of labour. With wages and housing being often controlled, the empirical and institutional evidence hence points to a major labour market mismatch and thus significant geographic misallocation of resources.

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