Social Aspects of Industrial Restructuring and their Financing*

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Background Paper
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Abstract
The paper starts by outlining some basic definitions and conceptions of restructuring, noting that in transition economies the needed scale of restructuring is substantial, with the result that unemployment, and the associated social costs, can turn out to be very high unless the process of change is well managed. In what follows, I clarify what is meant by the social aspects of restructuring and give some examples to illustrate why dealing with them might be difficult. Then we examine the financial outlays associated with the identified social costs and consider various views of who should pay for them. Next, we highlight some key trade-offs in the restructuring process, starting from the observation that many countries, not exclusively, but especially countries from the CIS, have bowed to political pressures and allowed restructuring to be delayed, ostensibly for social reasons. While acknowledging that this is an appealing line of argument, I shall argue that in the longer term it is exceptionally costly. The argument continues by identifying a few aspects of restructuring that seem to me to be unusually problematic for transition economies, especially for those that are not on track to join the EU in May 2004. These aspects include the special problems faced by small states, and those faced by rapidly declining regions within larger states. We conclude with a list of major findings about the social aspects of restructuring and their financing, plus a short list of suggested policy recommendations.

JEL Classification: J65, L52, P31

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1. Introduction

1.1 Basic Definitions
At the national (or economy-wide) level, restructuring refers to the process whereby the shares of certain sectors in GDP, employment, exports, etc., increase, while the shares of other sectors fall. Such restructuring can be stimulated either from the demand side - such as the usual changes in the pattern of demand that accompany increases in per capita income; or from the supply side - due to large changes in cost structure (e.g. impact of energy price increases) or significant changes in key technologies (development of plastics, development of electronics).

In most of the former socialist countries embarking on transition, there is an additional factor underlying the need for extensive, national-level restructuring, which can be summed up in the term, initial conditions. What this signifies is the presence of many firms and branches developed under the socialist planning system which, for diverse reasons, suddenly became uneconomic once the early stages of transition brought about substantial price and market liberalization, together with massive changes in the international trading environment. These troubled sectors might sometimes be in heavy industry, or in other sectors where location decisions were not soundly based, or where technologies and/or markets have moved on. For some countries, how to deal with branches facing such difficult conditions is perhaps the greatest challenge of the whole transition process, one that is politically highly sensitive.

In a normally functioning economy, national level restructuring is going on all the time, regardless of government policies. However, as we shall see below, it is possible for deliberate policy intervention either to inhibit restructuring, or to accelerate it. In any case, what is special about transition economies in this context is the sheer scale of restructuring that needs to be undertaken in a relatively short period.

Sectoral restructuring occurs when, due to changes in the structure or level of demand, or changes in cost conditions, a sector of the economy finds itself producing the wrong mix of products, or producing the right products with the wrong technology. In that case, unprofitable products must quickly cease production or be modernised, new products have to be designed and
introduced, and the technology used to produce the better products must itself be modernised. Again, governments can intervene to assist or to inhibit such adjustments, or they can simply elect to provide a suitable environment of rules and incentives within which “normal” market forces can bring about any needed adjustment.

Regional restructuring refers to the somewhat parallel situation when a town, province or larger region finds itself in severe economic decline, usually due to an economic structure in which declining sectors/activities are significantly over-represented as compared with the national average economic structure. Russia, for instance, has many one-firm towns (e.g. Vorkuta - coal) for which problems in that one firm can spell economic and social disaster for the area concerned. In such circumstances, it is no help to know that elsewhere in the country, there might be other regions where new businesses are taking root, and where economic activity is increasing strongly. For the badly affected areas, the key questions are: (a) how to manage a process of decline; (b) how to find alternative, viable economic activities for the area or for the local people. As has been observed in several transition economies, restructuring at this level is unavoidably political, and again, extremely sensitive.

Enterprise-level restructuring is, of course, the key to everything, since whatever form of restructuring we care to discuss, what actually happens in the economy always takes place in individual enterprises. Taking a somewhat broader perspective than that often adopted in this field, and drawing on Hare (2001), restructuring at this level can be thought of as composed of three components:

1. The entry of new firms or the relative growth of high productivity firms;
2. The restructuring and re-organization of existing firms; and
3. Exit from the market by failing firms, or the decline of low productivity firms.

The balance between these components varies from country to country, and over time in any given country, but all are important. As far as new firms are concerned, for instance, it is vital to have high rates of entry since the experience of most countries is that up to 80 per cent of such firms fail within 3-5 years. Hence to find the successful firms of the future, the few that will become large enough to employ thousands of people, lots of entry is needed, accompanied by the rapid and orderly weeding out of those that cannot make money. Of course, many of these new firms will simply start small and survive by staying small, exploiting some local market niche to enable them to do so. In total, such small firms provide a large amount of employment in most developed economies as well as in the more successful transition economies. But in the less successful transition economies there are still far too few small businesses.

According to Roland (2000, p234), the restructuring of an existing firm can take defensive or strategic forms. The former refers to restructuring that involves cutting out loss-making activities, measures to cut costs, shedding some labour, and so on. These are, in essence, survival tactics for a business under pressure. In contrast, the latter - strategic restructuring - refers to much more forward-looking measures to re-shape the business by introducing new products, modernising production processes, identifying new markets, and the like. It requires substantial entrepreneurial expertise as well as access to technology and finance.
Sometimes restructuring is interpreted in purely financial terms, such as when governments or banks choose to write off some or all of the accumulated debt of an enterprise, or convert debt into equity, as part of a rescue plan. Such financial restructuring raises many practical difficulties that lie outside the scope of this paper, such as how to design schemes in such a way that the beneficiaries have strong incentives not to engage in further debt accumulation, but instead to undertake the needed real restructuring of their businesses. In practice, I would generally favour policies - both by banks and governments - that consistently and credibly harden the budget constraints faced by ailing enterprises, with financial rescue operations of the sort just referred to seen as an occasional, last resort option.

Last, restructuring is frequently perceived as an issue precisely because there is a widely held presumption that where it is needed, government intervention is called for. In a sense this is bound to be so, in that government policies and the legal/institutional framework established by governments determine the environment within which all firms must function. It is a more open question, though, whether and when more direct government intervention will be justified.

1.2 Outline of the Paper
The focus of the present Regional Forum is on social aspects of restructuring and their financing, in the light of the definitions just outlined. By “social aspects”, what we mean is the likelihood that industrial restructuring might result in many people losing their jobs in circumstances where new jobs are hard to find. In extreme cases, such job losses can devastate entire communities, and even in “more normal” situations what new jobs there are might be in different sectors. Hence one can envisage a variety of social costs in the wake of an initial restructuring “shock”, followed by the need for retraining/re-education, possibly some assistance to support labour mobility, measures to encourage faster rates of new business formation, and so on. All of these measures cost money, hence immediately raise questions about how large the costs might be, who ought to pay, and how.

Accordingly, the remainder of this paper will be structured as follows. Section 2 will clarify what is meant by the social aspects of restructuring and give some examples to illustrate why dealing with them might be difficult. Section 3 examines the financial outlays associated with the identified social costs and considers various views of who should pay for them. Taken together, these two sections therefore spell out the core agenda of the Regional Forum.

Section 4 highlights some key trade-offs in the restructuring process, starting from the observation that many countries, not exclusively, but especially countries from the CIS, have bowed to political pressures and allowed restructuring to be delayed, ostensibly for social reasons. While acknowledging that this is an appealing line of argument, I shall argue that in the longer term it is exceptionally costly. Section 5 continues the argument by identifying a few aspects of restructuring that seem to me to be unusually problematic for transition economies, especially for those that are not on track to join the EU in May 2004. These aspects include the special problems faced by small states, and those faced by rapidly declining regions within larger states. Section 6 concludes with a list of major findings about the social aspects of restructuring and their financing, plus a short list of suggested policy recommendations.
2. Social Aspects of Restructuring
Restructuring is rarely perceived as a serious social problem when there are lots of suitable alternative jobs available in the area concerned, or in circumstances where people can easily move elsewhere to find work, and are willing to do so. Hence to understand the social aspects of restructuring, it is crucial to be aware of the constraints that either limit local/regional job availability, or limit individual/family mobility to seek jobs available elsewhere. Suitable policies are then needed either to overcome these constraints, or to help people find ways around them. In addition, in promoting restructuring it is important to be sure that the problem has been analysed correctly, since otherwise the restructuring is likely to be done badly. It is often best to rely on market signals to provide the necessary guidance, but in such a case it is evidently vital that the prices are “right”, and that neither demand nor supply sides of the market in question face avoidable, artificial constraints.

Some examples will help us to identify the key constraints. The examples are all based on places and activities that I have either visited or studied extensively at various times.

Example 1. Coal in the Russian Far North
Harsh production (and living) conditions, the long distance from major coal users, and much higher freight charges than formerly make coal production in the Far North much less economic than it appeared to be in the past. Workers’ savings have been largely eliminated by inflation in the early 1990s and again after the 1997-8 financial crisis, hindering their mobility, and alternative local jobs are scarce. It is worth investigating whether current freight charges are economically well founded, though even so, deep-mined Vorkuta coal would still be in competition with surface-mined coal from more central regions of Russia (see Hare, 1998).

Example 2. Water and Energy in Central Asia
Upstream states have more water than they can use, but they can hold it behind dams and generate electricity or they can sell it to downstream states for irrigation, buying back electricity and other energy. In recent years, these transactions have been based on barter deals, using prices that are most likely not justified by the underlying cost structures. In the presence of such unreliable price signals, it is not clear whether downstream states should undertake less irrigation and/or whether upstream states should generate more electricity throughout the year. Hence there may well be a need for significant restructuring, but without better pricing the nature of the need cannot be identified correctly.

Example 3. Steel in Ukraine
This is an instance of a branch that faces a substantial decline in domestic demand as well as increasingly difficult international trading conditions, whether with the EU or with CIS partners. Traditionally, much production in Ukraine and the neighbouring countries was very steel-intensive, and steel production itself is energy intensive, too. The latter point implies that more rational energy pricing drastically affects the economics of steel production, most likely requiring, in the longer term, conversion of production to newer technologies that use energy more efficiently. Hence just as in Western Europe, the industry has to be down-sized sharply, with production most likely concentrated in as few as two or three large plants of economic size. In a case like this, the overall economics of restructuring might not be much affected by the designation of the particular plants that should survive, but it is wholly predictable that reaching the key restructuring decisions will be a strongly politicised process. Local communities will use what influence they can bring to bear in order to protect “their” steel plants. If there is a
restructuring option that makes the social costs of restructuring a bit lower than they might otherwise be, that might be a reason for choosing it; but in principle, such arguments should not be allowed to delay or halt the whole process.

**Example 4. Wine Production and Marketing in Moldova**

Much wine production was carried out through large, state-owned wineries, with a great deal of the resulting product exported to Russia and Ukraine. These exports are now very difficult due to higher transport and transit charges, problems with customs regulations and the like at border crossings (not excluding a degree of corruption). At the same time, exports to the EU face quantitative restrictions as well as technical problems to do with product quality, reliability of supply and so on. In other countries that produce wine successfully, most of the best wine is produced in small to medium vineyards, typically under family management and control, with sales and marketing often done on an area or regional basis. Hence for Moldovan wine to be successful in the future, one would have to envisage major restructuring to form a number of smaller vineyards (most needing significant technical modernisation), together with more centralised marketing, quality control and certification, bottling and labelling. This is complicated enough, but it will not succeed without far more assured access to markets than Moldova currently enjoys.

**Example 5. Real Estate Services in Tomsk, Russia**

The point of mentioning this is simply that such services barely exist - this is a sector that needs to grow substantially. In most of Russia outside the capital, Moscow, the housing market is barely functioning, with many people still unsure of their property rights, little mortgage finance available to support purchases, and few services available to help those wishing to buy and sell property. Many transactions occur through informal, personal connections, to the disadvantage of all parties. Real estate services are just one of many services needed to facilitate mobility in Russia. To enable such services to function there is a need for: (a) proper, professional training courses; (b) financial market development so that mortgage finance is available; (c) legal development so that people in default can be turned out of their houses (without such security, normal practice in developed OECD countries, lenders will never be willing to lend); (d) effective advertising through the local press and other media.

**Issues Identified through the Examples**

Some of the issues that were highlighted in the above short descriptions of restructuring might seem somewhat removed from the principal theme of the present UNECE/ILO Forum. However, I would argue that their neglect is likely to lead to some very bad restructuring decisions, probably imposing social costs that are unnecessarily high or that occur in the wrong places. Hence it is important to pay attention to these issues, and for ease of reference they are listed here:

1. **Getting the key prices right.** As examples above illustrated, restructuring decisions can easily be seriously wrong if key prices are not sensible. The basic principle should be that prices must cover costs and provide suppliers with an adequate profit, without any exceptions or special treatment for any customers (whether state-sector or private, and regardless of size and political influence). Prices should also be set and paid in monetary terms, not using barter or other non-monetary means of conducting transactions. Further, if businesses are to be kept alive for social policy reasons (and see below for more discussion on this point), it must be through direct and explicit subsidies, rather than
indirectly via price distortions. The basic principle in all this should be that of transparency.

Access to markets. The extent and nature of restructuring needed in a given industry or sector will depend on the extent of access to markets. If the industry/sector concerned only supplies the domestic market, then this entails the lifting of internal trade barriers (still rather widespread in large countries such as Russia, where a good deal of regional protection is still in place). If the products of the sector are internationally traded, then the same issue arises at that level. Formally, the CIS countries constitute a free trade area, but this can hardly be considered an operational reality. EU trade barriers are important in some sectors, including with countries with which the EU has established Partnership and Cooperation Agreements (PCAs), and local content rules in these agreements are often unnecessarily restrictive.

Assessing demand. It is often tempting to imagine that the domestic demand for the products of a given branch will pick up again following a sharp decline, or that exports will soon recover. Such arguments are frequently used to delay or stop restructuring, on the grounds that the existing capacity will shortly be “needed”. Unless exceptionally well founded on some serious analysis of the markets concerned, however, arguments like this are nearly always in the nature of wishful thinking, and should be strongly resisted.

Politicisation of restructuring. This is virtually unavoidable in practice. However, political resistance to needed changes should not normally be allowed to stop the whole process of restructuring; and sometimes, there might be a restructuring option that enables the social costs to be somewhat lower than they would otherwise be, and if there are no other counter-arguments, that would be a good reason for choosing it.

Development of services to households. The example of real estate services was used above, but it could equally have been employment services (incl. training, job information both locally and in other regions, recruitment, etc.) or business support services (e.g. information packs on how to set up a business, one-stop shops to make the process quick, easy and cheap, technical and financial advice connected with new businesses, etc.). In the absence of such services, major restructuring will prove to be much more costly than it needs to be. Both state (mostly local and regional levels of government) and private providers can play their part in delivering these vital services.

Suppose, now, that we have a situation where substantial restructuring is needed. What are the social costs associated with this process and how do they arise? There are, in fact, several possibilities, depending on the local circumstances. Given this, what follows will be clearer if I simply list some of the principal cases.

Case 1. Closure of a firm that provides many local services
This is very common, and has often been discussed under the heading of the “one-company town”. What it refers to is the fact that many firms in the former Soviet Union not only produced whatever product(s) they were set up to make, but also delivered such services as basic health care (through polyclinics and the like), housing for the workforce, recreation facilities, primary
schooling, kindergartens, and so on. In practice, local authorities did little but provide the street lighting!

Hence closing such a firm would give rise to three types of social cost: (a) the cost of redundancy compensation, when that applies; (b) the cost of subsequent income support and other types of support for those who become unemployed; and (c) the alternative cost of providing social services formerly supplied by the closing firm (and sometimes, this might mean the costs associated with simply withdrawing such services and not providing them at all).

**Case 2. Closure of a firm providing no local services**

This is much simpler than Case 1, since the social costs of closure are then just the type (a) and type (b) costs identified above.

**Case 3. Downsizing a firm to cut its cost base and make it more competitive in the market**

Under socialist conditions it is well known that many firms were grossly over-manned, in the sense that with better management, better organisation of the production processes, even firms operating with their existing technology could find ways to produce their output using many fewer workers. Many potentially sound firms, operating in the more competitive environment of a market-type economy, come under increasing pressure to cut back the workforce, or to downsize, to use the standard American euphemism for the process.

When they do so, the main restructuring costs are those associated with types (a) and (b), identified above.

**Case 4. The impact of restructuring on a region and/or sector**

When several large firms in an area, or several within an important sector, need to close or downsize within a fairly short period, additional social costs arise that extend beyond what we have considered so far. These are (d) the costs of assisting workers to migrate to other regions where jobs are more plentiful; (e) the costs of retraining workers to fit them for alternative occupations; and (f) the costs of encouraging new firms to move into a given area (incl. completely new starts and firms that choose - or can be persuaded - to relocate).

**Six types of social cost**

To sum up this section, therefore, we have identified six types of social cost likely to be associated with a substantial programme of industrial restructuring. These are:

(a) redundancy compensation  
(b) income support for the unemployed  
(c) provision of local public services  
(d) assistance to migrate  
(e) assistance with retraining  
(f) encouraging new businesses to start up.

Taken as a whole, this is formidable list, and one cannot be too surprised that governments are often inclined to delay or even prevent restructuring - usually failing to appreciate the high costs of a different sort that then arise (see Section 4). Most restructuring decisions are, of course, taken at the level of an individual firm or even establishment, but they are necessarily taken within the context set by the prevailing government policies. The whole process becomes
politically when, instead of responding to the established policy framework, firms perceive that the government is weak and indecisive, or afraid of the social consequences of major restructuring, and hence vulnerable to lobbying and pressure from firms in distress.

Making provision for all of (a) to (f) evidently entails substantial institutional reform and development, some general aspects of which were discussed in Hare (2001). We now turn to examine how to pay for restructuring, and the awkward question of who should pay.

3. Financing the Social Costs of Restructuring

In a developed OECD country, the typical assignment of responsibility for the above cost types (a) to (f) would be: (a) the firm (possibly with some public support if there is a publicly funded redundancy scheme in operation); (b) the national government, through its social security policy; (c) local authorities; (d), (e) and (f) national and regional levels of government.

In transition economies, especially those in the CIS where many reforms have progressed more slowly than in those states due to join the EU in 2004, and where industrial restructuring has also been delayed, this assignment of costs might not yet prove workable. In any event, the countries concerned need to take some fundamental decisions concerning how large various elements of the costs can feasibly be, given their overall budgetary constraints and their ability to collect tax revenues.

Cost type (a), redundancy payments

Most firms in transition countries will prove unable to fund remotely reasonable redundancy payments. They will not have made any provision to do so, and most countries have no workable public scheme to help them. A few countries, including Russia, have in the 1990s passed laws declaring that firms making workers redundant must pay them compensation in amounts depending on their years of service\(^2\), but to my knowledge such schemes are pretty meaningless in practice, since firms about to go into liquidation have no available resources, and nor does anyone else. The situations in which redundancy payments might actually be made include those where a foreign firm takes over an incumbent and provides its own (external) funds to support downsizing the workforce. For the longer term, of course, it makes sense to develop policies on redundancy compensation very much along the lines of OECD member countries, but I suspect that in most of the CIS, not much redundancy will be paid out in the present round of major restructuring. Hence although the likely scale and speed of restructuring suggests that cost type (a) ought to be large, my judgement is that it will not be. In the longer term, as the pace of restructuring slows down somewhat, it will become more feasible to implement more generous redundancy programmes.

Cost type (b), income support for the unemployed

Cost type (b) really comprises two elements: unemployment compensation (UC) and (true) income support (IS). UC is generally paid for a fixed period (six months to a year) to those meeting whatever contribution conditions are set by the government concerned. Sometimes the

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\(^2\) The standard pattern in the UK, for instance, is that firms must pay redundancy at a rate equal to one week’s wages per year of service. In practice, many firms pay more than that in order to secure trade union agreement to a major restructuring scheme.
amount paid out in UC is related to the former wage, sometimes it is a fixed payment. Either way, it is usually set at a higher level than the basic rates of IS, and is often regarded as an entitlement by workers, since their own social security contributions (linked to their former wages) are, in effect, paying for it. This is why in many countries, unemployment compensation is often termed unemployment insurance. It is usually paid out for a fixed period, partly to keep down the aggregate budgetary costs, partly to provide the unemployed with incentives to seek alternative employment within a reasonably short period. Such incentives, of course, are only effective in conditions when other jobs are available.

The second element of cost type (b), IS, usually has some form of means test associated with it, rather than a contribution condition, since the purpose of income support is typically to alleviate poverty by providing a basic income to those in need. Again, incentives to work are usually provided by requiring those of working age and not disabled to declare their continuing availability for work, and sometimes even requiring them to accept jobs deemed to be “suitable” by the authorities (on pain of losing all or part of their benefit for a period).

Needless to say, when unemployment is high and poverty widespread, the budgetary cost of UC and IS taken together can be substantial. In practice it is often kept down by a combination of factors: for UC - stringent contribution conditions, short periods of payment, inefficient administration so that few succeed in making a claim; and for IS - strict eligibility criteria, low levels of benefit, inefficient administration. While these factors do indeed keep down the public expenditure costs of UC and IS, they do nothing to alleviate the real social costs, since the people concerned are still unemployed, still poor. Many of the costs, however, remain hidden from view.

**Cost type (c), local public services**

Financing the provision of local public services, has proved quite difficult to manage properly in several transition economies. In principle, one would advise firms undergoing restructuring to start by hiving off any services to workers they currently provide as a by-product of their main productive activity. Such services should ideally then be taken over either by the relevant local authority, in the case of services normally provided free at the point of delivery (e.g. primary schooling, basic healthcare), or by new private or collective providers (e.g. private nurseries, housing associations to manage public housing, etc.). While this approach has often worked well in more developed countries, and in some of the Central European transition economies, it runs into severe problems in other countries for several reasons. The most important of these are:

2. Hiving off services to local authorities assumes the latter have a budget to cover their costs. In large, multi-level countries like Russia, this has not been the case. Even today, public finance reforms to provide reliable budgets at the local level - based on an assessment of local needs for services - is the exception rather than the rule, though important steps have been taken in the right direction.

2. A related point is that without comprehensive public finance reform, many smaller local authorities rely on tax revenue from “their” firms in order to cover their costs. That works well in a stable environment with little or no restructuring, but in conditions where major restructuring is going on it can turn a local difficulty (due to unemployment resulting from firm closure) into a major local crisis (as funding for local services also

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dries up). There has to be an absolutely clear separation between the fate of local firms, and the state of the local public finances.

When local incomes decline due to a major firm closure, those services formerly provided by the firm which the local authority cannot or does not wish to provide will face a collapse in demand - realistically, the local population will simply not be able to pay much for services they previously obtained for free or at a nominal price. Hence the initial firm closure exerts a negative multiplier effect upon the local economy.

Moreover, the fall in demand for the now privately provided services is quite likely to affect women relatively unfavourably. For instance, although nurseries notionally benefit the whole family, in practice they are means of social policy that facilitate women’s engagement in the workforce, so when nurseries become too expensive it is typically women who end up staying at home to undertake childcare.

Taking these points together, the local public services aspect of restructuring, which might have seemed fairly straightforward to handle, can be seen to be more like a political minefield. Few of the slower reformers among the transition economies have managed it particularly well.

**Cost type (d), assistance to migrate**

**Cost type (e), assistance with retraining**

**Cost type (f), encouraging new businesses to start up**

When policymakers and their advisers discuss the social costs of restructuring, they usually refer to the items (a), (b) and (c) that we have just discussed. However, I have included these last three items, (d), (e) and (f), for the sake of completeness, even though they are more often thought of as part of a wider industrial policy, rather than as a social cost of restructuring per se. Accordingly, I make a few remarks about these items here, but later in the paper I shall not have much more to say about them.

Regarding (d), there is naturally little point in assisting someone to migrate if there is no job awaiting them “at the other end” of the proposed move. Otherwise, the authorities are merely moving social costs from one place to another, with no overall gain to show for their efforts. This means that effective migration assistance must be linked to jobs in the receiving areas, in which case one might ask why the firm or organisation seeking new employees does not contribute to the costs of relocation for incoming workers. Such a contribution to removal costs is quite standard for firms in many of the OECD costs, though the contribution normally only covers the costs of shipping furniture and personal items, rarely much more. In transition economies, by contrast, one would expect to see measures to assist incoming workers find housing, surely a critical factor in the absence of a well functioning housing market, and with little private mortgage finance available in any case.

So thinking about assistance to migrate suggests the need for better provision in terms of:

- information about jobs available elsewhere;
- assistance to find suitable housing in a new area.
Especially in the very large transition economies such as Russia, Ukraine and Kazakhstan, these forms of assistance could prove very beneficial.

On (e), the main point to make - a rather negative one, unfortunately - is that retraining of displaced workers rarely finds them new jobs very quickly. Very often, as confirmed by the long experience of many other countries, new jobs tend to go to younger people (and in places where women previously had few job opportunities, to women) and to incomers to the area. For instance, a 45 year old unemployed steelworker will often find the process of adapting to new types of employment practically impossible, and many simply never make it. Thus the retraining of such workers is not only costly, but quite often ineffective. What this implies is that restructuring the economy of an area formerly dominated by one or a few declining branches of industry, especially heavy industry, is a process that will occupy at least a generation, one that will prove very painful to many displaced people, and unavoidably so. I am not aware of any “quick fix” for this difficult and politically delicate problem.

Training opportunities should certainly be available everywhere. They should focus on old skills that are expected to continue in high demand (such as joinery, plumbing and the like) and on new skills that are increasingly generic across a wide range of growing sectors, especially in services (basic IT skills are the obvious ones, here). What should not be continued is the training of people in skills best suited to branches in strong decline or in technologies that are known to be outmoded, such as traditional welding, metal cutting using very low technology machine tools, and so on. Training for the sake of training is simply a waste of resources (even if it keep a few more trainers in jobs - for I would rather argue that the training process itself probably needs to be restructured!).

Last, regarding (f), it would be hard to find anyone who disagreed with the idea that encouraging new businesses to form is likely to assist restructuring. Going beyond such platitudes to making it happen in practice is far more difficult, however. Interestingly, most transition economy governments already claim that they have good policies in place to provide for a supportive, business-friendly environment, and surveys carried out by the World Bank and EBRD provide a little evidence for such claims - in the limited sense that these surveys confirm that between 1999 and 2002 the business environment did improve when assessed according to a number of different criteria (see discussion of the BEEPS surveys in EBRD, 2002).

However, two important caveats should be borne in mind: (i) the survey results do not claim that the business environment is especially good, only that it has become “less bad” than before, in other words that there is some movement in the right direction; there is still a good way to go; and (ii) the survey only looked at firms actually operating in the countries concerned, since firms that never started up could hardly be included. But to assess the business environment more objectively, what we should really be studying is the rate of business start up, and the rate of job creation associated with new starts, bearing in mind the normal experience of more developed countries that most new firms only have a short lifetime. Hence a dynamic business sector would be characterised by very large rates of business formation, high rates of attrition and business turnover, and at any one time, a large stock of functioning business.

Ideally, it would be useful to have good comparative data on these matters, but what there is is both patchy in coverage, inconsistent across countries, and complicated by the informal economy (so many active firms are not officially registered). Nevertheless, even the very rough data that
does exist strongly suggests that a country such as Russia ought to have at least five times as many firms as it appears to have at present. This observation implies that the Russian business environment is markedly less conducive to enterprise than the authorities would insist. It also implies that measures to foster a massively faster rate of new business formation across the country would render many of the supposedly highly sensitive and politically difficult social aspects of restructuring far less problematic - and costly - than they presently appear to be.

Overall, we have implicitly accepted the traditional assignment of payment obligations in this section, while pointing out some of the very real practical obstacles preventing early and comprehensive implementation of the various measures we envisage to assist countries in managing and keeping down to the lowest feasible levels the social costs incurred under headings (a) through (f).

4. Key Choices: Speed vs. Cost, New Jobs for Old
Many transition economies have actively sought to slow down restructuring in order to delay, or hopefully avoid altogether, some of the social costs identified above. In this section, therefore, I provide a brief analysis of the main trade offs involved in such choices, which can be summed up in two key points:

1. Delaying restructuring and keeping workers employed in existing enterprises provides a route to a low unemployment, but low income and slow growth, development path. Moreover, I would argue that such a path, in the longer term, will not prove sustainable, implying that the social costs of adjustment cannot be delayed “forever”. Further, even in the medium term it might prove impossible to sustain such a course, since the natural turnover of the workforce will result in steady - but eventually very large - declines in employment in many enterprises.

2. Very rapid restructuring, forcing lots of layoffs from existing firms before the conditions are in place for rapid rates of new job creation through the expansion of good firms and the creation of new ones, can prove self-defeating, especially if significant payments (of types (a) and (b) from the above list) are made to displaced workers. For then tax rates on functioning businesses need to be high, which in turn further discourages new firm formation.

The most elegant analysis of these trade offs has been set out in Blanchard (1997), which develops a nice formal model of the interactions between state-owned and private sectors - through privatisation and new firm formation; between restructuring and growth - through the implied tax rate on business sector activity; and of the path of unemployment along alternative transition paths.

Without going into technical details, it turns out that by considering alternative transition paths, a path can be found along which the unemployment rate does not become unacceptably high, and on which the long run growth rate is satisfactory. The precise characteristics of such a “best path”, naturally, depend on important features of the institutional environment. For instance, if institutional conditions are not especially encouraging for new firm formation, then even a fairly slow rate of restructuring will eventually lead to high rates of unemployment and will give rise
to slow long-term growth of the economy. Likewise, governments that set high tax rates at the start of transition risk “killing the goose that lays the golden egg”, in the sense that they can again end up with slow rates of business formation, slow aggregate growth. Hence it is unlikely to be wise to be over-generous with social benefits and other public sector spending in the early years of transition. It is better to tax business when there are lots of businesses to be taxed, and to do so at rates that are not too high that they discourage enterprise.

The figures below illustrate two possible scenarios that result from this sort of analysis, labelled S (slow transition with rather poor conditions for new businesses) and F (fast transition, with good conditions for new business formation). These are not the only possible outcomes, of course, but they usefully serve to highlight the two trade offs referred to above. Figure 1 shows the path of the unemployment rate along these paths; Figure 2 shows the path of real GDP (using a log scale so that a straight line is equivalent to a uniform growth rate, and the steeper the line the faster the rate).

**Figure 1. Unemployment along Alternative Transition Paths**

![Figure 1](image1.png)

**Figure 2. Real GDP Growth along Alternative Transition Paths**

![Figure 2](image2.png)

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3 For a recent comparative analysis of tax structures in transition economies, including some useful advice on sensible rates of tax, see Mitra and Stern, 2003.
Thus a fast transition path can push up unemployment very rapidly in the early years, but as business formation occurs and the new market-type conditions become established, unemployment rapidly falls towards a long-run steady state rate, called $U_0$ in Figure 1. In contrast, slow transition results in a slower rise in unemployment, but once it rises it stays high for longer, and may not come down for many years unless the rates of investment and business formation eventually do accelerate.

Likewise, at the start of a fast transition output might fall faster, but it quickly recovers and with the right conditions in place (corresponding to rapid completion of major reforms), growth then ensues at a rapid rate (the red line in Figure 2). With a slow transition, the output fall takes longer and declines to lower levels, with the eventual growth occurring at slower rates (the dotted blue line has a smaller slope than the red line). In this sense, the eventual output costs of a delayed transition can be enormous, with a correspondingly adverse impact upon the population’s living standards.

While offering a nice theoretical analysis of some important transition issues, empirical evidence suggests a couple of caveats that need to be borne in mind. One is the so-called stagnant pool problem, whereby those entering unemployment often remain in that state for long periods, resulting in significant numbers of long-term unemployed. This is a phenomenon not unfamiliar in connection with UK restructuring experience, as a result of which former miners and steel workers, for instance, commonly remained unemployed for very long periods, often despite substantial public outlays on retraining programmes and the like. The second is the simple observation that growing firms find most of their new workers from those already employed elsewhere, rather than from the ranks of the unemployed.
5. Special Issues for Economies in Transition

Much of what was discussed above could be applied to any economy, but there are a few features of transition economies that make the topic of this paper - indeed of the whole UNECE/ILO Workshop - especially pertinent for them, and also make it more difficult for these social costs of restructuring to be managed satisfactorily. In this section, therefore, I shall try to identify the features that make transition economies “different” or special in some way, and this will assist the reader to appreciate better some of my findings and recommendations in the final section. This discussion does not add materially to the preceding analysis, but I hope that it will provide enough background to explain some of the very difficult issues facing the transition economies.

The features that I wish to highlight are as follows: (a) weak and/or small states; (b) initial conditions; (c) the need to build a complete set of institutions to underpin the new economic system; (d) incomplete and/or poorly functioning markets.

(a) Weak and/or small states

Most transition economies, notably those in South Eastern Europe and the CIS, are new states that only came into existence as independent political entities in the very early 1990s (sometimes even later than that, as with Bosnia and Herzegovina). Quite aside from the far from trivial task of managing the transition to a market-type economy, these new states have had to construct - sometimes from scratch, sometimes building on institutions of former regional powers (as with Russia, and Serbia and Montenegro), all the core institutions of a modern state. At the same time, they have faced the daunting challenge of creating and sustaining political unity under the new conditions. While this is hardly the place for an extended political analysis of the region, I think it is at least fair to say that some of the new states have succeeded fairly well in achieving a basic framework for political stability, others are still struggling to do so.

Many of the states concerned are very small (both geographically and economically), some still suffer the fall-out from civil war, and one cannot be surprised that economic reforms - including the issues of restructuring and the associated social aspects that are the focus of this paper - have not exactly been at the top of the agenda! Where the states are large, a different type of problem arises, namely that of establishing proper relationships between different levels of government, different regions, so that tax revenues and spending obligations (and needs) match up reasonably well. Russia, in particular, has had great difficulty in achieving this matching. With a large state, also, there is the issue of how to manage regional differences, such as situations where one region is doing well, another has massive unemployment. In principle, a lagging region might like the option of devaluing against the rest of the country, but it cannot since all use the same currency. Hence it must resort to measures of regional policy, in the knowledge that the experience of many other countries suggests a slow, and fairly weak, response to such measures.

In all cases, a functioning state is clearly the *sine qua non* for proceeding successfully with coherent programmes of economic reforms in these countries.

(b) Initial conditions

After decades under communist governments, most transition economies inherited economic structures with some characteristics making restructuring both difficult and urgent. There is no space for a full analysis, but it is worth listing the major economic “distortions” in the inherited economic structures:
within industry, an exaggerated and mostly economically unjustified share of heavy industry;

excessive energy intensity of production (averaging two- to three-times the energy intensity of the OECD);

distorted size distribution of businesses, with too much production from a few large firms, far too few small ones;

much production in uneconomic locations or on sites where too much land is being used (a consequence of Soviet accounting practice under which land and freight transport were wrongly treated as virtually free);

many uneconomic trading links between countries of the CIS, many of these seriously disrupted by the break up of the Soviet Union;

lack of basic knowledge and understanding of how market economies function.

Clearly, starting transition to a market-type economy in economies distorted in these very drastic ways implies that the scale of needed restructuring is far higher than would be the case in more “normal” economies.

(c) **Institutions**
Contrary to what many people believed (or hoped) at the start of transition, building the institutional framework for a market economy is neither easy nor quick. It does not happen automatically as soon as markets are declared “open”, nor can the state create the needed institutions very quickly - except in the more fortunate states of Central Europe that still had institutional memories of the market economy, and even, in many cases, still had old laws on the books that could be brought back to life. In the CIS countries, in particular, none of that was true.

To apprehend the true complexity - and associated challenge - of market institution building, simply consider one really simple example, say the market for furniture. For this market to work well, I would expect to see some competition, so I would not think it very desirable for one factory to be allowed to operate its own exclusive distribution channels; buyers might need access to credit at reasonable rates; advertising channels need to be working well; delivery services are also needed; and ideally, there should be some consumer protection so that defective goods can be replaced or customers reimbursed. There might also be a need for some independent measures/evaluation of product quality, some form of product certification. This is already a long list of institutional requirements, and this is just for a single market, not one of the more complicated ones.

(d) **Incomplete markets**
Earlier I stressed the importance of reliable market pricing in providing guidance for restructuring decisions. In many instances, however, especially concerning factors of production and important assets, markets either do not exist at all or function badly. What I have in mind here are such markets as those for financial assets, credit, capital equipment, housing, land, and manpower. In all but the most advanced transition countries, most of these very important
markets are still developing, and their lack of development - among other things - can often raise 
the social costs of restructuring. For instance, the financial markets in most of our countries are 
thin, weak and fairly unstable, with very limited ranges of financial assets available to hold. 
More relevantly, credit markets work badly so people moving home to find work would not 
easily get mortgage finance to help them do so. Similarly, poor labour market information and 
non-transparent hiring practices imply that jobs will often not go to the best people, and that 
people unemployed in one area will not have an easy time finding out about opportunities 
elsewhere. These are just a few examples of problems in what is, really, a very complex area.

6. Conclusions
In this final section I start by summing up my main findings about the social costs of 
restructuring and how one might finance them (Section 6.1) and then go on to offer a list of 
recommendations (Section 6.2).

6.1 Major Findings
We first argued that in judging the need for industrial restructuring in a given situation, it was 
important to get the basic prices “right”, and to assess demand for the relevant products 
carefully. In addition, we noted that lack of sophisticated consumer services and pointed out that 
this lack could often impede restructuring or raise its social costs, as could the tendency for 
restructuring decisions to become embroiled in political controversy, lobbying and the like.

We then classified the resulting social costs of restructuring into six categories: (a) redundancy 
compensation; (b) income support for the unemployed; (c) provision of local public services; 
(d) assistance to migrate; (e) assistance with retraining; and (f) encouraging new businesses to 
start up. The last three of these fall within the scope of regional policy, but the first three are the 
ones which people usually refer to as social costs of restructuring. We suggested that most firms 
would be unable to pay much under heading (a), that governments would have difficulty paying 
very high rates under (b) given their public spending constraints, and that without significant 
reform of the multi-level structures of public finance, it is quite difficult simply to insist that 
costs of type (c) should be delivered by local authorities. However, that would be the ideal, since 
it properly separates the provision of local public services from the economic fate of local 
businesses.

A more formal analysis was then presented in summary form, to show some of the main tradeoffs 
between speed of restructuring and the associated social costs, distinguishing between a fast 
reform scenario - with high unemployment for a while, then rapid growth; and a slow reform 
path - with gradually rising unemployment and then slower growth. If the necessary political 
conditions are in place, the fast reform variant is to be preferred on the grounds that it will ensure 
higher living standards in the future, while keeping the social costs of restructuring down to 
tolerable levels in the short and medium term.

We then drew attention to some of the key issues that make restructuring in transition countries 
unusually difficult, distinguishing: the problems of weak and/or small states; unfavourable initial 
conditions; the complexity of institutional reforms when examined carefully at the level of 
individual markets; and incomplete markets, namely the fact that in many countries some rather 
important markets have not yet been properly established as functioning systems.
6.2 Policy Recommendations

In the course of this paper, the reader will already have found a scattering of remarks and observations that would help in formulating and developing better policies to support restructuring. Here I want to focus on a few points that are especially relevant for the social costs of restructuring, and for their financing.

It seems to me that in designing social policies to support transition, there should be two objectives: first, to design policies in order to keep the associated social costs as low as feasible; and second, when social costs arise, to pay for them in ways that do not unduly discourage new production. The first point can be summed up as: encourage enterprise. The second as: keep tax rates and other charges on business low. These are my two central recommendations. Failing to follow them will result in a delayed transition, along with higher social costs of restructuring and slower economic growth in the longer term.

My view is that the key to success in transition is to foster competitive conditions, but within moderate limits, since it is well known that excessive competition results in low profits, with the consequence that no one has funds for new investment. For existing businesses, this condition means that public authorities should not tolerate lobbying efforts to secure special protection, though I acknowledge that this already takes for granted that a sufficiently strong state is in place (cf. 5(a), above). Since the social costs of restructuring have to be paid for, the authorities should not tolerate non-payment of taxes or social security contributions by existing firms - if they do so they also discourage the entry of new, more efficient firms.

Business tax rates have to kept quite low, but social costs of restructuring must be paid somehow. While earlier I suggested that one should not make over-generous payments, something has to be paid to keep people out of the deepest poverty, and for the most part it is the public budget that must pay. To sustain the conditions for macroeconomic stabilisation in each country, including holding inflation rates down, public deficits cannot be permitted to be too large, or to remain large for long unless the country concerned foresees massive aid inflows, remittances or FDI inflows for the foreseeable future. With the possible exceptions of Russia, Turkmenistan and Kazakhstan, which enjoy trade surpluses as result of their large energy exports, none of the countries under discussion is in this fortunate position. Hence to cover the social costs of restructuring from public funds, while keeping general tax rates low, it is vital that other components of public spending are held down severely. This presents governments with some tough choices, but they are not avoidable choices.

Thus contemplating the various dilemmas and policy options concerning the social costs of transition is neither easy nor especially pleasant. I strongly suspect, though, that those governments will do best in the long run which have the courage to go for a quick and comprehensive transition, rapidly creating highly favourable conditions for business formation, high rates of FDI, and so on. The last few years of quite rapid growth actually provide a good platform for such an approach, for many governments have been experiencing improvements in their public finances and hence have greater capacity than they would have had 5 or 6 years ago to provide reasonably adequately for the social costs of transition, even without further increases in public sector indebtedness.
References


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