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INVESTMENT INCENTIVES IN THE FORMERLY PLANNED ECONOMIES

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INVESTMENT INCENTIVES IN THE FORMERLY PLANNED ECONOMIES

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Abstract

The institutions of markets supporting property rights are defined, and linked via incentives for investment to economic growth. The political and business risks affecting investment in formerly planned economies are defined and compared with returns to investment of domestic and foreign investors. Deficient or lacking institutional structures in formerly planned economies often make political risks prohibitive. Various ways of reducing them to western levels or unloading them from investors to supporting western Governments are discussed. It is found that many problems of opportunistic political behavior are common to western and formerly planned economies, the difference being a matter of degree. One conclusion is that while western economies may be burdened by excessive law and regulation the formerly planned economies lack most of the institutions needed for a viable market economy. Only a very little, critical core of legal code may, however, be needed to establish critical market functions, provided it overrules all other remaining legislation from the communist past.

When the former Soviet empire collapsed, it was believed, quite plausibly that enormous investment resources would be needed to restore run-down communist economies to industrial nations. This massive investment boom would be privately and socially profitable and would drive up real interest rates in the West, halting expansion there, notably in the not so competitive mature industrial nations. The West would have to live with that situation for years. Even though private savers would be happy, unemployment and low real income growth would follow after an initial boom in investment goods industries.

This scenario has failed to materialize, at least so far. What is the reason?

1. Why not growth?

There are two ways of approaching the investment growth problem in the formerly planned economies. The first, standard approach by economists is to look at the various national accounts figures involved and observe, as was done above that neither investment nor growth was showing up, conclude that more investment is needed, and suggest that more western financial support should be administered. This is the *welfare* approach.

The alternative approach is entirely different: it shuns statistics and mechanical analysis, and looks at *the institutions that define the incentives to invest.* Proponents of that policy alternative asks the question: Are incentives properly directed and sufficient? Perhaps, one should *not* expect to see the desired investment boom. This is the *institutional incentive* approach.

In this paper I will follow both the welfare and the institutional incentive proposals. The reason is that without properly structured incentives there will neither be a desired indigenous investment boom, nor a desired growth development based on foreign investment. The institutions so to speak define

the investment climate of the economy. If incentives are properly directed, the desired welfare targets will eventually be achieved. It all depends on how institutions are designed to support incentives, and how long the people and its political representatives are prepared to wait. On the other hand, if incentives are right, and large investment and rapid growth follow, significant and very unevenly distributed social adjustment will be the consequence. To cope with that a well designed social insurance system (call it a welfare system) will be needed to gain political acceptance for economic success. My analysis is organized around the definition of property rights in Table 1. On the one hand, I relate the property rights (through the financial system and financial incentives) to the four investment growth mechanisms in Table 2. On the other hand, I relate the credibility of the three components of property rights to a hierarchy of risks associated with the various contractual arrangements that support the property rights. Also these risks depend on the institutions supporting the property rights and the corresponding investment incentives that generate economic growth through the four investment mechanism in Table 2. This is all summarized in Figure 1. We will find that opportunistic political behavior constitutes the core growth problem of the formerly planned economies and that the solution lies in the ability of the economic political system to spontaneously create, through deliberate policy a market for such risks.

(Tables 1 & 2 and Figure 1 in about here).

Any country, any economy is governed by institutions (legal codes, conventions, ethical norms) designed by decree or through evolution and popular acceptance to guarantee certain minimal rights to its citizens and its firms. The most important such institution for the economy is the *property rights* institution (North-Thomas 1973, North 1990, Pelikan 1987). Property rights define ownership and are, hence, necessary for trade in markets. As pointed out by Douglas North many times over the years, without property rights there is no market economy. You have to own what you sell, and you

have to know that you own what you buy. The most sophisticated property rights for an advanced market economy, however, (Eliasson 1993a) is *the right to future profits from investment commitments today.* This property right is the foundation of the standard ownership contract called the stock certificate, and hence also of the stock market. It requires a complex legal and institutional structure to be defined and enforced, and hence took very long to develop. Until recently many advanced industrial countries relied on very crude financial substitutes to a full fledged financial system. The entitlements to future profits from investments today define the *incentives* for the actors of the economy to engage in growth promoting long term investments, and, hence, the efficiency of the economy. These institutions have to be sufficiently stable to ensure predictability in their application. But there also have to be institutions that allow the incentive system to evolve, to accommodate new technologies and forms of economic organization, in short, to make improvement possible. It is very difficult, probably impossible to write law that identifies and realizes improvements. Hence, the procedure should be the opposite. Law should be formulated explicitly to prevent restrictions and hindrances to improvement in law through interpretation and precedent. I will call such law *enabling law* in what follows. (See further Eliasson-Rybczynski-Wihlborg 1994).

There is, in fact, when discussing the transition of formerly planned economies to market economies only one reason for going beyond the "incentives" issue and the supporting institutions, namely *the time dimension,* and the *risks* investors are carrying between their investment and the time (if they succeed) they have recaptured the principal and the rents. If speed is required to prevent a political collapse of the transition process, empirical analysis is needed to assess the quantitative and dynamic time relations involved, and the financial support from the west required.

For instance, there seems to be no feasible way of generating a sufficiently rapid growth path in any of the formerly planned economies, based on

domestic savings alone, however appropriate the incentives, to forestall the social and political unrest that will follow if a Western type market economy does not deliver in pace with boosted expectations.

2. The four elements of economic growth - dynamics

To assess the dynamics involved let us assume, for simplicity, that growth in output is the only desired outcome and proceed to break the growth process down into its components. Growth occurs through four basic mechanisms (Eliasson 1992, 1993b); *entry, reorganization, rationalization* and *exit* (See Table 2). Each category represents a particular investment activity, the last a disinvestment to make room for new investment and help adjust factor prices.

The so called Salter curves in *Figures 2* illustrate the principles involved. It ranks labor productivities in an economy by firms or establishments, one column representing one firm, and the width of the column the size of the firm in percent of the value added of all firms. The lower curve is the matching wage cost level per effective employee, and the difference gross operating profits per employee. In practice labor market arbitrage makes the wage cost level much more even than the distribution of productivities. The firms at the upper left, apparently should be able to pay high wages without suffering in profitability.[1] The dark columns at the far right represent two East European firms.[2] The problem with an East European economy is that its firms would all cluster at the far right, very low end if the industry structures of a Western European and an Eastern European economy were to be merged. The upgrading of the Eastern European industry structure is the vehicle to achieve economic growth. This occurs through the four mechanisms of growth in Table 2. Reorganization and rationalization raise the

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[1] Note that large capital output ratios will require high profit margins to achieve the same rate of return as a company with a low capital output ratio.

[2] See Eliasson (1991c)

columns of existing firms. Exit removes low performers at the far right. Entry adds new columns from the left. In practice (see Eliasson 1991b) entry comes in a very diverse lot, illustrating the fact that the ex ante expected performance characteristics of new, entering firms often is far above ex post realized performance.

Entry, on the one hand, and investment in reorganization and rationalization in existing firms on the other, also operate on *very different time scales.* Rationalization investments combined with exit give immediate and large productivity effects, but not sustained economic growth. Long run growth has to build on new investment in new technologies.

Economic growth is, however, not a matter of independently taken investment decisions in firms. Considerable *clustering of activities* occurs and forms the basis for long lasting synergies. This was called *development bloc* formation by Dahmén (1950) and has more recently been "independently" reformulated by Lucas (1988) and Romer (1986) in a thin macro economic version, called the "new growth theory". The formation of development blocks is a necessary part of the transformation of formerly planned economies. The critical part for the nation is for its industries to find, through experimentation a viable industrial technology around which to specialize and build new industries. Decisions for this development block formation, however, is the establishment of the non-economic institutions, constituting the back-bone of the incentives to invest. To this I turn next. However, first the investment elements of the growth process of Table 2 have to be clarified in terms of the synergies created/and the dynamics involved. The kind of growth witnessed among the industrialized nations since the industrial revolution, and desired in the formerly planned economies, won't take place without

(1) significant *clustering* of investment, creating large economies of scale (development blocs)
(2) the transformation of those investments into an *expanded capacity* to

produce for international markets and

(3) *patience* among investors, during the *time lag* between the enhanced capacity to produce and actual production growth and profits (*dynamics*).

When all four investment activities in Table 1 become viable and active, the growth process will move of itself and nobody has to worry about statistics. They are not in the formerly planned economies, and therefore it becomes important to ask why. I will do that by linking the future investment and growth mechanisms to incentives, notably to the *risks* associated with property rights (Eliasson 1993a). A particular issue is the different rules that accompany new entry in the small business sector and the privatization of the old, mammoth (in employment terms) Soviet production organizations.

I will then discuss how property rights can be designed to establish incentives that stimulate investments, rather than how to arrange financing for investments. As it turns out such financing will, anyhow, have to come from the west. It is therefore twice important for investment and growth to make the formerly planned economies attractive economies for direct foreign investments and/or the financing of domestic investments.

3. The critical property rights institution

In their book from 1973 Douglass North and Robert Thomas concluded that by the early 1800 century most of the institutions required to support the functions of a viable market economy were in place in Western Europe, notably the legal functions supporting the property right system. Property rights can be defined as consisting of three different, supporting elements (see Table 1) the right to *manage* one's assets, the right to *access* the profits and the right to *trade* in the assets (**Usus, usus fructus, abusus** in Latin). This property right in turn has to be supported by explicit and implicit *contracts* and

institutions designed to *enforce contractual agreements*. This definition of property rights is quite clear when it comes to physical assets like land. *The most important property right for a market economy, however, (Eliasson 1993a) relates to intangibles, namely the entitlement to future rents from investment resources committed today.* This is the property right upon which financial markets are based, notably the stock market. It strongly influences the incentives to engage in long term investment commitments, namely the present value of the profits generated, discounted by an appropriate interest rate, including all the *business risks* and all the *political risks* associated with the credibility of the property rights institution. Without legal protection and enforcement of financial contracts long term commitments of investment funds won't take place, because investors cannot feel confident that the rents, even from a successful business can be recaptured by the owners. And entitlements to future profits cannot be defended by brute force, as was the case earlier with land. The bridging function between today and the future is vested in the institutions that protect the ownership right to financial contracts, underwritten by parties unrelated to the authorities that are responsible for the same institutions.

It is unfortunate that so much of the privatization discussion in the East has circled around physical property. Profitable production does not require that the producer owns the land on which, and the machines with which, production is organized. They can both be leased. But it is essential that *the investor owns the profits he generates* (has a title to the profits he creates). If investors have no confidence in the institutions that protect such long term benefits, risks will be considered too high. There will be no long term financial commitments and economic activity will contract into short-term trading. The ability to induce long term financial commitments through reducing the entire spectrum of risks that are not directly related to the true economic-technical business decision is the basic institutional foundation of an advanced industrial market economy. It is apparent even from recent Government practice among socialistically inclined Western economies how difficult it is to understand this

simple institutional function of economics. In fact almost all of the economics profession has had great difficulties of understanding, leaving the few early writers on such matters, like Douglass North, for decades in academic backwaters not worthy of attention.

4. Political risks are shortening the time horizons of investors

Risks undermining the property rights institution in financial markets operate in several dimensions (Table 3) and consists of two principally different types; *political* and *business*. Political risks relate directly to the institutions protecting the property rights. Business risks relate to the competence of the investor to take the right technological and economic decisions. Since some of the economic factors that have to be incorporated in business decisions are indirectly influenced by the institutions of the economy (like inflation) the two types of risks are not entirely independent.

Most western capitalist nations have managed more or less to organize themselves such that the property rights system is reasonably well enforced and predictable. There have been great difficulties of getting it properly organized to function well in the intangible, financial dimension. In fact, not until recently are sophisticated financial markets beginning to function outside the United States. Furthermore, ownership capital and wealth being the focus of dispute between the socialist left and the capitalist right, Western nations with a socialist tilt during the 60s and the 70s used the legal system to restrict ownership of wealth, destroying important resource allocation mechanisms in the process. Here the situation has rather been the deliberate and unwritten creation of redundant, unnecessary or hindering institutions.

The typical characteristic of formerly planned economies, on the other hand, is that few, or no institutions (whether formal or by convention) exist to support private property rights, and the property rights supporting the

managing and trading of financial wealth in particular. The proper institutional functions to support private incentives are *lacking*.

Thus, even in the absence of other political or macro economic risks (in Table 3) the incentives to commit funds long-term on private account are virtually absent in most of the formerly planned economies, except on the hope that the appropriate institutions will soon be introduced. In some economies, notably Poland and Checkia necessary minimal institutions are beginning to be created, and economic growth slowly beginning to show.

In addition, but to a varying degree, political and macroeconomic risks loom over most formerly planned economies, meaning that investments in local currencies may be suddenly confiscated and/or rendered without value. Considering this, it is perhaps not so surprising that we don't see an investment boom in the formerly planned economies, except in places (like Eastern Germany) where a Western Government has underwritten the risks. Future expected profits are simply discounted so heavily (because of risks) that only extreme investments become profitable. Rather, the fact that so many large and small private firms, nevertheless, have committed investment funds in those countries can only be interpreted as reflecting faith in the spirit and political power of the authorities in those countries that the necessary institutions will eventually be introduced. A realistic assessment of the investment and growth prospects of the formerly planned economies therefore must include an assessment of the probability that these nations, or some of them will successfully build such institutions and/or that western nations will cover the political, non-business risks. This is synonymous to assuming that the necessary institutions will be created for a market in such risks to be created.

CASE 1; Grand Hotel Europe, St. Petersburg.[3]

In 1988 a group headed by Reso International Hotels and SIAB teamed up to restore the old hotel Europeijskaja in S:t Petersburg to a luxury hotel of international standards. 600 million SEK were invested and the hotel began to operate in December 1991. The first year was a success, with 92 percent capacity utilization, very high by any standard.

During the first year the hotel had a problem with managing its cash flow. There was no banking service in S:t Petersburg and the hotel was granted informal permission from Moscow to run its accounts through Nordbanken in Stockholm. In March 1993 banking service had been established in S:t Petersburg and the hotel moved its banking services back to S:t Petersburg. The same year (1993) in June, however, the new tax police in Russia was created. It claimed that it had been illegal to use a foreign bank and ordered the hotel to pay $24 million on the transactions accumulated through the Stockholm account. This case is currently pending. If the hotel is ordered by court to pay, it will go bankrupt and the investors will lose their money on account of an arbitrary (opportunistic) reinterpretation of rules. Since the case has not been cleared the value and ownership of assets cannot be determined. Thus the Swedish investors have had difficulties selling their assets and recapturing their investment. Expecting such legal trouble is synonymous to eliminating the private incentives to invest.

Problems like those of Grand Hotel Europe are compounded by the almost daily change of laws in the former Soviet Union, the uninhibited use of retroactive taxation, unclear rules of who should pay and which institution should receive payment, and the infighting between local and federal tax authorities on who should receive the tax payments. One example is a recently (*The Wall street Journal* April 20, 1994, page A16) enacted tax law that allows

[3] Sources are *Dagens Industri* sept. 15, 1993, p.17, and interviews.

tax inspectors to levy a tax of up to 23 percent on foreign loans to enterprises in Russia. Under such risky circumstances any investment evaluation will heavily discount future profits, rendering most long-term investments unprofitable.

5. How to reduce the risks that shortens investment horizons in the formerly planned economies – the incentive issue

The conclusion of the previous section was that lack of credible institutions that protect the ownership right to financial contracts radically reduces incentives to take on long term investment commitments in formerly planned economies, not lack of investment funds. The question then becomes, *first* to identify these institutions in sufficient detail to assess feasibility and *second* to detail the critical time dimension.

In discussing this problem two distinctions have to be made. *First,* we have to distinguish between the rules regulating entry and small business, notably in the service sector and the existing big production establishments. This takes us right into the privatization debate. *Second,* we have to distinguish between *domestic* indigenous *investments* and *foreign direct investment.* Free competitive entry is one form of privatization. Turning sluggish Soviet production organizations into privately operated competitive firms is an entirely different form of privatization.

The domestic investor has to raise financing and for that he needs credible collateral, say a mortgageable house, land etc. For the foreign investor, with ample finances, this is not the problem. He needs a credible contract to get his money and his profits back. There are two different property rights to consider.

Huge and run-down Soviet production facilities overstuffed with low quality

labor with job guarantees is probably nothing to have. Why all the fuss about privatizing them, when they may be completely worthless? The ownership of physical assets is not the important property problem, but the entitlement to future entrepreneurial and competence rents is. It may also be the case that the appropriate investment mechanism in Table 2 to apply to most existing physical capital in the formerly planned economies is to achieve a speedy and low cost divestment (exit item 4). Then attention can be focused on the creation of new businesses that efficiently exploit the comparative advantages of formerly planned economies; cheap and fairly well educated labor. The exit or bankruptcy process is no easy task legally. There may be something of value even in a bankrupt company. For an investor to be willing to pick up that part and do something, he has, however, to be able to get rid of all the obligations, like debt and employment responsibilities associated with the defunct company. If that cleansing is not well defined in bankruptcy law it has the same negative consequences as the absence of property rights and means that valuable assets will remain idle. In countries with very few assets of any economic value, this is of course extra serious.

On the whole privatization of small businesses is rapidly going on in the formerly planned economies, notably in direct household service production. When it comes to new entry, the earlier absence of such phenomena means that investments through new entry of firms is not even covered by statistics. On the other hand, collapsing large firms are well covered statistically. Hence, development of total manufacturing output is probably significantly underestimated.

Turning old production units into private firms is more difficult. While the new firms start from scratch, the old firms employ thousands of people and are in a terrible mess. Only a fraction of the existing workforce can be gainfully employed in production for international markets, and the main management-privatization problem is to get rid of the bulk of the labor force and shut down most old capacity. Even after that has been done, the market

value of such a firm is often negative, something the Treuhand experience illustrates.

To "minimize" the social problem privatization authorities often require employment guarantees, notably from foreign investors, making the investments unattractive. The problem therefore becomes to clarify – given the current state of affairs – what can happen if you engage in long term investments, and/or what is needed as a minimum in the form of institutions to avoid the risk that such bad things might occur. The problem is how to make a country legally and institutionally attractive for an investor.

How to make a country institutionally attractive for investors

The complex of explicit and implicit code (law and conventions) that coordinates a market economy is immense. Only a fraction of the needed rules can be formulated explicitly. The rest has to develop in the market. Even if western law is adopted the legal expertise to implement it may be lacking. Hence it is impossible for an East European country to institute it all in the short time needed to get the economy moving. In addition old rules, still in force work against the desired objectives.

All western legislative practice rests on a vast structure of procedures relating to the implementation, interpretation and enforcement of coded law and precedent. Investors in transition economies face political risks even when written law exists, because interpretation and enforcement practices have not had time to develop. In addition law tends to be changed frequently, sometimes from day to day.

Some formerly planned economies like the Baltic countries, Poland, the Czech Republic, Slovakia and Hungary, and, of course, East Germany, can fall back upon a legal Germanic-French tradition from a not too distant past. This

tradition may perhaps be reestablished and updated. In Poland, in particular, a functioning market economy based on pre-communist legal traditions has existed parallel to the Soviet rule (Eliasson-Rybczynski-Wihlborg 1994).

An important *first* source of political uncertainty refers to unclear definitions of what is allowed and not allowed. The legal system of Western market economies is normally negative. What is not explicitly forbidden in law is permitted. In the socialist economies prohibitions were instead often general. Under these rules economic actions not explicitly listed in law should be thought of as forbidden. Under the new regime the situation has been turned upside down. "Anything is allowed", which creates a different type of uncertainty. Another source of business uncertainty in the formerly planned economies is that the socialist legal system has not been generally abolished. Old laws are often allowed to remain in effect until new laws have been explicitly introduced. Similarly, administrative procedures granting licenses have remained. Thus, vested interests have been able to prevent new ventures by means of, for example, permit-requirements. New and old law may also be conflicting.

As I mentioned already, the first important thing a western observer learns when looking into the Eastern European economic problem concerns the institutional design of his own so-called market economy, above all the tangle of rules, regulations and legal code, that are not needed, and the fact that much of the redundant code may hinder economic growth and should be removed.

That insight makes you very cautious when attempting to design the necessary market institutions for the formerly planned economies, especially about the danger of overly detailed specifications, increasing the probability of faulty specification and the rigidity of the institutional structures in the necessary adaptation of legal code to new circumstances through interpretation and evolution.

These considerations lead to the following conclusions.

Enabling law

Excepting a full scale implementation of an already existing institutional system, including all legal code, regulations and interpretations and enforcement practices (as in Eastern Germany), a complete institutional system on the mode of a Western industrial economy is not possible within the timeframe allowed. Some new intermediate institutional device will be needed.

One should rather opt for (Eliasson-Rybczynski-Wihlborg 1994) what can be called *enabling law*, designed to achieve a speeded up evolution of an informal and formal *common law*.

Enabling laws is a provisional set of explicit and implicit code to make the market economy workable until the needed institutional framework has been instituted. If it works well very little explicit code may be needed. One aspect is to create a list of rights[4], that frees a business activity from restrictions. Enabling law would have to obtain superior status. *All other law, especially preexisting law that contradicts new enabling law, excluding specially listed exceptions are considered inapplicable.* Exceptions should also be limited by dominant principles. For example, doing harm to a third party should be limited in certain well defined ways, *but these limitations have to exclude economic damage* to third parties, i.e. all limitations on desired competition. Competition (by definition) means causing economic damage to competitors.

Enabling law has the advantage of speeding up the legal process, and preventing bureaucratic use of old law to slow down the process. If old law

[4] An example would be the unlimited right to start a company, provided it is registrered, excepting a listed number of activities where particular licenses are required, e.g. in surgery.

that contradicts the new enabling laws represents socially important regulations, interest groups that want to see them remain in force have to argue their case explicitly to secure exemptions. This means that only restrictive rules explicitly passed through the political process will be valid. One further advantage is that enabling law can be made effective before the exceptions.

Another advantage of enabling rules is that they allow stakeholders in corporations to develop arrangements as circumstances change. Mandatory rules, on the other hand, imply one "standard form contract" as mandatory. All rules can be classified on a scale between the extremes, since even highly flexible enabling rules must have a mandatory component.

Enabling law should, hence, be seen as a set of guidelines designed to facilitate the interpretation of remaining old law[5] and new minimal code in the interest of economic growth. Such enabling law will automatically (through its guided interpretation) make existing law that is detrimental to economic growth invalid (inapplicable), and enabling law should explicitly be written to achieve that result.

This particular design may sound outrageous to the traditional legal expert of the West. To me, however, it represents the only convenient, speedy and democratic way to achieve the desired results sufficiently fast. And we want to add the fact that this opportunity not only avoids the risk of writing (however carefully done and however long it takes) redundant and inflexible code that will soon retard growth. It also creates the opportunity for the East to significantly improve upon the west in institutional design.

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[5] A similar suggestion was made for Sweden in *Den långa vägen* (*The Long Road*), IUI, Stockholm 1993, arguing that it would be politically impossible to remove the tangle of legal structure, inserted all over that hinders innovative competitive entry and small business. A general instruction about how existing legal structures should be interpreted and not interpreted would be a faster solution.

CASE 2: Interview Swedish multinationals.

A few interviews with Swedish multinational companies operating in the formerly planned economies have been carried out. There are two different motives for being interested in these countries. For the very large companies it is important to establish a presence in a market that *may* become large and important in the future. For companies of all sizes, with production using skilled labor intensively, subcontracting of simple component etc. production can be profitably located in the East. Many companies are therefore looking for subcontracting arrangements and/or acquisitions of existing firms or building new plants. On the basis of the small number of interviews carried out so far the following picture emerges:

The establishment of subcontracting arrangements and/or production facilities in a formerly planned economy takes time. Management and workers are not used to the discipline, the precision and the technologies required in the west. Existing production plants often (but not always) have to be entirely rebuilt or replaced and the local producer has no financial resources for that. But as long as we are talking about subcontracting arrangements with limited contributions of finance from the buying western company things will happen, albeit slowly.

The extreme lack of product development and marketing knowhow in the companies of formerly planned economies in a sense makes them attractive acquisition targets, since Western product technology and marketing knowhow can be rapidly introduced, without increasing the wage level in local production plants very much. This is attractive provided the Western company can prevent the knowhow transferred from being used against it later by a potential competitor, and provided it can capture the rents from the same technology transfer (the property rights problem).

When major acquisitions and establishments are concerned the picture is different. Takeovers of existing production facilities are often effectively killed by local employment requirements. The normal situation is that after reorganization of production and modernizing of the plant only a small fraction of earlier employment is needed. If redundant labor cannot be laid off the business proposition is no longer profitable. So nothing often happens.

On the commitment of significant funds the investing company always points to the arbitrary rules and regulations, not ownership of facilities, that restrict access to profits, and the possible difficulties of recouping the investment if the company wants to change or sell out. Again we are not necessarily talking about large investments in physical capital but of transfers of know-how. There are few credible rules protecting the investor from arbitrary opportunistic political behavior and frequent cases of such behavior have been reported. This uncertainty is often enough to significantly slow down foreign investment.

All firms interviewed emphasized the need to take management control of the operation and install market discipline on the staff. This was necessary if large financial commitments had been made. Under current institutional circumstances arms length management practices were considered impossible.

More important than financial commitments, however, are transfers of potentially learnable Western technology and/or production knowhow. Such transfers were not even considered if full management control could not be achieved. And if there was no guarantee that the knowhow commitment could be removed, including the rents created the investment was not even considered. The latter is a far reaching requirement that has very little to do with the ownership of physical assets. If the foreign investors cannot count on a long term presence in the formerly planned economy under Western legal conditions, he won't engage in large scale, long-term commitments of Western technology. Such technology, if committed will soon be learned by the local

staff, and remain as potential competition if he has to pull out for one reason or another. Hence, *credible* commitments among the political authorities in the formerly planned economies to the property rights institutions, are necessary for sizeable commitments of financing and (in particular) technical knowhow of Western firms.

CASE 3. Talleks, Estonia[6]

In December 1991 the president of the Supreme Court in Estonia allowed the Government to privatize seven industrial enterprises. *Talleks,* a producer of small trucks and earthmoving equipment was one of them. Two joint stock companies made bids on Talleks, both representing employees of Talleks. The group presenting the most modern business plan won the bid, and began negotiating with the State Property Department (SPD) about how to realize the privatization. The other group, however, led by the former managing director filed a protest with the prime minister. It did so despite the fact that it had only offered one tenth of the winning bid for Talleks, and had tried all kinds of backstage political maneuvering to win the case. The prime minister decided the decision of the SPD had been correct. The new owner group began to invest in the firm.

The earlier managing direct, however, sued both the SPD and the Ministry of Industry, arguing the both procedure and the implementation of the principles of the Property Reform Act had been violated. A new Government was now in charge. The parliament had amended the contested paragraph of the implementation act. It was also revealed that the former director of Talleks was backed by influential circles of Estonian Society not willing to lose their positions during privatization.

[6] From Kukk, M., 1993 *Privatization in Estonia,* IUI Mimeo.

Government however, explained to the court that the privatization of Talleks was according to law.

The Tallin City Court, nevertheless (in September 1992) declared the purchase invalid. The new owner then appealed to the Supreme Court, which supported the Tallinn City Court. This whole outcome rested on inconsistencies in the new law, even if the practice was in accordance with Government intentions. Seven other privatization cases were therefore also at stake, and several companies had made significant investments on the basis of the granted privatization. Important principles were at stake. Then the vice Chairman of the Supreme Court demanded that the president of the Supreme Court consider the case again. In January 1993 the president declared that the privatization had been legally correct.

The former director now turned to the Chairman of the New Constitutional Highest Court, the National Court and protested the privatization deal, this time citing formal inaccuracies of procedure contradicting civil code. The privatization of Talleks was once again declared illegal on May 12, 1993, this time by the National Court. This time (on May 14 1993), however, the prime minister acted, accusing the former nomenclature of hindering privatization efforts, and proceeded to initiate a special law to privatize Talleks as already decided. Parliament approved the law on June 16, 1993, and decided that in determining the final price for acquiring Talleks the costs and losses associated with the long law suit would be taken into account.

6. The synthesis: how to create a market for risks

There are now three ways of dealing politically with the investment issue in a formerly planned economy. The *first*, welfare approach, tried extensively for years in the underdeveloped economies, can be ruled out as non-workable. Supplying more money won't solve the investment incentive problem, only

worsen the economic problems of the formerly planned economies.

The *second* and *third* approaches are related, and probably have to be mixed. The second approach, attempting to build the appropriate *minimum institutional* structure, will have to be the main policy course but will take too long. Therefore it has to be provisionally complemented with an *insurance arrangement* for foreign direct investments, western countries carrying the political investment risks of their firms.

We are now close to the *first* task of specifying the minimal set of institutions supporting the three elements of the property rights of Table 1 such that non-business risks are sufficiently reduced in Table 3 to make investments viable. Table 2B illustrates.

Second, we relate the elements of the property rights definition to the four fundamental mechanisms of economic growth (see Table 2). These mechanisms can be interpreted as four *investment* mechanisms, the last being a case of disinvestment. In doing this we have established necessary and sufficient institutional conditions for investments needed to ensure sustained economic growth. The final step (not taken in this paper) will be to discuss which elements in Table 2 that are the most important.

As can be seen from Table 1B large complexes of law and the associated interpretative and enforcement mechanisms have to be created to achieve the minimal institutions necessary to reduce the risk of opportunistic political behavior associated with the property rights institutions, notably the ownership of corporate equity. And this is only (see further Eliasson-Rybczynski-Wihlborg 1994) the surface of the complex rule system needed. Most of this rule system does not exist in the formerly planned economies, and the complementary political mentality necessary for the smooth functioning of a market economy is lacking.

As long as this situation prevails business and political risks will mix in an unsound way. Both indigenous and foreign investments will be destimulated.

Since indigenous investment will not, in the foreseeable future be sufficient to achieve a reasonable growth rate in formerly planned economies focus should be set on the conditions needed to stimulate foreign direct investments (see further Eliasson, Rybczynski-Wihlborg 1994). Again relying on the indigenous development of the necessary legal system, the only way to move will be by way of Western financial support, in principle in the same way as Western Germany is salvaging the former Eastern Germany.

The insurance solution

Since it won't be possible in general to implant an entirely new legal system to protect property rights the solution will have to be to combine (1) a western financial insurance coverage for political risks *(opportunistic political behavior)* taken on by firms with (2) strong incentives, directly linked to this support to allow the necessary legal framework to develop. I have referred to *enabling law* as the vehicle to achieve this. Only in this way will it be possible to reduce the investment risks in the formerly planned economies such that firms only have to cover their normal business risks. Using an insurance arrangement (as that suggested in Eliasson 1993d) Western Government aid to the formerly planned economies could be in the form of a guaranteed insurance against their own opportunistic political behavior, covering the investing Western companies. The incentive will then be strong to move fast in creating an efficient property rights system.

The problem will be to define operationally the limiting line between business risks in Table 3 to be covered by the firm and the political risks for which Western Government extend aid to the formerly planned economies. To do this ahead of the development of rules and conventions through enabling law,

an extensive and imaginative interview study of the experiences of firms in similar circumstances would have to be carried out. It is then not necessary to restrict oneself to the recent experience in formerly planned economies. A large reservoir of similar experience exists in the developing countries and in most of the heavily regulated parts of Western industrial nations. Such an inquiry would, in fact be very valuable also to the Western industrial world.

Let us outline some particular problem areas.

One thing to remember is that the different legal structures in Table 1B are effective on different parts of the growth mechanisms in Table 2.

Bankruptcy law

Thus for instance, to take a concrete example first, if there is no *bankruptcy law* (see item 2 in Table 1B) there will be difficulties terminating unprofitable operations efficiently (the exit item 4 in Table 2), especially when it comes to clearing up financial obligations. Similarly, if there is no enforceable *company law* the founders of a firm would have to formulate their own contract regulating their internal relationships, and the external relationships of the firm, for instance to outside lenders. Delegation of operations control would be unclear as will the *right to* manage (item 1 in Table 1B), restricting the possibilities of organizing production efficiently and reducing redundant staff. The abscence of standard contracts and enforceable company and bankruptcy law will not prevent firms from being established, but risks and transactions costs will be higher.

The big firms

In many formerly planned economies it is not allowed to fire people. This

restriction holds back the *exit* process and the efficient *reorganization* and *rationalization* of big firms. The existing, big Soviet firms pose a particular problem. For one thing, they employ a large part of the existing labor force. While many of these people won't be an asset in the new firms, several will be needed, and part of the transition problem is to induce redundant people to move to new and more uncertain jobs. This means that efficient reorganization and rationalization will be a formidable task under current legal regimes. There are large risks associated with securing new capital to modernize, and then a tremendous risk associated with closing down redundant physical and human capacity. If the large firm does not embody some unique competence, or asset it may be most rational to close down the entire operation, or at least not to pin any hopes on getting a contribution to growth. Under that conclusion the difficulties associated with the exit process will be a real obstacle to the transition process in the sense that it locks up resources and makes available resources more expensive. Hence, *in the long-run* newly established firms will represent the main growth factor, and as it looks, this may also have to be the case in the short-run.

New entry

This means that policy aiming at enhancing the transition process should focus on creating incentives that

a) improve conditions for the new establishment and the expansions of small firms and

b) (if there is a potential), induce foreign firms to invest to upgrade existing plants.

In both cases, however, it will be necessary to establish tradable property rights in the entitlements to future profits from these business ventures, such

that

(1) profits can be freely disposed of, and/or returned to some other country

(2) the entitlement to the business can be transferred to some other party, without any restrictions imposed by political authorities.

These rules also have to be credible in the sense of being enforceable by courts, or by some other means.

Improving such institutional conditions, furthermore, will be a slow process, requiring extreme patience on the part of politicians.

The spontaneous creation of markets for business financial risks to facilitate the funding of profitable long-term growth investments in formerly planned economies will thus have to await the reduction of the political risks in Table 3. On this a few conclusions can be drawn.

First of all, the existence of strong expectations of type one and two "major" political risks will effectively reduce all major investments in the formerly planned economy. Large foreign firms may gamble on the possibility that such events won't occur and establish a presence in those markets. But this is a far cry from engaging in larger expansion investments. Small foreign firms in low technology production might engage in subcontracting arrangements of a short-term nature, with small commitments of funds and technology. Again, if such political risks are expected to be large, they will always maintain supplementary supply relationships in Western economies, a negative circumstance for the East European producer. The strong growth injection won't occur.

This, *second* allows the following conclusion. Among the couple of dozen or so formerly planned economies those considered most stable in terms of first

and second order political risks will receive most long-term investments. There is a case for competition among the nations to establish an orderly and predictable judicial system.

Even if first and second order political risks have been reduced to reasonable levels (remember that significant macro instabilities occur also in Western countries) the third political risk category; *opportunistic political behavior* imposes a basic restriction on growth. This is the risk category we have paid most attention to in this paper. We are now into the details of Table 1B and we have already concluded that to do it on their own the formerly planned economies have to face a long time horizon, far longer than most of these nations can handle politically and socially. There is probably only one way to overcome the waiting period, or the time needed to allow the natural evolution of a viable Western legal system, namely to look for Western support. This should not be in the form of financial aid, but in the form of private direct investment and an insurance of the foreign investors for the political third order risks. There should be plenty of possible arrangements to secure risk reduction under category three with a minimum of moral hazard on the part of receiving countries and investing firms, along the lines development in Eliasson (1993d). This provision of risk coverage should be the main task of the European Bank for Reconstruction, not to disburse financing to firms and formerly planned economies.

The reduction of political risks of all three kinds in Table 3 is furthermore necessary to enable an orderly development of the institutions of the financial system.

7. The investment calculation

A careful analysis of most firms from any formerly planned economy would reveal the following three facts. The firm *(first)* lacks the management and

technical competence and the equipment to develop, to produce and to market products in western international markets such that costs are covered. *Second*, the country lacks the competence to develop within reasonable time the same competence and the needed equipment and, hence, is critically dependent on foreign investments in the same competence to support an investment and growth rate that matches expectations in the formerly planned economies. *Third*, the economic value of the needed competence and capital investment in each firm is enormous compared to the value of existing competence and equipment. Taken together, for all firms and formerly planned economies the total investment requirement is gigantic. If it had taken place during a short period the consequences would probably have been as was foreseen and indicated in the introductory words of this paper. But incentives have not been there because of high political risks. Investment is not only a question of financing. Valuable competence plays an important role, and the cost to western firms in terms of increased competition from parting with their technology under not controlled circumstances is potentially very high. Hence there won't be an investment boom in the formerly planned economies until the political risks have been eliminated through institutional reform and/or taken on by some other party, say a benevolent and wealthy western nation (the insurance problem). Suppose, however, that the political risks have been eliminated, how do (then) the profitability prospects look?

Some firms (like the two firms in Eliasson 1993c) can sell their obsolete, but still useful products in western markets through western intermediaries, the latter capturing (in the two cases) some two thirds of value added in the process. Even though the value added created domestically (excluding the part created by the foreign intermediary) is only sufficient to create a labor productivity far below the worst Swedish producer (Figure 2A), very low wages (valued in western prices and currencies) still makes the firms profitable by western standards (Figure 2B), in fact more profitable than the "corresponding" Swedish competitor. To raise the performance of the two east European firms to western standards, it is not sufficient only to invest in new

equipment and new competencies in the form of a marketing and product development organization. Also competent labor and technicians have to be trained or hired at significantly higher compensation than the current salary levels. It is perfectly possible to compare the costs of that transition, using stylized data and the information in the Eliasson (1993c) study. The political risks discussed in the main part of the paper can be included in this calculation. These political risks will apply to the domestic and the foreign investors alike. But the foreign investor will be able to compare his returns net of these political risks with what he can earn from investments in western markets.

Using the data on two firms from Eliasson (1993c) we find that total capital intensity has to be increased at least three times. First hardware production capital has to be at least doubled by modernizing the equipment. In addition hardware capital has to be added at least as much for inventories and other current capital. Furthermore, hardware capital amounts, on average in these types of firms, to some 60 percent of total capital, including also accumulated stocks of product and market knowledge and investments in training the staff. This is a cautious estimate, noting also that these were the best firms in their respective countries (see Appendix). This investment alone will, however, not bring the East European firms on par with the Swedish firm.

In the long-run the investments indicated will have to be made for the firms to become competitive on their own in international markets. There are two critical issues. *First,* to carry out the needed investments, also the requisite receiver competence has to be upgraded. *Second,* what will happen to wages in the process?

We have already concluded that the profitability calculation collapses if the needed business and technical competence cannot be brought in. The only way will probably be to use foreign expertise through foreign direct investments. The foreign investor, will then be compensated through a high return to his

investments. This can only be occasioned at reasonable returns to investment if the property rights are in order, and if wage and salary levels for considerably time remain much lower than in the West.

In the East German case this has not been possible. It won't be possible in other formerly planned economies under a program of massive investment and upgrading of existing facilities, requiring the recruitment of labor with a competence that doesn't exist in sufficient volume. Wage inflation will then follow.

A few firms doing this rapidly and alone with western inputs of competence would, however, profit handsomely. This is essentially the case of foreign direct investment.

Using the rate of return formula in the appendix, we can see that the most profitable western strategy is to acquire an East European firm and use it as a subcontractor only, upgrading the factories with western technology. This arrangement will considerably improve profitability compared to production in a corresponding Swedish facility. Technically the foreign firm could team up with a domestic subcontractor. It would, however, not be willing to share its own technology with the subcontractor if it cannot control its use through an ownership contract. This contract thus has to be legally supported in the country in question.

Such an arrangement (as the appendix shows) could support a significantly higher wage cost level. But it would not necessarily be in the interest of the foreign investor to introduce its product design and marketing knowhow in the East European subsidiary. It is more profitable (as the calculations show) to keep it as a producer of rents and components. Such knowhow to be developed by the domestic producers on their own will require considerably investments, that will not be as profitable as a subcontracting arrangement.

Appendix

The *real rate of return* of a company is defined as:

$$R = \frac{PQ - WL - \rho K}{K}$$

when:
Q= output volume
P= output price deflator
W= wage cost per unit of labor import
L= unit of labor input, say man years
K= capital, replacement valued
ρ= depreciation factor
It follows immediately:

$$R = \left(1 - \frac{W}{PQ/L}\right)\frac{PQ}{K} - \rho$$

or

$$R = M \cdot \frac{PQ}{K} - \rho$$

Where M is the gross profit margin in percent of value added and
M= (1 - unit labor cost).

From Eliasson (1993c) we have data expressed in international currencies on Firm B in Tables 2A, B. Figure B is the best machine tool manufacturer in one East European country. Firm S is the best machine tool manufacturing company in Sweden. The two firms happened to be of roughly comparable size in terms of value added. This means that we have adjusted the Swedish data so that the two firms produced (in 1989) exactly the same output in SEK. The data are explained in detail in Eliasson (1993c). The comparison is shown in the table below.

If production facilities are modernized to Swedish standards, assuming blue collar labor is capable of producing as efficiently as Swedish labor, but earning the same wage as before. The profitability calculation improves considerably to R=19 percent. It is, however, important to observe that wages mean some, but not very much. This is the most optimistic case a foreign investor will meet, using the East European firm only as a subcontractor. If wages escalate to half the Swedish level, the Rate of return will decrease to be = 11 percent. This is still the case of an East European firm being used as a subcontractor by its Swedish parent. If the East European firm tries to go it alone acquiring the needed marketing and product knowhow at western costs, the rate of

return collapses (assuming half the Swedish wage) to R= 5 percent. This is higher than for the Swedish firm, but below standards and with no margin for political risk coverage.

	Swedish Firm	East European Firm
Value added (=pq)	220 M SEK	220 M SEK
Employment (=L)	600	1500
Labor productivity (= PQ/L)	$\frac{220}{600}$=367 *thousand*	$\frac{220}{1500}$=147 *thousand*
Wage costs (=w)	250 thousands/employee	30
Machines and buildings	350 M	350 M
Total visible capital in balance sheet (Replacement values)	700	700
R (percent)	0	15

Table 1	**Definition of property rights**
as the right to	
1) *Manage* the property	
2) *access* and use the profits	
3) *trade* in the property rights.	

Table 1B	**Institutions supporting property rights**	
1	*Right to manage*	– New establishment – Corporate governance – Company law – Operations control – Competition - Monitoring and control.
2.	*Right to access*	– Tax law – Exchange controls – Bankruptcy law.
3.	*Right to trade*	– Constitutional property rights – Registration – Rules for identifying property rights with persons – Court recognition of voluntary contracts (enforcement, resolution of conflict, procedure).

Table 2 **The four mechanisms of economic growth**

1. Entry
2. Reorganization
3. Rationalization
4. Exit (shut down)

Source: Eliasson, G., 1992, *The Economics of Technical Change*, IUI Working Paper No. 349b, and Eliasson, G., 1993, "Företagens, institutionernas och marknadernas roll i Sverige", Appendix 6 in Lindbeck, A. (ed.) *Nya villkor för ekonomi och politik*, (SOU 1993:16).

Table 3 **The risk hierarchy**

Political risks

1. *Force Majeure* - referring to non-economic events (military intervention etc.)

2. *Macro economic* - refer to uncontrollable macro development (run away inflation, collapse of monetary system etc.)

3. *Opportunistic political behavior*

Business risks

4. Opportunistic behavior of competitors.

5. Pure business risks.

Figure 1 **The links between property rights investment incentives and economic growth**

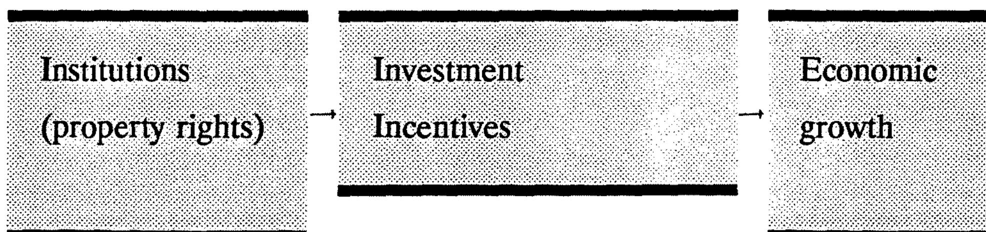
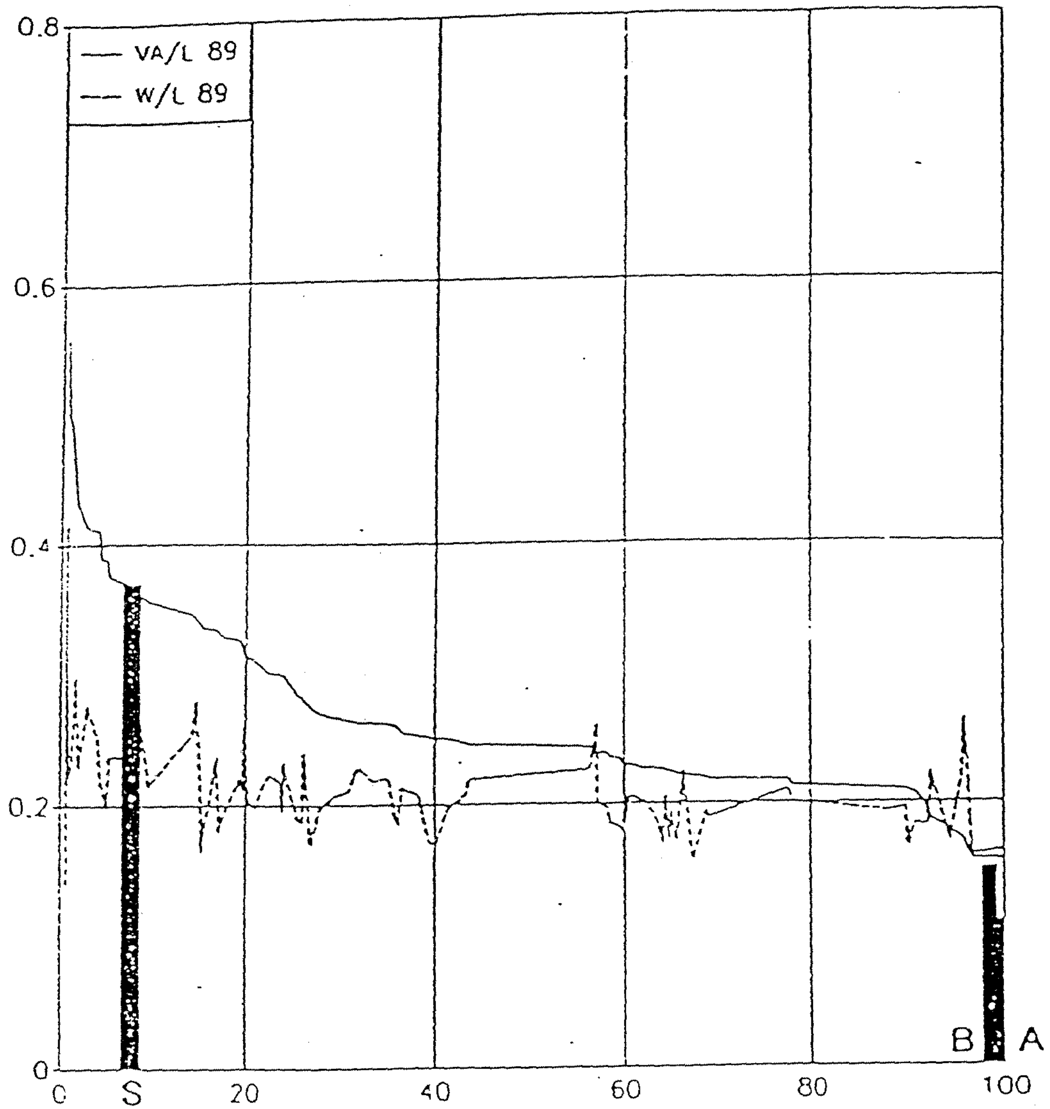


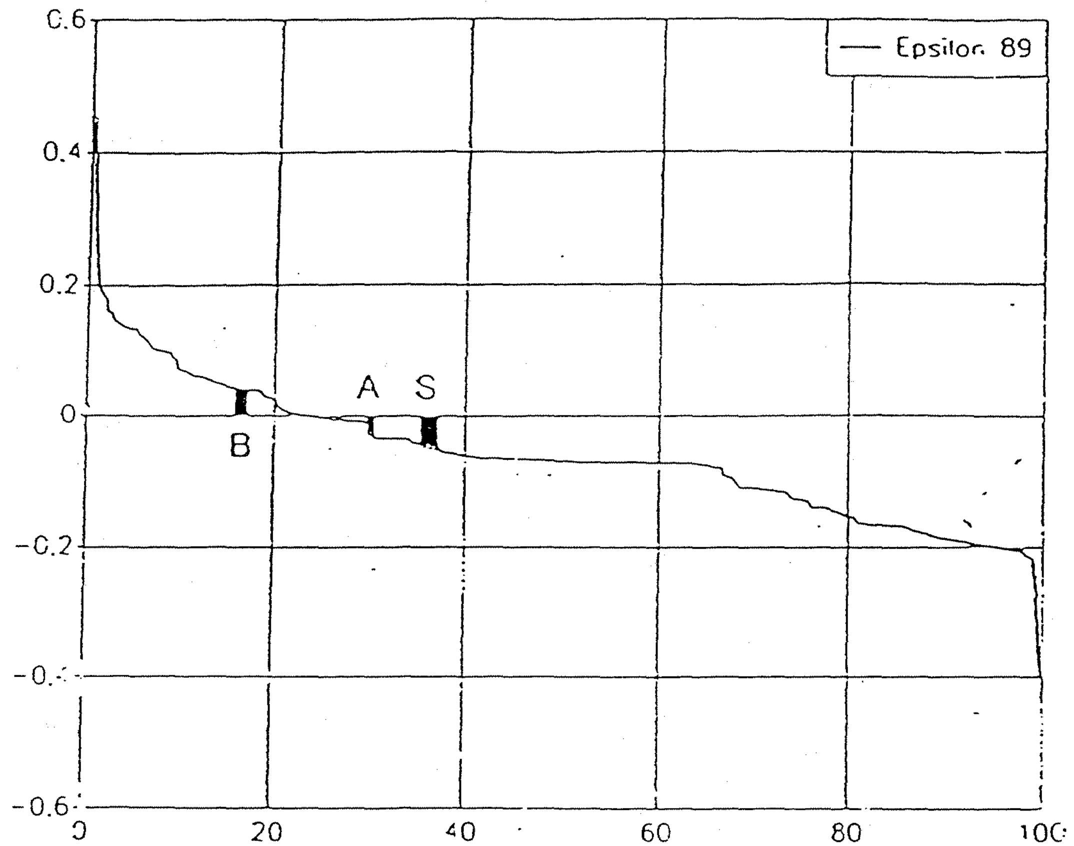
Figure 2A Labor productivity distributions in small Swedish manufacturing firms and subcontractors 1989



Note: Two east European firms (A and B) and one "comparable" Swedish machine tool manufacturer (S) are indicated. See further, the text.

Source: Eliasson, G., 1991c.

Figure 2B Rates of Return over the interest rate (=$\hat{\varepsilon}$) in 1989 in small Swedish manufacturing firms and subcontractors



Note: Two East European firms and one "comparable" Swedish machine tool manufacturer are indicated. See further, the text.

Source: Eliasson, G., 1991c.

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