Europe's economy looks east

Implications for Germany and the European Union

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Comment

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The paper by Professor Welfens is an analysis of three related issues: privatization, structural change, and productivity. The study of the relationship between structural change and productivity is an ambitious topic. To add in privatization is a necessary piece of the understanding of the new landscape of economies in transition. Professor Welfens does an admirable job of pulling these issues together, and in the course of this journey avoiding most traps and, despite the complexity, arriving at a number of important insights and recommendations.

His most important observation is that privatizing an entire industry poses fundamentally different implications than privatizing a firm. There are macroeconomic implications due to the effect on the budget, financing, and employment. There are also important network externalities that are generated through establishing suddenly large numbers of private firms.

Welfens's assessment of privatization is largely positive. He sees privatization increasing productivity, as long as a number of pitfalls are avoided. He places particular emphasis on the effect of increased competition on productivity and warns against the policy that privatizes without establishing competition. His comments on the dangers of subsidies are particularly apt. Noting first that the potential for externalities suggests a policy of intervention, he cautions that a program of subsidization is likely to open the doors to rent seeking. It would be better to restructure first, close down inefficient operations, and then consider subsidies for particular activities. For particular sectors, he notes that government finances are inadequate to correct potential gaps between private and social returns. This perspective leads him to argue for the privatization of university education, since the current wage gap between the public and private sectors has led to the loss of the more qualified teachers.

One can quibble that the distinction between privatization and competition is frequently lost. Much of the listed gains to privatization appears to be the consequences of deregulation or of resolving financial constraints. Certainly, the massive investments required in energy and infrastructure are beyond the financial resources of these governments. Yet, given the sizes of these countries, a policy that allowed for deregulation, import competition, and entry would provide itself a powerful engine for change.

While not assessing the relative contribution of privatization versus other policies, Welfens is certainly aware that structural change alone will increase productivity through the reallocation of resources across sectors. In particular, he notes the declining role of agriculture and industry and the growth of the service sector. To a certain extent, the growth of the service sector is not so much simply an expression of increased efficiency, but a necessary element of a capitalist system. Insurance and financial derivatives are good examples. It would be inaccurate to say that people and property were inadequately insured previously, or that there were inadequate mechanisms by which to manage many kinds of risk. Rather, many of these risks have been newly introduced into these economies.

The final part of Welfens's paper looks at reindustrialization. He notes that the effects of opening an economy to trade poses complex implications for income distribution, especially given current distortions. His discussion appears to refer to the kind of analysis associated with Jagdish Bhagwati on immiserizing growth and trade with distortions. There is a difference, insofar as Welfens notes that these income effects will influence the political acceptability of reform. Similarly, he notes that direct investment may provide the capital flow required in a period of inadequate savings, but that higher net claims of foreigners on resident assets implies a persisting inequality in income distribution between transition and lending economies.

The discussion could apply to either portfolio or direct investment flows. Welfens's discussion of direct investment implies that the issue is not so much income inequality as ownership. It is also unclear whether a policy that permits capital imports coupled with wage restraints could not increase the level of income sufficiently to compensate for foreign interest and dividend reimbursement. After all, the persistence of net claims of the United States on European and Asian countries was not long-lived. Moreover, if one moves away from the production function described in these pages to the endogenous growth models described earlier in the paper, a policy of borrowing for human and capital investment might have more than compensating effects.

The reason these issues get messy is that there is no good theory to separate out the effects of portfolio from direct investment. The issues involved are not far removed from the overall literature on corporate governance, whereby different types of owners are poised to influence the productivity of firms. Does it matter who owns the firms?

From an economic standpoint, the issues are cloudy. There are two types of considerations. The first is the question of valuation in a period of highly imperfect and incomplete capital markets. It is easy to dismiss the occasional outcry over privatization as nationalistic. At the same time, the valuations placed on assets can be surprisingly low. A study conducted by CS First Boston (1994), in their efforts to market the Russian economy, pointed out that in sectors such as telecommunications, energy, or metal, the capitalized value of capacity was a fraction of Western equivalents; only the tobacco industry, in which foreign investment has been large, shows Western valuations. These underevaluations might represent the shortage of domestic savings, or the discount applied to firms with poor governance oversight. In fact, astute analysts of this problem seem to swing between these interpretations (see Boycko et al., 1993, 1994). Yet there is no doubt that this period of transition presents unusual opportunities to those with the requisite wealth. Often, this wealth is foreign.

The second consideration has to do with whether the subsequent investment behavior of foreigners differs from nationals. Cantwell (1989) has presented a formal description and some evidence to suggest that foreign investment can enhance productivity if the domestic sector is already enjoying positive externalities; but productivity may be hurt if investment is used for market access and the activities that are responsible for externalities, for example, research and development, are closed down. Tyson's (1992) argument for an activist trade policy seems to be based upon similar considerations.

Of course, in the context of an integrated European economy, these considerations dim, for why should externalities respect national borders? Czechoslovakia, Poland, and Hungary are closer to the industrial heartland of Europe than Portugal. (See Sachs, 1993, for data.) The German investment in these countries is a reflection of the disregard of national boundaries. The fate of Bulgaria is partly its lower level of development, but also its location. The large share of Greek investment in its economy might, one can hypothesize, have lower externalities than that of German or Austrian.

A simpler explanation rests on the politics of these economies. There is a tendency, one feels, to treat the politics of these countries as an expression of why economic development is stalled. But there is another side to all this, namely, that the nature of the future state and society is very unclear. People are naturally trying to influence their destinies in very profound ways.

What is at stake is the creation of "bourgeois" societies, and I use this expression in the context of what it means in Europe. Balzac's observation of capitalist development in nineteenth-century France that behind every great wealth lies a great crime was exaggerated but still insightful. It would seem to hold true with regard to the accumulation of wealth in transition economies today. It is a great puzzle how to deal with the conflict between the need for the educated Old Guard and their belief in the earlier system. The rapidity of business creation and growth, which has particularly propelled the Polish economy, is explainable partly by the capitalist opportunities created by misvaluations and access to specialized resources.

For this reason, the process of privatization is a deeply political issue, about who will belong to the future class of owners. Welfens is not correct in stating that Russian privatization has been less extensive than that in Central Europe, but he is right if he means that privatization has not resulted in the creation of Western-style governance mechanisms and has not displaced managers. The

Polish privatization program has not been especially impressive, but it has come to be an increasingly less interesting question. For with the rapid development of a private economy inhabited by new start-ups and by foreign firms and the atrophy of the public sector, the Polish economy is more Schumpeterian than neoclassical. And if the Hungarian economy looks stagnant by comparison to its Czech neighbor, it is because the resolution of competing claims between labor and new interests is far from complete.

The link between privatization and productivity is, one suspects, a real phenomenon, but I question the generality of its significance. The nationalizations of France following Mitterand did not palpably affect French productivity, even though the most important enterprises were affected. Some might argue that this change in ownership was efficient from the perspective of Olson; it broke up the inertia that had accrued in the extensive intercorporate ties of the French economy. If privatization looks more promising now, it is because the French economy, and financial markets, are significantly different.

The case of Russia is instructive. One accepts the argument of Boycko et al. (1993) that privatization in Russia succeeded above all in breaking up the power of the ministries and fostering a climate of competing claims on government resources. This result had the ironic effect of both weakening the traditional ministries and increasing the strength of government agencies responsible for the disposition of state property and for fiscal relief. Boycko et al. like this outcome, because reform interests dominate these agencies. Privatization has not, as we all recognize, led to an obvious gain in productivity, but it has laid the foundations for a balance of political interests.

In all of these countries, there has been a search for mechanisms by which to exercise corporate governance in order to discipline managers. Despite the interest in equity markets, these markets are relatively small. In any event, external equity financing has been historically minor in most industrial countries; retained earnings has been the most important source of financing. If motivated owners are unlikely to be generated by equity markets, then it is natural to look toward banks as corporate overseers. But by and large, the banking systems of transition economies are very weak, and remain fragile despite major infusions of capital and writing down of bad loans. It is also ironic that many of these banks are still state-owned. (Here, Russia is a telling exception.) In Czechoslovakia, where a few banks are important owners of mutual funds, the state through its bank holdings remains an important owner of many newly privatized companies.

Yet there will remain two important influences on enterprise behavior. One is simply the force of product market competition. Welfens notes the importance of hard budget constraints, but of course, private firms, as he observes, can also wield tremendous power in acquiring subsidies. Russian subsidies still amount to 6 to 7 percent of GDP, even though 45,000 firms have been privatized. The second influence is other enterprises, who, through supplier and buyer credits, are heavily indebted to each other. In Russia in particular, there is the

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