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Economic Reform and Citizen Entitlements in Eastern Europe: Some Social Implications of Structural Adjustment in Semi-Industrial Economies

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Contents

Preface

This paper forms part of the Institute's work on the social and political transformation in Eastern Central Europe and the Soviet Union. When the project was initially formulated nearly three years ago, the intention was to explore the implications for social participation of the emerging economic reforms in centrally planned countries. The focus of the project has changed in line with the rapid pace of political and economic reform over the past two years in these countries. The research programme is now focusing on different dimensions of participation in the light of the changes in property relations currently taking place in communist and post-communist societies.

The author of this paper, E.V.K. FitzGerald, Professor of Development Economics at the Institute of Social Studies, The Hague, has published books and articles on Latin American development problems. He has acted as an advisor to the governments of Mexico, Nicaragua and Peru. At UNRISD, the project is being co-ordinated by Ann Zammit.

In this wide-ranging paper, FitzGerald attempts to relate the processes of economic restructuring currently under way in Eastern European countries to the social aspirations of the people and the political imperatives of a democratic state. The paper highlights a major dilemma facing the countries of Eastern Europe in their attempts to promote structural reform and economic growth. With levels of productivity nearly a quarter of those in Western Europe, the countries of Eastern Europe had attained indices of social achievement not too far below those in the West. At the same time, with the establishment of political and civil liberties have come social aspirations for welfare systems prevailing in Western Europe. These are in direct conflict with the current policies of economic liberalization, stabilization and restructuring. The strategy of the "big bang", promoted by the Bretton Woods institutions and several Western countries and adopted increasingly by countries of Central Europe, implies in the short to medium-term sharp falls in private consumption, curtailment of social services and creation of high levels of unemployment.

The states in Eastern Europe are thus faced with the contradiction between the economic consequences of restructuring and the social aspirations of the people based on the citizenship entitlements of a modern democratic state. These contradictions are the more difficult to resolve as the modernization project itself calls for major investments in education and skills of the labour force. The author concludes that the contradictions can only be resolved within the framework of an explicit social contract between management, labour and the state. This may in turn call for the establishment of clear entitlements as citizenship rights and necessitate the social planning of basic need provision.

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Dharam Ghai
Director

Introduction

The return of markets and elections to Eastern Europe after 50 years of state-centred economy and politics presents the historical prospect of both re-attaining technological modernity and civil society. The economic reforms and democratic pluralism upon which the transition from backward socialism to advanced capitalism is to be based mainly refer to the semi-industrialized countries on the "European periphery" (Czechoslovakia, Hungary, Poland, Romania and Yugoslavia) and follow a broadly similar pattern. Greater Russia presents a quite different problematic, due to its status as both major primary exporter and super-power[1]; while the Asian Soviet Republics, Bulgaria and Albania can best be regarded as agrarian societies on the periphery of the world economy, with a distinct reform agenda[2].

The dismantling of the state enterprise sector is justified by the long-standing diagnosis of the systemic problems of state socialism, but the accompanying economic policies appear to be strongly influenced by a particular reading of the structural adjustment experience of the "newly industrializing countries" (NICs) by the International Monetary Fund and the World Bank[3]. Although there is a general expectation that these reforms will lead to a gradual approximation to Western European social and economic standards over the longer-term, there are clear signs of opposition to the distributive consequences of orthodox structural adjustment. Such opposition is commonly attributed to "conservative" forces (i.e. the bureaucracy) or at best, to "social constraints" which must be overcome in the medium-term in order to achieve the undoubted longer-term benefits. Indeed one of the strongest arguments for "shock treatment" is the essentially political perception of the need to transform economic behaviour before popular enthusiasm for economic reform wanes.

In contrast, this paper argues that although the Eastern European combination of a semi-industrialized production structure with a skilled labour force implies enormous productive potential for the longer-term, this combination also contains a fundamental conflict between efficiency and welfare during a prolonged transition which has perhaps been overlooked in the design of economic reforms along the lines suggested by the Bretton Woods institutions. Above all, the relatively well-educated and socially integrated workforce which provides the basis for future productivity at Western European levels also expects corresponding levels of public and private consumption as "citizen entitlements" which are inconsistent with the radical income redistribution required by orthodox structural adjustment programmes.

The first part of this paper outlines the systemic problem of the pre-reform economies, the existing levels of industrial productivity and welfare provision, and the logic of the economic reform project in Eastern Europe. The second part discusses the perceived "constraints" on the structural adjustment – fiscal stabilization, trade liberalization and privatization – which supports the reform process, from the point of view of their distributional implications. The third part of the paper suggests that these issues of employment, wages and access to public services are better seen in terms of "citizen entitlements"; leading to the conclusion that the

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[1] An excellent survey of the "roadblocks to reform" in the USSR is provided by Nordhaus (1990).

[2] The United Nations Research Institute for Social Development (UNRISD), in Geneva, is currently co-ordinating a research programme on the social consequences of the changing relationship between markets and the state in the socialist agrarian economies of the Third World. For some antecedents, see Saith (1985), and FitzGerald and Wuyts (1988).

[3] Despite the longer involvement of the Bank in research into the economic problems of socialist economies (Solimano, 1990) – particularly Hungary and Yugoslavia – the Fund (Wolf, 1985) appears to have had greater intellectual influence on the reform debate; which may explain (or possibly be explained by) the emphasis on short-term financial and ownership measures rather than longer-term issues of investment and trade. For critiques of the "Bretton Woods" view of finance and adjustment in LDCs, see Taylor (1988), and FitzGerald and Vos (1989).

reform programme should be redesigned in order to contain the social consensus necessary for a sustainable re-industrialization strategy – and thus political democracy.

Table 1		
Comparative Development Indicators (1988)		
	Income Level (US$ per capita)	**Health Service** (population per physician)
Czechoslovakia	3,300	280
Hungary	2,460	310
Poland	1,860	490
Romania	---	570
Yugoslavia	2,520	550
Middle-income economies	1,930	2,520
EEC	11,363	385
Spain	7,740	320

Source: Tables 2 and 3. **Note:** Spain is the poorest of those OECD members categorized by the World Bank as "industrial economies".

1. The Economic Reform Project

The breakdown of the "socialist" (i.e. soviet-type) economies of Eastern Europe is self-evident[4]. After an initial period of rapid social reform in the post-War period, the main thrust of economic strategy became "catching up" with Western Europe by forced industrialization based on centrally administered state enterprises and extremely high rates of capital formation[5]. By the 1980s three key factors had combined to make economic reform unavoidable: first, an inadequate supply of basic consumer goods (especially food) and quality of public services, particularly in comparison with Western Europe, which undermined régime legitimacy; second, the inefficiency of modern sector industry, which had fallen behind technologically not only Western Europe but also many NICs, and was unable to meet domestic requirements for wage-goods and producer goods; and third, chronic convertible-currency balance of payments difficulties, where the inability to export manufactures (of sufficient quality) restricted the capacity to import the technology needed for modernization.

According to the "shortage" model,[6] the form of institutional organization in planned economies leads to non-price behaviour and "soft budgeting" as a systemic characteristic of the state firm. Unconstrained demand from firms generates excessive investment rates, inefficient resource use, paternalistic relations between firms and ministries, labour hoarding

[4] The analysis presented here of systemic breakdown is based on the work of Kornai (1980) and Brus and Laski (1989). Of course, there had been earlier reform attempts throughout Eastern Europe in the 1960s, while the 1970s saw considerable economic liberalization in Hungary and Yugoslavia; but nothing on the scale of the present changes.

[5] Of course, socialism was originally supposed to **follow** mature capitalism, with all its productive capacity developed (Brus, 1975). In fact indigenous socialism emerged in what would now be called the Third World – particularly Russia and China while in the case of Eastern Europe, socialism was the consequence of World War II.

[6] See Davis and Charemza (1989) for an excellent survey.

and chronic shortages of consumer goods. In contrast, the "disequilibrium mode"[7] suggests that the origins of economic system failure, particularly after the enterprise reforms of the 1970s and 1980s when central planning was virtually eliminated, are to be found in planners' errors in attempting to achieve high rates of growth through over-accumulation; excessive defence expenditure; slow response to external shocks transmitted from the world market[8] and price distortions – particularly the difference between domestic and international relative price ratios. These two models are not mutually exclusive, of course; but the relative importance attributed to each logically affects the way in which reform policies are designed and the effect they can be expected to have.[9]

Reliable comparative data on the Eastern European economies (EEEs) is hard to come by, but that which is available indicates that levels of output per head lie well within what the **World Tables** (World Bank, 1990) define as "middle income countries" (MICs)[10] and around a quarter of those in Western Europe (EEC) – as Table 2 indicates. Real standards of living (ICP) do appear to be somewhat higher than those in MICs due to different price structures, but are still only a third of those in the EEC. Compared to Spain (the first on the **World Tables** list of "industrialized countries"), the gap is similarly large – output per head one-third and living standards one-half. It appears that while Eastern Europe had been comparable with (say) Greece or Spain in the 1960s, by the late 1980s the progress of Western Europe and of many Third World economies (particularly the so-called "newly industrializing countries", or NICs) was such that it could even be argued that EEE had achieved "permanent developing country status".[11]

[7] This had been discussed for some time, of course: see Portes (1979), Nuti (1979) for instance. For an excellent survey of the debate, including a useful comparison between the "shortage" and "disequilibrium" approaches, see Davis and Charemza (1989).
[8] Particularly the oil shocks of the 1970s (Neuberger and Tyson, 1980), but also the subsequent debt shock as repayment of borrowing, designed to permit industrial accumulation to accelerate, became due.
[9] This is not to suggest that the roots of reform are to be found in the discourse of economists, but there is no space here to discuss the social forces generated by the post-War experience of communism – although they will be referred to indirectly below.
[10] These sources should be consulted for definitions, methodology and coverage. The 40-odd "middle-income economies" as defined by the World Bank range from Bolivia (US$ 570 per capita GNP) to Greece ($4,800); with the median case being Chile ($1,510). Good points of reference are Mexico ($1,760), Brazil ($2,160) and South Korea ($3,600).
[11] Winiecki (1989).

Table 2						
Economic Structure (1988)						
	Income Level GNP/capita	ICP*	**Energy Use** TOE#/capita	**Industrial Share** GDP	emp.	exp.
Czechoslovakia	3,300	---	4.4	49	37	80
Hungary	2,460	31	3.1	37	33	69
Poland	1,860	25	3.5	48	28	67
Romania	---	---	3.5	50	36	---
Yugoslavia	2,520	29	2.2	49	41	79
Middle-income economies	1,930	20	1.1	40	25	59
EEC	11,363	65	3.1	41	34	81
Spain	7,740	46	1.9	37	24	73

Source: World Bank (1990), IMF (1990a, b). **Notes:** * ICP is United Nations estimate of per capita income (USA = 100) in 1985 adjusted for the purchasing power parity of currencies; # "TOE" is tons of oil equivalent.

The industrial figures in Table 2 are instructive. The share of industry in output is quite high in comparison with both MICs and EEC, although this also reflects the relatively small tertiary sector.[12] In contrast, the share of industry in employment is similar to that of the EEC, but much higher than that of the MICs, which reflects the relatively low level of labour productivity. The proportion of manufactured exports in EEE is much higher than in MICs and approaches that of the EEC, but of course these products were primarily oriented toward captive CMEA (Council for Mutual Economic Assistance) markets. Finally, energy use in EEE is extremely high, which not only reflects problems of industrial efficiency but also has serious implications for both the balance of payments and the environment.

In sharp contrast, as Table 3 indicates, the levels of welfare in EEE are far superior to those of MICs and comparable with those of EEC. Levels of literacy and secondary enrolment have a clear impact on the quality of the workforce, and thus the potential (if not the realized) level of labour productivity, technological absorption and export competitiveness in the longer run. Similarly, health standards are clearly far superior to those of MICs and approximate those of the EEC. Measures such as per capita calorie intake and population-per-physician indicate levels similar to those of the EEC, although life expectancy and infant mortality are somewhat worse.[13] In any case, all these measures indicate a situation far superior to that in MICs and, more importantly, these levels of health and education (housing is far more problematic) have established a popular perception of entitlement to free social services. Indeed their recent deterioration clearly contributed to the loss of legitimacy by Eastern European communist régimes.[14]

[12] Chenery, Robinson and Syrquin (1986).
[13] IMF (1990a) suggests that since the mid-1960s life expectancy in Eastern Europe has actually been declining.
[14] Szentes (1990).

Table 3								
Social Indicators								
	Czech.	**Hungary**	**Poland**	**Romania**	**Yugoslavia**	**MICs**	**EEC**	**Spain**
Health:								
Population/ physician (1984)	278	310	440	570	550	2,520	385	320
Infant mortality (1984)	12	16	16	24	25	52	8	9
Calorie intake (1986)	3.2	3.6	3.3	3.4	3.6	2.8	3.4	3.4
Life expectancy (1988)	72	70	72	70	72	68	76	77
Education:								
Adult illiteracy (1985)	*	*	*	*	12	28	*	7
Enrolment (1987): primary	100	97	100	97	95	100	100	100
secondary	82	70	80	79	80	54	94	100
tertiary	13	15	18	10	19	17	39	30

Source: World Bank (1990). **Note:** * Less than five per cent according to UNESCO.

Relative productivity, particularly in industry, is thus at the heart of the problem. Table 4 gives a rough estimate derived from the data presented in previous tables: productivity in EEE appears to be less than one-fourth of that in the EEC and to approximate that of the MICs. To some extent this may be due to overmanning and low work intensity, which is reflected in the higher share of industrial employment than in MICs, and probably more significantly to bureaucratic delay and lack of managerial incentives. What is more, the industrial growth rate in Eastern Europe fell from nearly 5 per cent per annum in the 1961-1980 period to little over one per cent in 1981-1988; productivity growth was probably negative.[15] This is why changes in economic behaviour are the key objective of the reforms. Nonetheless, the major productivity difference between the EEC and the EEE can only be explained by the enormous disparity in endowments of modern technology, which in turn can only be overcome by an intensive and sustained process of investment based on imported capital goods, management methods and labour training.

Table 4			
Relative Industrial Productivity			
	EEE*	**MICs**	**EEC**
GNP/capita	2,535	1,930	11,363
Ind./GDP	46	40	41
Ind./Emp.	35	25	34
"Productivity"#	3.3	3.1	13.7

Notes: * Average of Czechoslovakia, Hungary, Poland and Yugoslavia; # defined as [GNP/capita] x [ind. prodn share] / [ind. emp. share], and thus approximates industrial value-added (in US$ '000) per employee; data from Table 2.

The case of the "two Germanys" is particularly illustrative. The pre-unification (1988) industrial productivity ratio was 0.3:1, reflected in an industrial wages relation of 1:3. The ratio of household consumption levels, however, was only 1:2 – although relative price

[15] IMF (1990a).

differences make such comparisons difficult.[16] The equalization of prices through monetary unification makes these differentials more evident and the real wage ratio has emerged at around 1:4, while as much as one-third of the industrial labour force may become redundant through market unification. This enormous difference in purchasing power and earnings capacity, in a situation where unification has been brought about as much by a desire for comparable living standards as for political emancipation, is being compensated by massive subsidies to prevent mass labour migration until sufficient investment can take place in order to equalize productivity levels.

Table 5 shows that the very low levels of consumption are not only the result of the level of national income per capita (see Table 1) but also the low proportion of consumption in GDP – or to put it in another way, the high level of (forced) savings in Eastern Europe. At nearly two-fifths of GDP, it is nearly double the savings rate in either MICs or the EEC itself. This is the result of the "investment bias"[17] of managers, bureaucrats and technicians characteristic of these economies, although this has not lead to proportional increases in productivity or even social infrastructure. In the late 1980s the resource balance was also positive, reflecting the net outflow of foreign exchange to service debt.

Table 5

Expenditure Patterns in Eastern Europe, 1987-1989
(percentages of GDP)

	Czech.	Hungary	Poland	Romania	Yugoslavia	Average
Defence (% of GNP)	6	4	6	4	---	6
Shares of GDP/NMP:						
Govt. consumption	22	11	8	7	14	12
Private consumption	44	61	56	47	47	49
Investment	33	25	33	30	39	32
Resource balance	1	3	3	16	1	7
Saving	34	28	35	46	40	39

Source: Gronocki and Charap (1990) for data on defence and Romania; World Bank (1990) for Hungary, Poland and Yugoslavia; Prout et al. (1990) for Czechoslovakia.

Of the other categories of demand, defence expenditure as such is a relatively small proportion of GDP in EEE and not large by the standards of similar industrializing countries;[18] government consumption (the use of goods and services by the central administration) in the usual national accounting convention is not very large either because it excludes state enterprises, which themselves provide a large part of social services to their employees. Nonetheless, the tax level (including net enterprise surpluses) is quite high – about half of GDP on average – due to investment finance and price subsidies.

The aim of Eastern European governments in opening up their economies by privatization is twofold: first, to dynamize the large enterprise sector by exposure to capitalist markets and the acquisition of modern technology through foreign investment; and second, to stimulate the local supply of consumer goods and services by stimulating small-scale production. Although some ideological reservations may persist, the resistance to privatization as such does not appear to be significant, as it is accepted as the only way to raise productivity because state

[16] Purchasing power parities depend on the basket of goods chosen: according to IMF (1990a: 89) these "range from M 1: DM 1.45 for a two-person pensioner household with a GDR consumption pattern, to M 1: DM 0.89 for a four-person wage-earner household with a FRG consumption pattern".
[17] Kalecki (1985), Nuti (1979).
[18] In fact, average defence expenditure in LDCs is eight per cent of GDP (Deeger, 1986).

enterprise management has been found to be neither efficient nor equitable. The negative effects on employment and incomes arising from the shedding of labour from large inefficient firms are confidently expected to be balanced by the expansion of small enterprises. However, in order to transform enterprise behaviour, it is necessary to change market conditions themselves.

The orthodox approach to "structural adjustment" involves two key elements other than privatization itself: on the one hand, the alignment of external and internal prices and the exposure of domestic firms to international competition through external trade liberalization; and on the other, the sharp reduction of the level of aggregate domestic demand, particularly by the elimination of budget deficits. These two policies – known respectively as "expenditure switching" and "expenditure changing" measures[19] – are designed to redistribute income toward traded and away from non-traded sectors, and away from real wages toward profits. The expected result is greater exports (and less imports), higher private savings and investment; followed by higher growth and employment. However, the establishment of currency convertibility is seen to require a fall in consumption demand to prevent balance of payments collapse, and the establishment of a high real exchange rate (i.e. the ratio of the official exchange rate parity to the wage rate) to make exports competitive. In addition, the exposure to foreign trade is regarded as essential in Eastern Europe so as to impose financial restraint by ensuring true enterprise autonomy and eliminating "soft budgeting".

Judging from the experience of other semi-industrialized economies, it may well be the case that the social problematic centres on the distributional issues raised by orthodox structural adjustment programmes – rather than the changes in the ownership of the means of production.

2. "Constraints" on the Implementation of the Reform Programme

To date (i.e. the end of 1990) reform progress has been marked more by good intentions than substantive results:[20] privatization has proceeded slowly while fiscal stabilization and trade liberalization have proved more difficult than was anticipated in the heady days of late 1989. Brus and Laski (1989) go on to argue that the experience of reform so far[21] indicates that economic efficiency can only be regained by radical reform at the micro-economic level and that enterprise decentralization – or even privatization – is not enough. Only if factor markets, particularly those of capital and labour, are fully liberalized will the twin threat of bankruptcy and unemployment be really effective. They make an exception, of course, for public goods and welfare provision; and are explicitly aware that the macro-economic management required to secure full employment will still require considerable government intervention, including centralized investment allocation and a "capital levy" to finance it.[22]

The Bretton Woods institutions have far less reservations about the "big bang", which the IMF understands[23] to comprise three factors: the "speed at which reform is undertaken, the comprehensiveness of the reform package, and the sequencing of the reform". The evident consequences of this approach are recognized: "any comprehensive economic reform program designed to improve economic performance over the medium-term will entail significant risks during the transition period. In particular the short-run consequences for output, employment and the trade balance may be worse than is anticipated and could jeopardize the whole

[19] Dornbusch and Helmers (1988).
[20] Gronocki and Charap (1990).
[21] They suggest in fact that Hungary and Yugoslavia are the only examples with sufficient reform experience to permit a considered judgement.
[22] Which they call the "Keynes-Kalecki problem".
[23] The following quotations are taken from IMF (1990a: 70-72).

program. Moreover, the transition period could be quite long, especially if reforms are delayed or are insufficiently comprehensive". Nonetheless the logic is remorseless: "for a number of reasons, a rapid implementation of market-oriented reforms may be preferable to a gradual approach. The more rapid the reforms, the less those who benefited from the old system and other interest groups will be able to obstruct or slow implementation of the reform programme"; while "the credibility of the economic reform package, and hence the probability of it succeeding, is likely to be greater if it is comprehensive...". The financial and intellectual prestige of the Fund – in both Eastern and Western Europe – is such that views are taken very seriously.

It is probably useful to distinguish two aspects of privatization. The liberalization of small-scale production and trade is relatively easy to achieve because the agents concerned support the move, they can be set up with little capital and family labour, while all that is required from government is to cancel existing restrictions. Although real wages may be affected (especially in the short-run) by the removal of price controls; the increased variety of services offered and the high proportion of households involved in one way or another ensure considerable political support. The privatization of large firms is far more difficult, for a number of reasons. First, a large proportion are not viable technologically or financially, and thus must be closed down or restructured before privatization. Second, purchasers are difficult to find for viable firms, and despite imaginative schemes for share flotation and worker co-operatives, management buy-outs financed with bank credit are likely to be the main vehicle except for a limited number of foreign take-overs. Third, the pressure from the existing workforce, local authorities and sponsoring ministries to maintain the status quo are likely to be politically influential.

In consequence, as Kornai (1990) points out for the case of Hungary, the sheer size of the state sector will ensure that a "dual" public-private economy will continue to exist for another two decades at least. What is more, a dual economy – in the more usual sense of large firms concentrating most of production and small firms most of employment – can also be expected to emerge. Under these circumstances, the effective allocation of resources, price formation etc. will become problematic issues requiring continuing government regulation of the market. Kornai stresses the ever present danger that a dominant sector will "crowd out" private business unless it is kept under strict financial control. Small enterprise is also likely to be displaced by large privatized firms in the competition for imported inputs, bank credit and government contracts.[24] In a real sense, the banks will replace the planning ministries as effective macro-economic managers and controllers of the reform process itself – which puts in question the degree of social control over these institutions as well as their source of funds.[25] What is more, the rates of enterprise profit required to both stimulate private investment and maintain the required savings rate, in the face of the income requirements of shareholders and managers, imply severe restrictions on the share of wage-earners and the self-employed in national income.

Despite theoretical enthusiasm for simultaneity, it is fairly clear that financial stabilization is essential in order to contain domestic demand **before** the liberalization of prices and foreign trade (central to the adjustment process required to transform economic behaviour) can commence. This stabilization involves both the elimination of (often hidden) budget deficits and also requires a freeze on wages. However, the reform process itself is likely to generate a systemic "fiscal crisis of the state". On the one hand, central government expenditure will come under upward pressure as the welfare commitments of enterprises to their employees are socialized, debt service increases with more realistic rates of exchange and the absorption of

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[24] FitzGerald (1988).

[25] Of course, a major problem in the past has been the tendency of state banks to extend limitless credit to large supposedly autonomous firms, so that continued public ownership is probably inadvisable; an attractive possibility is employee and social membership of bank boards.

new technology requires investment in higher education, applied research and communications facilities. On the other, the fiscal resource base will be weakened as enterprises are decentralized and trade becomes privatized; while direct tax will be difficult to collect from nascent corporations and individuals who may not recognize the legitimacy of state access to their earnings.

There are of course some compensating fiscal factors, such as the reduction of food subsidies and the prospect of import duties, but the budget deficit is likely to widen during the reform process itself, and in the presence of a narrow capital market, monetary emission could become uncontrollable – accelerating the flight from domestic money and reducing the capacity for macro-economic management. In this context, warnings against "macro-economic populism"[26] seem somewhat misconceived, as if income distribution were a policy variable to be manipulated at will – or at best mitigated by the discretionary "targeting" of poverty groups.[27] As the next part of this paper will argue, the issue is rather of **citizen** claims on the public sector as an essential component of an explicit social contract which underwrites the modern democratic state (de Swaan, 1988).

The emphasis placed on a high real exchange rate (and thus low real wages in traded sectors) as a centrepiece of orthodox structural adjustment policy is based on a particular interpretation of the basis of industrial export competitiveness and unit labour costs, which takes labour productivity as given and price as the main determinant of market penetration. However, the present trade position of Eastern Europe reflects the reliance on administered CMEA trade in which raw materials (especially oil) from the USSR were exchanged for inferior EE manufactures, and members were forced to use each other's outdated technology. Much of the hard currency exports during the 1980s had been used to service excess borrowing from Western banks during the 1970s.

As Balassa (1981) points out, successful transition by the NICs from import-substitution to manufactured export promotion requires the reorientation of industrial production itself in terms of factors such as product quality, modern technology, energy utilization[28] and above all labour skills – all of which have entailed considerable state intervention. The growing knowledge-intensity of production processes means that competitiveness in the market place is determined not so much by price but rather by factors such as product quality and the ability of firms to continue to upgrade their technological capabilities. The Scandinavian experience also indicates that the role of the non-traded (especially public) sector in improving labour quality and flexibility is essential for export success. In the case of Eastern Europe the duration of this export transition will depend crucially on the extent of foreign investment and labour retraining;[29] neither of which are necessarily encouraged by low wages and or high unemployment. The problem of open competition with NICs such as Korea and Brazil (which have the ability to harness new technology to production) on world markets may only be ameliorated by preferential access to the EEC markets at the expense cost of the Third World.[30]

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[26] Such as in Dornbusch and Edwards (1990) which, although directed to Latin America, applies equally to Eastern Europe.

[27] World Bank (1990).

[28] As the data in Table 2 indicates, Eastern Europe uses 1.3 tons of oil-equivalent per thousand US$ of GDP, as opposed to 0.3 in the EEC or 0.6 in MICs as a whole. Incidentally, the USSR as a major oil and gas exporter stands to gain rather more from the breakdown of the CMEA than other members.

[29] Roy and Sengupta (1988).

[30] For a more optimistic view, derived from the belief that the expansion of world trade consequent upon the re-integration of Europe will raise EEC GDP sufficiently to compensate for this effect, see Cohen and van Tongeren (1990).

Despite these structural realities, influential authors such as Lipton and Sachs[31] are boldly optimistic about the "big bang". In the case of Poland, popular tolerance for price rises is taken for granted and "cuts in military spending and investment in heavy industry, combined with new external financing from abroad, can reduce the need for large cuts in current consumption" (Lipton and Sachs, 1990: 87). However, as Table 5 indicates, large defence cuts are not a realistic option, and even in the case of the USSR the "peace dividend" from demilitarization would take the form of a reduced state wage bill rather than the reconversion of defence industry.[32] The scope for reducing investment levels in favour of consumption is limited on both the demand and supply sides: the modernization of industry and social infrastructure will require the maintenance of high savings rates over a long period; while capital goods sectors cannot easily be converted to consumer goods production. Although construction capacity could be redirected toward housing, there is an enormous infrastructural deficit to be made up as well.

One way of relieving the stress of macro-economic adjustment is, of course, external resources. However, the impact depends upon the **form** which such funding takes. Commercial bank involvement will probably be confined to trade credit and support for MNCs, in view of their negative experiences with both Eastern European and Third World lending during the past decade. Direct foreign investment (DFI) cannot be expected to contribute greatly to resource availability as such; its main effect is expected to be through the transfer of technology – incorporated as capital goods and managerial services. Moreover, in the absence of any integrated technology strategy, industrial policy would effectively be made by the micro-economic decisions of multinational corporations in search of cheap labour, local markets or natural resources. The labour régime will also be affected (i.e. non-union plants), and in any case the experience of the NICs is that the employment created is very limited. In other words, DFI is likely to reinforce the tendency toward a drastic reduction in the industrial workforce, lower real wages and a weakening of fiscal control.

Concessional loans from multilateral and bilateral official sources are the mostly likely source[33] of new funding; most of which will necessarily be allocated to modernizing infrastructure. Leaving aside future debt problems (which will sharply limit the amount of borrowing that can be allowed) such official assistance will tend to strengthen (or at least maintain) the role of the public sector as a sovereign borrower and channel for aid. Moreover, a greater reliance on foreign savings often **reduces** domestic savings rates (particularly given the pressure to convert domestic money balances into imported consumer goods) so that consumption may well increase rather than investment. Although the "quality" of consumption may be improved thereby and wages become a real incentive to productivity, as well as providing short-term social relief, the long-term problem of creating a competitive manufacturing base remains.

A more realistic view of the experience of orthodox adjustment programme design is perhaps that of Rodrik (1990), who argues not only that fiscal stabilization is necessary before trade liberalization, but also that the **sustainability** of macro-economic policy is as (if not more) important than free markets in encouraging appropriate private sector response. In practice, stabilization has taken longer than was originally anticipated by the Bretton Woods institutions (especially the reduction of welfare expenditure and employment) while private

[31] Especially pp. 99-103 on "the strategy of transition".
[32] **The Economist** (1990).
[33] These allocations of funds are likely to imply a shifting of the credits presently provisionally allocated to other MICs after the (relative) success of their recent stabilization efforts. In contrast, the lower-income countries (LICs) are not expected to lose their aid commitments, which are based on "solidarity" (i.e. pressure groups concerned with poverty). It is worth noting that within European governments, both aid to EE and Third World debt re-negotiation are handled by the ministries of finance rather than by the ministries of overseas co-operation.

investment has fallen because of uncertainty about future policy. The credibility of the fiscal stance and the real exchange rate is increased by the absence of the sharp distributional changes that trade and price reforms require "in order to be validated", changes "that would create political pressure to reverse course down the line" (Rodrik, 1990: 935). In consequence, there exists considerable doubt in practice whether the static efficiency gains from liberalization are in fact translated into longer-term growth gains in the case of the NICs. The same argument might be applied *a fortiori* to Eastern Europe.

3. Citizen Entitlement

The categorization of distributional issues as "constraints" on economic policy analysis does not only overlook the real problems of industrial modernization; it also implies that the main social actor is the government itself (or more precisely the "reformist policymakers") while the private sector (firms and households) behaves in a reactive fashion to changes in the policy instruments. This approach can lead to an underestimation of the economic significance of the changes in the relationships between the diminished state and emerging civil society, and of the capacity of the latter to establish its "own rules". This is particularly significant in Eastern Europe due to the radical change in the channels of household access to goods and services implied by the rapid decline in state management of economy and society, the restructuring of employment and relative wage levels, and the marketization of much that was previously supplied by the state.

A useful way of entering this complex topic may be to adapt the concept of "entitlements" developed by Sen[34] to analyse radical changes in access to consumption in the very different situation of famine in Asia. Sen conceptualizes access to goods and services in terms of entitlements, which are the sets of alternative commodity bundles that the person can acquire through the use of the various legal channels of acquirement open to someone in his or her position. Sen distinguishes between "endowment" (such as property or wages) and social institutions as means of establishing entitlements. He identifies the source of famines not so much in supply shortfalls but in the loss of entitlement to food on the part of the poor, due to market failure, unemployment, administrative collapse and so on. However, it has been pointed out that Sen's analysis does not give sufficient emphasis to the fact that the possibility of making legitimate claims depends on the existence of corresponding obligations on the part of others to respect those rights. Markets and property are not real things in themselves but rather legal relationships: in other words, all sources of entitlement are socially constructed – as Adam Smith himself emphasized.[35]

In a wider sense, entitlement theory logically raises the questions of who defines public needs, who is to pay for their provision and who is to control their distribution. In the past these may have been based on traditional social arrangements, but the spread of markets has involved "modern" legal systems and the shift of entitlements from collective institutions to private resource-based access. Indeed, "where entitlement structure changes from institution-based to direct resource-based entitlement, processes of marginalization of the weaker members of the community are likely to take place".[36]

Present Western European entitlements to health, education, housing, subsistence incomes and so on were generally established **after** industrialization, when the labour force had become fully integrated to the modern economy and economic surplus was sufficient to finance comprehensive welfare services. Moreover, although access to state-arranged entitlement is essentially subsidiary in nature, in democratic societies people usually prefer **primary entitlement** in the sense that they have access to resources and rights to goods and

[34] Dreze and Sen (1989).
[35] Deane (1989).
[36] de Gaay Fortman (1990: 16).

services on the basis of their integration into the community rather than as compensation for vulnerability brought about by their dis-integration.[37] In the semi-industrialized countries of Asia and Latin America, the existence of what is in effect a "dual economy"[38] means that reasonable wages and social security can still be limited to the minority of the population integrated into the modern sector. Where "populist" governments have extended these entitlements to the whole citizenry (or even to all urban dwellers), one of the main objectives of orthodox adjustment policy is to reduce this form of access by liberalizing the labour market and replacing social entitlement by discretionary "targeting" of relief to specific target groups.[39]

Broadly speaking, pre-reform Eastern Europe had abandoned resource-based entitlement in the sense of property or wages as such providing access to goods and services. Rather, a good deal of access was based on **employment** in particular sectors of the state and **citizenship** in the sense of participation in territorial networks of food distribution, social services and so on. There did exist a widespread incidence of corruption, of course, but entitlements were largely constituted in law. Wages had in fact ceased to have much incentive effect precisely because money incomes were not matched by an adequate supply of consumer goods, the main objective of employment being access to facilities provided by the workplace.

As was indicated above, about one-third of the labour force is presently located in industry – of which potentially up to a half is to be "shaken out" in the reform programme. This shake out would allow effective labour productivity to rise because of chronic overmanning in state enterprises (arising both from the influence of local politicians on management in a planned system and from the household strategy of maintaining family access to workplace services even if other income opportunities arise) and fear of unemployment on the part of the remaining workforce. The possibility of absorption into agriculture is of course limited: on the contrary, liberalization of labour and housing markets is already leading to migration toward urban areas. The low proportion of the workforce in the service sector offers an obvious prospect of absorption, but in differentiated forms. One the one hand, the government sector itself will presumably reduce employment, and while modern services such as banking will undoubtedly expand, this will generate a demand for younger skilled white-collar workers and thus is unlikely to adsorb the blue-collar workers and older bureaucrats "shaken out" by the reforms. The major employment prospect is in the informal service and commercial sectors ranging from construction and transport to shops and restaurants. However, such small-scale firms, with little capital or technology, will see their present high incomes reduced as scarcity rents are eliminated and will not be able to offer high wages or tax and social security contributions.

Wages in Eastern Europe are low by EEC standards in terms of modern consumer goods, and although underpinned by cheap wage-goods[40] – as Kalecki (1986) points out, they are probably of the order of one-fourth of EEC levels. At present wage scales are still extremely compressed and set centrally according to formal skill definitions rather than labour market considerations or plant level productivity.[41] The potential for increasing wage differentials to encourage productivity is limited, however, by low absolute productivity levels on the one hand, and the combined upward pressure from the demonstration effect of European wages

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[37] de Swaan (1990).
[38] FitzGerald (1979).
[39] World Bank (1990). Of course, this approach is not confined to the Third World, having been in vogue in the United Kingdom and in the United States during the 1980s.
[40] Kalecki (1986).
[41] In a market economy, from the point of view of employers, labour costs do reflect the cost of labour (as a charge against potential profits) but this is not so in a planned economy where wages are set centrally (according to skills) and the budget provides for agreed production levels with prices set as a mark-up on costs.

and the need to avoid absolute poverty on the other. For example, if one-fourth of the EE workforce is to receive one-half of the EEC earnings level, then the remaining three-fourths can only get one-sixth of that level; and even this would require a specific set of prices for the non-traded sector in order to provide the necessary intersectoral subsidy. A similar problematic occurs in the market relationship between large and small firms.[42]

In Eastern Europe, a comprehensive welfare system was established in the immediate post-War period as an explicitly social objective in its own right (and became the major source of régime legitimization for some time) including not only universal health and education but also housing, transport and food subsidies. Despite the failure to provide these basic needs at adequate levels of quantity and quality, and the undoubted discrimination in access (i.e. through Party membership), they were legal entitlements of all citizens – along with the constitutional right to employment. However, welfare provision was highly dependent upon facilities supplied at the workplace (particularly government departments, military establishments, state enterprises and large co-operatives), and in the early reform period as other income opportunities open up, these may be the main reason for households to keep a family member in the formal sector. As these workplaces become more autonomous, shed labour or even close down, the basis of much welfare provision (i.e. the former entitlement system) will inevitably collapse, and have to be replaced by a modern and comprehensive government system organized by the central or local authorities. In view of deteriorating welfare quality standards in the 1970s and 1980s, a considerable commitment to both recapitalization and subsequent operation is required which cannot be met from social security quotas (particularly for the old and unemployed) and which probably implies a fiscal commitment disproportionate to the existing level of national production.

The gender issue in Eastern Europe[43] is symptomatic of this entitlement problem. Women were integrated through employment but are not empowered in their own right: the absence of independent women's movements in the past made it difficult for these governments to change direction in response to the consequences of economic policies for women, or to the emergence of new needs. Women's material welfare undoubtedly improved in terms of health and education, but the low priority given to housing, home appliances, retail commerce, etc., did not reduce the burden of the "double day", particularly since in the private sphere pre-communist values and roles persisted. The economic reform process might well improve women's situation in terms of housing and queues but has already markedly increased the vulnerability of widows and single mothers who do not command commercial labour power. The political space for independent women's movements clearly exists, but so does that for a return to traditionalist family values.

The skilled population, integrated into the organized productive system and enjoying reasonable welfare levels, constitutes a clear advantage in the process of rapid re-industrialization, particularly in the medium-term; but by the same token it may be seen as constituting the basis for two distinct projects. The first is the "state-led" project outlined above, which (not for the first time) attempts forced modernization "from above" and appears to be led by a younger generation of technocrats counting upon support from abroad and from the eventual beneficiaries of the reforms themselves. The second might be seen as a project to establish the entitlement of all members of society to a minimal standard of living (defined in terms of Western European standards of essential consumption and social services) derived from their status **as citizens**, to be derived from both their own "resources" (particularly adequately waged employment) and public action. As Sen himself points out "...public action involves a great deal more than activities of the state. This is partly because the public can do a great deal more for itself even without governmental assistance, but also because the nature

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[42] FitzGerald, 1988.
[43] Wolchik and Meyers (1985).

of governmental policy can depend very extensively on the nature of public activism, including articulated demands and criticism".[44]

This kind of "public activism" need not only be expressed through political discourse. In particular the private sector in an open economy has considerable capacity to counter official policy by its own decisions on the disposition of the resources of firms and households.[45] On the one hand, the opportunities presented to firms and households by administrative liberalization for tax evasion (especially in the informal sector) and by currency convertibility for capital flight (including domestic hoarding) can make fiscal and monetary stabilization very difficult to achieve. On the other hand, labour itself can be withdrawn from the formal sector in response to low wages (either explicitly or implicitly through absenteeism, etc.), or in the last resort westward migration could remove the younger skilled segment of the workforce required for re-industrialization.

Within this oversimplified dichotomy, there are of course other social conflicts over the allocation of economic resources, such as those between bureaucrats and entrepreneurs, or between urban consumers and rural co-operatives. These will be expressed as views on economic policy reflected in the political system, either through electoral choice between parties or through direct mechanisms for the representation of interest groups. All these pressures inevitably reduce the relative autonomy of the reformist state to implement economic strategy, particularly after the "vacuum" brought about by régime collapse is gradually filled by an emerging civil society.

4. Some Conclusions

The argument presented above is clearly oversimplified and highly tentative, being intended to stimulate debate about the best way to design research into the relationship between economic reform and civil society in Eastern Europe rather than to propose alternative adjustment policies. These concluding remarks attempt to summarize and qualify the paper and to draw out some of the implications of the argument put forward.

The dismantling of the state enterprise sector in Eastern Europe is clearly a necessary condition for moving toward Western European productivity levels over the next two decades, while financial restraint and trade liberalization are also necessary in order to create the necessary market conditions for emerging private enterprise to be efficient. However, the initial optimism of many governments and much of the populace that rapid privatization combined with orthodox structural adjustment policies would somehow rapidly transform not only economic behaviour but also labour productivity in the short-run is already fading. Eastern Europe is **not** the Third World: indeed, a reading of the experience of structural adjustment in the NICs quite different from that of the Bretton Woods institutions is possible. A competitive export sector and productive private investment is clearly necessary for advanced industrialization, but so also are a high-quality labour force, credible macro-economic policy, sustainable micro-economic rules and appropriate public sector support.

The belief that "reforms" based on privatization, low wages and budget cuts alone could lead to a rapid transition from industrially backward socialism to industrially advanced capitalism in a few years was always an illusion. The enormous gap between productivity levels in Western and Eastern Europe locates the latter in a state of relative underdevelopment and requires a long period of directed industrialization to catch up – not central planning, of course, but rather the sort of strategy pursued by Japan, South Korea and Brazil. Although EEEs have a much more educated labour force than the MICs, and thus a greater capacity to

[44] Dreze and Sen (1989: 276).
[45] The emergence of this phenomenon in developing countries as a form of "informal survival strategy" during economic crisis is discussed in Ghai (1991).

adsorb technology,[46] massive investment is necessary to embody this technology – in a situation where the claims of the workforce on resources for both private and public consumption levels comparable with Western Europe are equally pressing and cannot be simply dismissed as “populism”.

The resolution of this problem is not only crucial for economic policy but also for the legitimization of the post-Communist state and thus the continuation of the reform process itself. Appeals to “realism”, “belt tightening”, “national sacrifice” and so on do not really face the central issue, which is need for an explicit social contract between management, labour and the state (Kornai, 1990). The establishment of clear entitlements that this implies, however, may well imply the social planning of basic needs provision and will certainly require considerable budgetary support from Western Europe during the transition period – and thus implies the recognition of a wider concept of European citizenship itself.

[46] However, some NICs are already much more advanced than Eastern Europe in specific industrial branches (including telecommunications, informatics, biotechnology, etc.), having absorbed foreign technologies earlier and developed their own research and export capacity, than Eastern Europe. Examples are Brazil, South Korea and Mexico on the one hand, and Taiwan, Singapore, Hong Kong and Turkey on the other.

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