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Transitional Economics

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Labor Market Adjustment in Transitional Economies

EXECUTIVE SUMMARY

This paper outlines the principal labor market developments in the transitional (formerly centrally planned) economies, presents a framework for conceptualizing the functioning of these markets and draws conclusions with respect to public policy in the labor market. It assesses the effect of transition on wages, employment, and trade unions. The paper observes that although wage controls played an important role in stabilizing these economies, they also maintained and aggravated major distortions. The paper recommends the imposition of hard budget constraints and proposes that profitable enterprises in the business of producing tradables be permitted to set their own wages. With rapidly rising unemployment, the reallocation of redundant labor requires immediate attention. The paper argues that social — rather than private — welfare criteria should guide the behavior of state enterprises. Finally, trade unions and other employee institutions have not been involved in the formulation and implementation of market-oriented reforms. Although they have been amenable so far, the danger is that mounting job losses and economic hardship could turn these organizations into formidable adversaries of the transition process.

Labor Market Adjustment in Transitional Economies

As the economic transformation of the formerly communist countries unfolds, it is becoming increasingly evident that managing macroeconomic stabilization is far simpler than achieving an adequate microeconomic transformation. Poland, Hungary, and Czechoslovakia, for example, managed to bring inflation down to less than 2% A MONTH within a few months of the start of the transformation program (Bruno 1992), but they have so far failed to commercialize state-owned enterprises (SOEs) and only Czechoslovakia is carrying out large-scale privatization. Since evidence from the developing countries suggests that macroeconomic stabilization tends to unravel in the presence of inadequate microeconomic restructuring (Kiguel and Liviatan 1991), the early successes of the transitional economies may be misleading.

An understanding of labor markets provides important insights into how economies operate, how their enterprises function and how governments formulate microeconomic policies. This paper assesses the development in the labor markets of the transitional economies, uses stylized facts to conceptualize the behavior of the main kinds of firms, and draws conclusions about public policies vis-a-vis the labor markets.

1. Features of the Labor Market

The formerly centrally planned economies have all embarked on the transition to free markets with a common set of labor market characteristics: zero open unemployment and visible excess demand for labor; a relatively low level and rate of growth of absolute wages; small wage differentials across most skills and industries; significant quit rates but low geographic mobility; virtually 100% membership in the official Communist trade unions; and the introduction of

worker participation in enterprise management.

The system of soft budget constraints for SOEs, the shortages and unpredictable deliveries of material inputs, and the penalties incurred by managers and workers for underfulfillment of plan targets made it rational for firms to hoard labor. This system led to full employment together with parallel vacancies and redundant labor. Marginal productivity of labor was low or zero (see Terrell 1992), work effort was generally low, and yet firms continuously advertized vacancies.

The system functioned because the authorities maintained absolute wages at a low level. Workers tolerated the system because it seemed egalitarian (wage differentials were small) and because it was promulgated and supervised by trade unions in a totalitarian system. The strength of the labor unions can be attributed to their affiliation with the communist party apparatus (Windmuller 1971). Members enjoyed special bonuses in the form of vouchers for vacations at recreational facilities and spas, subsidized purchases of consumer durables, and so on (Freeman 1992).

The full employment-*cum*-vacancies system resulted in significant labor turnover because workers could advance somewhat by changing employers (Riveros 1990). Regional labor mobility was minimal, however, in large part because housing was under strict rent control and hence in short supply.

In the 1980s, Poland, Hungary, and Czechoslovakia gave employees participatory rights in the selection of management. These rights were not as extensive as those enjoyed by the workers in Yugoslavia, and under the Communist regime participation was more *de jure* than *de facto*. As a result, attempts to spur productivity by involving workers in the production

process were by and large ineffectual. Enterprise (workers') councils were staffed mostly by party members, and influence over the nomination and recall of enterprise directors was limited.

A natural outcome of the system was a low-wage, low-effort equilibrium in the public sector and a marketlike behavior in the informal (private) sector. The private sector gradually became more important as the communist party began to lose control, and workers in state-owned enterprises increasingly engaged in informal — and sometimes illegal — activities.

The quality of the labor force in Central and Eastern Europe (especially Czechoslovakia, Hungary, and Poland) is relatively high: the proportion of the labor force with more than a basic education is comparable with that in the average member country of the Organization for Economic Cooperation and Development (OECD), (Boeri and Keese 1992). In higher education, the transitional economies do not rank as well, but they usually dominate some of the OECD countries. The type of education also differs; a higher proportion of secondary school students attend vocational schools, and the proportion of higher-level students in the field of engineering tends to be greater. Data on enrollment rates in secondary and postsecondary schools indicate that Central and Eastern Europe lags the West in the educational level of recent labor force entrants. Finally, perhaps the most important question is to what extent are the skills acquired by Central and East Europeans obsolete, and how much retraining is necessary to renew their human capital?

2. Transitional Labor Market Policies and Shocks

In all the transitional economies, independent trade unions, collective bargaining and the right to strike are now legal. Pattern bargaining takes place at the level of a tripartite

decisionmaking apparatus made up of trade union (con)federations, government representatives, and employer federations, but additional earnings adjustments take place at the company level.

While comprehensive price liberalization has been one of the pillars of the transformation, every country has imposed wage controls to prevent high (hyper-) inflation. These incomes policies have taken various forms. Poland, for instance, established an enterprise wage indexation scheme in 1990 that compensated in part for expected inflation. Any increase in the growth of the wage bill above the benchmark level was penalized by a prohibitive 500% tax. In 1991 the scheme was targeted to the average wage to minimize a potentially negative impact on employment. The government of Czechoslovakia established a similar, although graduated, tax scheme targeted to the average wage in 1991, forgot to renew it in the first half of 1992, and reimposed it in July of that year. In recent years Hungary, where wage controls have been in effect since the 1980s, has not taxed — or has taxed only lightly — wage increases if they correspond to increases in value added. Moreover, since 1991 tax levied on wages decreased in parallel with a decrease in the firm's employment, thus encouraging firms to lay off redundant workers.

Layoffs are now legal, as are short hours and part-time employment. Unemployment benefit schemes and active labor market policies have been introduced to cope with rapidly rising unemployment. Initially, these compensation schemes were relatively generous and provided workers with more than 60 percent of their previous wage for up to a year. Recently, budgetary problems and rising unemployment have forced Czechoslovakia and Poland to scale down these generous benefits and reduce the eligibility period (Boeri and Keese 1992). Other countries may have to follow.

A number of other policies as well as external shocks have altered labor demand and the operation of labor markets. Subsidies to enterprises have been cut substantially — as have commodity subsidies — making it difficult for firms to maintain employment and wages at previous levels. In some countries retroactive increases in interest rates on existing bank loans had the same effect. The dissolution of the Council for Mutual Economic Assistance (CMEA) and the collapse of the Soviet market led to a decline in regional trade and negative terms of trade shocks as transactions shifted from transferable rubles to convertible currencies. Rodrik (1992), for instance, estimates that the total 1990-91 Soviet trade shock amounted to a loss of 7-8% of gross domestic product (GDP) for Czechoslovakia and Hungary and 3.5% of GDP for Poland. Because theses calculations are conservative (they do not include, for instance, the multiplier effect), they probably understate the external shock.

3. Principal Labor Market Outcomes

Table 1 contains comparative data on output, employment, and real wages for 1989, 1990, and 1991. In Hungary, where a gradual transition began earlier (Dervis and Condon 1992), the decline in employment and wages that could in part be attributed to external shocks and transition policies has been milder than in other economies. Poland's rather sudden transition in January 1990 resulted in a rapid decline in output, real wages, and (to a lesser extent) employment. Output fell in 1990 in Bulgaria and Romania as well — a reflection of the collapse of the CMEA market — but in both countries, and in Czechoslovakia, the principal shock occurred in 1991, when they had launched their economic strategies and were coping with the

Table 1
Production, Employment, Wages, and Unemployment
in Selected Transitional Economies

Country	Industrial Production (% change)	Annual Change in Employment (%)	Real Earnings[a] (% change)	Unemployment Rate (year-end)
Bulgaria				
1989	-1.1	0.2	2.3	-
1990	-16.8	-8.2	-2.8	1.5
1991	-27.5	-17.1	-33.8	10.5
Czechoslovakia				
1989	0.7	0.3	1.0	--
1990	-3.7	-2.5	12.5	1.0
1991	-23.0	-12.0	-26.0	6.0
Hungary				
1989	-1.0[b]	-4.0	0.9	0.5
1990	-9.0[b]	-11.3	-5.1	2.0
1991	-21.5[b]	-16.5	-5.8	8.0
Poland				
1989	-0.5	-1.4	--	--
1990	-24.2	-8.9	-37.2	6.3
1991	-14.2	-12.6	-8.4	11.4
Romania				
1989	-6.6	1.9	2.4	--
1990	-19.2	-1.3	4.6	1.0
1991	-13.0	-18.7	-24.9	2.2

-- Nonexistent.
[a] Real earnings for Bulgaria and Czechoslovakia; real wages for Hungary, Poland, Romania.
[b] Firms with fifty or more employees.
Source: Various government and World Bank data.

terms of trade shock associated with the shift of CMEA trade into convertible currencies.

A closer examination of the data in Table 1 and of more disaggregated figures reveals a number of regularities. First, the decline in output at the start of the transition tends to be deep and fairly (though not completely) uniform, signaling a shock rather than intersectoral restructuring. Furthermore, the decline in employment is significant, especially when one considers not only the decrease in the number of employees but also the decline in hours worked. In Czechoslovakia, for instance, the average number of hours worked declined from

1,859 in 1989 to 1,817 in 1990 and 1,724 in 1991. With the possible exception of Hungary, however, cuts in employment have not matched reductions in output, and labor redundancy, which was estimated to range from 15 to 25 percent of the work force before the transition (Jackman, Layard, and Nickell 1992), has increased.

The fall in real wages has been comparable to the steepest declines recorded in the developing economies during stabilization and structural adjustment. In Poland the decline was in part offset by the real wage gains recorded in preceding years, but in Czechoslovakia and Bulgaria real wages fell from a relatively low base. The wage differentials between Eastern and Western Europe have thus grown dramatically. Recent estimates, for instance, indicate that Volkswagen's hourly cost for production workers is more than DM 50 in Germany, DM 25 in Spain, and DM 8 in Czechoslovakia. Yet, the efficiency of the Czech and Spanish plants is reportedly comparable.

Unemployment, which was unknown outside of Hungary before 1989, emerged in 1990 and has risen rapidly. By the end of 1991, unemployment in Bulgaria, Poland, and Slovakia exceeded 10% of the labor force. In some countries (for example, Czechoslovakia) the unemployment rate fell in 1992, but much of the change was the result of a decreased eligibility for unemployment benefits.

There is no doubt that in an important way labor has borne the brunt of the early stages of transition. From the policy standpoint the interesting question is why there has been a more moderate decline in employment than in output and wages in most of these economies. There are several possible explanations. One, of course, is the tremendous decline in real wages that is documented in the table. With labor cost shrinking to between 5-10% of total cost, managers

have focused on economizing in other areas (energy, for example) and have tended to substitute labor for other inputs. Another reason is that managers, workers, and government officials view the maintenance of employment as an important goal during transition. Indeed, such behavior is consistent with the pursuit of rational objectives by state-owned enterprises, taking into account the falling shadow wage in the economy (Svejnar and Terrell 1991), the expected utility maximization by workers, and the cost-minimizing behavior of managers in the presence of costs of labor adjustment.

Private Firms vs. State-Owned Enterprises

Unlike state-owned enterprises, domestic and foreign private firms and joint ventures appear to economize on employment. They also pay considerably higher wages and elicit greater effort and quality of work from their employees. The private sector thus behaves consistently with profit maximization and possibly pays efficiency wages to generate higher effort. Stabilization policies severely constrain the ability of state-owned enterprises to pursue an active wage policy and stimulate their employees to exert greater effort. They are increasingly victims of brain drain as the best workers in all skill and occupational categories leave for the private sector. Unfortunately, although the private sector has expanded in all the countries in this group, it is still too small, and the inflow of Western capital has been too limited, to offset the decline of state-owned enterprises.

The evidence emerging from the transitional economies points to a number of common patterns. The enterprise sector includes private firms that behave consistently with profit maximization and state-owned enterprises that emphasize employment and try to evade hard

budget constraints. Unless bound by prior agreement with the government, Western firms that acquire local enterprises tend to slash employment; they usually employ a small labor force, frequently on short-term contracts. State enterprises, in contrast, maintain a large work force even in the face of sharp declines in demand. This situation is only tolerable because of declining labor costs and subsidies from the government (or the ability to increase the enterprise's indebtedness). The state-owned firms are releasing excess labor, albeit at a rate that is much slower than a rapid adjustment to a profit-maximizing level would dictate, and the private firms are absorbing the released workers and the new entrants to the labor force. The main problem is that in the early phases of transition, the private sector is too small to absorb all the workers who have been released by state-owned firms. The result is a gradually emerging and growing unemployment.

Unions, Wages, and Employment

The artificial 100% unionization rates characteristic of the former Communist economies have vanished, and membership is now estimated at between 30 and 75 percent (Freeman 1992). Surprisingly, however, most workers have opted to remain in the old unions rather than join new independent trade unions, apparently because of the advantages of incumbency. The old unions responded to the challenge posed by transition reforms by expelling the Communist leadership, taking control of the unions' (considerable) resources, and effectively representing their members in the workplace. The new unions face major disadvantages: limited financial resources; inadequate staff; and, frequently, an intellectual, rather than a blue-collar, orientation (Freeman

1992). The fragmentation of the union movement and the questionable legitimacy of the successor unions has enabled governments in most of the countries in transition to dominate the tripartite deliberations and reduce the unions to consultative — rather than bargaining — partners in wage settlements. The unions are, however, reported to be gaining influence within firms, where decisions about employment, layoffs, and wage increases are made.

The behavior of wages during the Polish (1990) and Czechoslovak (1991) big bang provides an instructive pattern. The nominal wage increases observed in the first six months of 1990 in Poland and the first six months of 1991 in Czechoslovakia fell well below the wage (control) norm, although real earnings declined dramatically in both countries (see Table 1). In the second six months of the transition (July to December 1990 in Poland and July to December 1991 in Czechoslovakia) wages started to catch up with the norm in both countries. In the second year average wages in Poland substantially exceeded the norm, and enterprises paid the stiff penalty tax.

These developments are interesting because they reveal a different approach to wages and employment at the national and enterprise levels. At the national level the decision to set the wage well below actual inflation reflected an underestimation of future inflation, an attempt to achieve price stability, and the desire of the social partners (especially government) to limit the negative impact of the transition on employment. Within the firm, the initial, (below-norm) wage increase reflected the desire of trade unions, management, and workers to limit layoffs in a period of uncertainty and existential anxiety. Nevertheless, when real wages fell precipitously and it became clear that reductions in employment could in large part be accomplished through attrition, hiring freezes, and the termination of fixed-term contracts, unions and workers pushed

for higher wages. The wage norm hence seems to be unsustainable in the medium term in the presence of a sharp decline in real wages.

Worker Participation in Management

Employee participation in management — and profits — is controversial and has been criticized by government officials and external advisors. Indeed, some observers (see Hinds 1991) have argued that the poor economic performance of Poland, Hungary, and Yugoslavia in the late 1980s reflected the strong control exerted by employees in these economies.

The potential abuse of power by workers inside the firms should not be underestimated. But economic theory and empirical evidence do not support such a negative view of participation. Economic theory on participatory and unionized firms indicates that in a competitive environment these firms do not behave very differently from their profit-maximizing counterparts. Moreover, under conditions of redundant labor, participatory and unionized firms tend to allocate labor by the same criteria as profit-maximizing firms even in the presence of extranormal profits or rents. Econometric evidence also indicates that the economic effects of these schemes are nonnegative (see the surveys in Blinder 1990).

More casually, economic performance worsened not just in the socialist economies that introduced participation (Poland, Hungary, and Yugoslavia), but also in those that did not — Czechoslovakia, the former Germany Democratic Republic (GDR), and the former U.S.S.R. Moreover, neighboring capitalist economies (Austria and the Federal Republic of Germany) fared well in the postwar period, with significant worker participation in management. The former GDR adopted codetermination after German unification with no obvious ill effects. And

a recent study by Prasnikar and Svejnar (1991) found that government intervention, a lack of competition, and the absence of clearly defined property rights — rather than employee participation *per se* — appeared to be the principal shortcomings of Yugoslavia's economic system.

The Social Safety Net

As noted above, fiscal problems have already forced Czechoslovakia and Poland to reduce the level and duration of unemployment benefits, and other governments are likely to follow. The ability to sustain social safety nets will become increasingly limited. Active labor market policies, including training schemes, public works programs, and subsidies for new employment have been introduced, but so far they account for only a small proportion of total labor market expenditures and do not appear to be very effective. As the financing of unemployment compensation becomes a growing priority, these policies may become marginalized.

4. Policy Implications

A relevant model of the labor market behavior of enterprises in transition can be cast in the form of a tripartite bargaining framework in which the government, managers, and workers jointly maximize an objective function that contains profit, wages, and employment (see Svejnar 1986; Prasnikar, Svejnar, Mihaljek, and Prasnikar 1991). As the transition proceeds, the weight that the three parties place on employment gradually falls, while the emphasis placed on profitability and wage growth rises. Figure 1 (see p. 17) depicts in a simple way the variety of wage and employment outcomes that can be observed in the transitional economies. Let R_L be

the marginal revenue product of labor, W the wage, and curves I, II, and III the isoprofit curves (all wage-employment combinations on a given isoprofit curve yielding the same level of profit; the higher the curve, the lower the profit). A labor market outcome corresponding to the private (profit- maximizing) firm is, for instance, $R_L = W$, depicted by point A in the Figure. Now, most enterprises started the transition with redundant labor, thus implicitly placing emphasis on employment and displaying $R_L < W$. In the Figure this means that the outcome is to the right of the marginal revenue product curve of labor at a point such as B. Because the pretransition situation was often characterized by subsidies (negative profits), the outcome is depicted in the Figure as lying relatively high in the northeast — lying on a low- (possibly negative) profit isoprofit curve and displaying relatively high wages and employment. The transition and the negative external shocks shift the marginal product curve to the left as demand falls, and they also result in a reduction in subsidies to the SOEs. This effect is captured in the Figure as a move to point C above the new marginal revenue product curve R_L'. The outcome is characterized by somewhat lower employment, significantly lower wages, and greater labor redundancy (more labor with low or zero marginal product). In the later phase of the transition one then observes a rise in wages and a further decline in employment (that is, a shift from C to D and later to E). The characterization of the transition in terms of enterprise employment and wage behavior hence consists of the accumulation and reduction of redundant labor and the absorption of the released labor by the emerging private firms.

From the standpoint of economic efficiency, a fundamental question that arises with respect to the transition policies is whether the wage (bill) controls (norm) ought to be maintained. The principal justification of the norm is that it induces price stability and prevents workers from

according themselves unwarranted wage increases and thus decapitalizing state-owned firms. The disadvantage of the norm is that it maintains much of the previous distortion and prevents the transforming economies from overcoming low effort and poor workmanship by a skilled and relatively well-educated labor force.

Since the transitional economies in Central and Eastern Europe are resource poor, the negative incentives imposed on the human factor are a major hindrance to a successful transition. This latter aspect appears so important in the context of the transforming economies that one ought to think seriously about alternative measures. Since the economies are now relatively open to trade, one possible scheme would be to allow the state-owned firms in the tradable goods sector to pay profit-sharing bonuses if they are able to (a) operate without subsidies, (b) reinvest a given proportion of capital and (c) pay the government a set real rate of return. A scheme of this kind retains the incentive for the firm to increase productivity, improve marketing, maintain prices at the world market levels, and reward key employees. Incentive schemes for managers (and possibly workers) should also be based on the company's successful long-term performance (for example, shares of stock that are nonredeemable for a number of years).

The second policy issue concerns the optimal approach to redundant labor. Measures encouraging labor mobility are clearly desirable. One often observes, however, an exclusive emphasis on reallocating resources and closing unprofitable operations. Far less attention is paid to increasing the efficiency of resources, given their allocation. In particular, the question arises as to whether resources ought to be reallocated to a massive extent in the short run. For instance, it is not clear how many workers would be employed in Czechoslovakia's steel industry under perfectly competitive conditions. Their productivity may be low, but as the earlier

discussion indicates, it is low elsewhere as well. It may not have made sense to develop the steel industry to begin with, but with a limited inflow of Western capital in the short run, the relevant issue is how to use labor optimally, given the existing capital structure. To the extent that governments maximize a social welfare objective such as GNP, the state-owned enterprises ought to employ labor to the point where labor's marginal product equals the shadow wage (productivity of the marginal employee elsewhere in the economy) rather than the actual wage. This makes it optimal from society's standpoint to maintain higher employment levels in state-owned firms than would be dictated by the profit-maximizing criterion alone because the total product of these firms cannot be increased by reallocating labor among them. By implication, as long as actual wages exceed shadow wages, too few workers are employed by private firms from society's perspective. Finally, in deciding to close unprofitable enterprises, it is important to take into account the fact that the profitability of a firm may not be indicative of its efficiency unless it is evaluated at shadow prices and wages. (For a detailed discussion of these issues see Svejnar and Terrell 1991.)

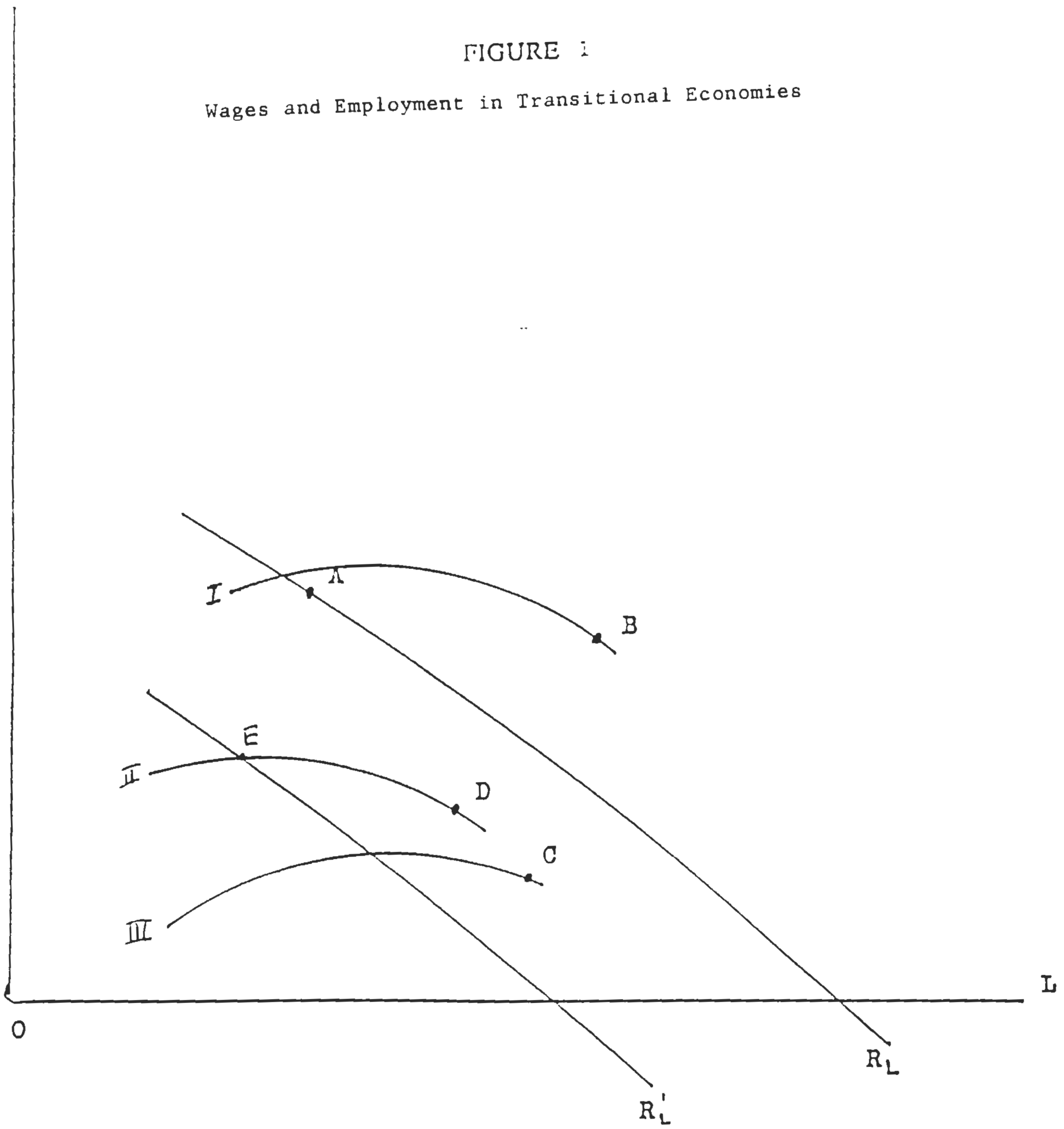
My third point concerns the role of trade unions and the industrial relations system. The early successes of the transition have come in part from the weakness of the unions and their tolerance of stabilization measures. Some governments have effectively ignored the unions and have pushed through labor market measures without "codetermination" under the framework of the established social partnership. This approach is effective in the short term and, if unionization does not take off in a major way, it will work in the long term as well. The approach may backfire, however, if unions become stronger and workers become less tolerant of the transition measures. Since transition promises to be a protracted and painful process, it

is likely that workers will sooner or later start questioning the merits of the transition program. The trade unions, which have in many cases been channeling membership dues and significant income from property rentals to the strike funds, may become powerful adversaries. With private employers and governments likely to be relatively weak, the entire transition process could be endangered. A more cooperative approach to industrial relations from the very start of the reform may hence be a superior strategy. Note that there are obvious advantages to a participatory rather than an adversarial system; participation has historically worked well in Austria and the Federal Republic of Germany. Workers' councils or similar mechanisms emerged spontaneously in Central Europe whenever central controls were lifted (after World War II, as well as during the Communist era) in the former GDR and Poland in 1953, in Hungary in 1956, in Czechoslovakia in 1968, and in Hungary and Poland in the 1980s.

Finally, unemployment has been growing rapidly and is likely to become an increasingly divisive social and economic problem. With fiscal problems worsening over time, this aspect of the labor market will require special attention.

FIGURE 1

Wages and Employment in Transitional Economies



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