Economic Reform

and

Efficiency

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Part 1

This paper examines the relationship between economic reform and efficiency in the socialistic countries.

Economic reforms is a fact of life in the most of Eastern European countries, especially in Hungary and Poland, whose efforts of reform go back to 1968 with the New Economic Mechanism and to 1956 with the Polish October.

Economic reforms which in other words are changes in the economic management, refer basically to the efforts of the government to institute economic decentralization in order to improve economic efficiency.

Although, "socialism must admit its limitations in terms of efficiency"[1], economic efficiency, lying in the core of economic theory and practice is one fundamental principle of a well working economic mechanism.

It is very difficult and ambiguous to define indicators of economic efficiency.

Different patterns of economies need different measures or conditions of efficiency.

For example, Babic[2] defines as many as eight indicators, such as income per worker, income in relation to average working capital used, accumulation in relation to income, cash reserves in relation to average working capital used etc.

Similarly, Kornai[3] enumerates "some of the necessary conditions for economic efficiency" such as a material and moral incentive system to stimulate better performance of all economic agents, careful calculation of costs and benefit of every project, fast and flexible adjustment to every situation, and the stimulation of entrepreneurship, creativity and responsibility in all decision makers.

Basically, the question and problem of efficiency evolves around the production of the material product with consequence of supply shortages.

Even in Bulgaria, a country hard and opposing to reforms, "the most recent attempts to counteract the economic downturn were management changes in the DSOs (durzhavno stopanstvo obedinenie) designed to increase the quality and production efficiency of production, particularly at the lower levels in the enterprises, by introducing enterprises and economic organizations."[4]

Closely related to the production efficiency is the efficiency of investment, so important to faster economic growth and partially to labour productivity.

Of course, "some increases in productivity can be achieved through improved work practices and the elimination of so called "unemployment inside the factory gates" (which is interdependent to the incentive scheme), but for the most part it will be the opportunity to work with improved capital equipment that raises productivity."[5]

But in almost all socialistic countries great amount of resources have been directed to different, mostly strategic projects by overlooking the investment efficiency problem.

Even during the 1980s the majority of state enterprises face soft constraints. That leads to the requirement of more and more capital for investments, in turn to more waste due to mismanagement and corruption and consequently inefficient production activity.

Naturally the x-efficiency enters with a rising trend and neither individuals nor firms work as hard as they could and a decline in the rate of growth of labour and capital productivity is unavoidable.

This, by the way, brings another excessively strategic and important element into the picture. The search for capital abroad and as a result the creation and/or increase of debt to advanced capitalistic countries like USA.

Reforms also try to reconstruct and modify guidelines for the adequate and careful cost-benefit analysis before any investment begins.

So, every government takes a close look at the preparation of investment projects so that the actual and planned investment expenditures should create only minimal disparities between each other.

Another important component of the reforms is directed towards the more efficient financing of the investments.

In the pure socialist form external financing of the state owned firms face only soft "budget constraints". The business unit can receive grants, permanent subsidies and other contributions which occasionally are accompanied without repayment obligations.

The reforming efforts of the governments attempt to harden the constraints of the micro0organization and to create self-supporting, independent firms with minor assistance from the state.

So, the projects are financed mainly by the enterprises's own funds and the state will give a hand, through bank credit.

If these two sources of financing are not sufficient and financial difficulties arise, in certain sectors or at certain time, subsidies may enter into the mechanism, basically in the form of grants.

If the state lacks or is short of "cash", then the firm is left with the option of external borrowing.

Part II

So, low productivity, continued manufacturing of obsolete items, slow technological improvements, excessive use of energy and raw materials, and managerial and organizational shortcomings, created and still create the urge for supply side changes.

Such changes took the form of loosing control over state enterprises, introduction of profit-incentives, liquidation of inefficient firms which in turn frees resources for more productive uses and different decentralization formats which make enterprises able to adjust quickly and more efficiently to changing conditions.

Consistent with the above is the continuous growth of the producer (industrial/worker) co-operatives (PCs) as Jones[6] indicated in the case of Poland.

And that because of the cooperatives' "better economic performance relative to an increasingly inefficient state-owned primary sector."[7]

The more efficient performance of the cooperatives can be traced down not only in terms of technical efficiency (i.e. stronger capital or labour productivity etc.) but also in terms of distributive efficiency which is not examined in this paper.

From the viewpoint of decision making the organization of the producer's cooperative allows the disaggrevation of the different decisions concerning the enterprise which overshadows the arteriosclerotic and rigid decision-making pattern of the state-owned firms.

In other words, the participatory firms by allowing worker participation in decision-making release a greater more creative effort and a higher commitment to the business unit.

These psychological factors coupled with organizational and cultural elements such as, attitudes to quality, work discipline, cooperation etc, create a threshold of a more efficient use of production resources.

Moreover, subordinated decision-makers slowly but progressively realize that they move towards the "hard budget constraints" situation through the disciplines of responsible participation, bankruptcy and liquidation and rationally functioning.

The profit orientation also links investment and earning to profits. So the bigger profits, the larger the part of the profits is retained for investment and the bigger the payment of the social dividend to every worker.

This forces enterprises to economize on scarce resources and stimulates public interest in the efficient running of the enterprises.

Consequently this will create a more flexible labour market. Workers from the state-owned firms will trade security of employment with risk of temporary unemployment and they will search employment in the cooperatives with higher profitability, and a higher return-wage.

The increase in the enterprise wage level gives employees an incentive to further increase enterprise performance.

Hence, "the motivating effect of profit sharing is likely to depend on workers perceived ability to influence managerial decisions affecting profitability."[8]

In other words, worker participation and profit sharing will likely raise higher productivity, enhance greater organizational unity and devise "greater unity of purpose and feelings of solidarity."[9]

"Even limited elements of participation or partnership are likely to generate loyalty and attachment to workplace which is rationally founded in the knowledge that personal prospects including promotion and job security do depend heavily on firm growth and profitability to finance investments."[10]

The reforms by forcing the enterprises to be more self-sufficient, attempt to induce higher productivity, reduce costs and speed technological advance through continuous upgrading of capital equipment.

The more efficient industrial supply system encourages enterprises to be more competitive and produce the most and the best product at the lowest possible cost. This simultaneously eliminates shortages, giving customers a greater choice of material products and improves goods quality, raising the living standards of the population.

Another initiative to give enterprises more responsibility and authority involves a reform of the pricing system. Pre-reform prices were based on a markup system and did not equate demand and supply, as supposed to happen in market economies.

The indirect steering instruments (such as prices, taxes, credits etc.) were restructured with the reforms.

Basically, they were separated into two groups, one attached to the domestic orientated products (domestic prices) and the other to export-oriented goods (world market prices).

So, "domestic prices for finished products of industrial branches participating in foreign trade were to be brought into line with prices obtained through export."[11]

And the prices of domestically consumed products were pushed to equate the expenditure of production.

Thus the prices lost some power of the previous distribution function, that had exercised when at lower level of the cost of production.

Furthermore, the reformed relationship between the wholesale and retail selling prices for consumer goods was constituted in order to establish and maintain a price stability and a uniform exchange rate, helping the external trade balance.

Finally, the efforts to ensure that domestic prices reflected the world market prices for similar products and raw materials, and the establishment of the stable exchange rate create a positive credit repetition at the world markets, and a greater opportunity for industrial and trade cooperation between East and West.

Part III

In the historical setting, since the famous speech of Alexei Kosygin in 1965, the authorities of USSR emphasized the profit motive in the state-run enterprises.

The Material Incentive Fund, from which bonuses were paid not only to the manager but also to his staff, workers and employees, was introduced in order to help the economic revitalization and to increase economic efficiency.

Again now, under Gorbachev, the Soviet leadership has made perestroyka a top priority policy. And that because either the proposed reforms, during the 1950s were distorted, or the bureaucratic machine of many socialistic countries never understood the necessity of the evolution and never promoted the reforms schemes, or the socialistic ethos is so well grounded and deeply rooted in the mass of the people in the Eastern countries so to confront any market-oriented reform.

In fact, all these three main processes or conditions prevented the full fledging operation of the reforms of economic institutions and mechanisms.

Accordingly Gorbachev's first initiatives was to boost production and reduce costs by trying to restore temperance, discipline and accountability in the work force and to upgrade technological production by encouraging innovation and creative application of different technological machines.

The expectation of the new government in Moscow is not only to stimulate the workers' collusive and strategic behaviour in the social context of productive organizations but also to extract the individual optimal effort, with the introducing packages of monetary and other economic incentives.

"It remains to be seen whether the new measures will in the event succeed or whether they will continue to be undermined by phenomena inherited from the tradition of directive planning or by events beyond the control of the economic managers."[12]

However, Kornai[13] concludes that it is impossible to create a system that would be both fully efficient and ethical. Because decentralization intensifies problems of externalities and therefore clashes with the socialist principle priority of general interests over partial interests.

Nevertheless, the creation of stronger links between performance and reward, the tighter control over privilege, patronage and corruption, the stress on quality products, modernization and anti-drug abuses in the industrial sector, the polemic attitude towards bureaucratic rigidity and inertia and the acceptance of joint ventures with foreign enterprises give the signal of rapid economic reforms towards efficiency at the heart of the socialistic body.

Footnotes

1 Flakievski, Henryk, "Economic Reforms and Income Distribution," M.E. Sharpe Inc., Armonk, 1986, p. 132.

2 Babic, Stojan, "The Problem of Choosing Indicators of Efficiency in the Yugoslav Economic European System, 1976-1980," Eastern European Economics, Winter 1984-85, p. 45.

3 Kornai, Janos, "Contradictions and Dilemma," The MIT Press, Cambridge, Mass., 1986, pp. 124-125.

4 Wiedemann, Paul, "Economic Reform in Bulgaria, Coping With the kj Problem," Eastern European Economics (EEE), Fall 1981, p. 100.

5 Hungary: A Decade of Economic Reform, Edited by P.G. Hare, H.K. Radice, & N. Swain, G. Allen & Unwin, 1981, p. 97.

6 Jones, Derek C., "The economic performance of producer co-operatives within command economies: evidence for the case of Poland," Cambridge Journal of Economics, 1985, 9, 111-126.

7 Jones, Derek C., "The economic performance of producer co-operatives within command economies: evidence for the case of Poland," Cambridge Journal of Economics, 1985, 9, 124.

8 Cable, J.R. & Fitzroy, F.R., "Productive efficiency, incentives and employee participation, some preliminary results for West Germany," Kyklos, Vol. 33, 1980, p. 104.

9 Jones, Derek C., "The economic performance of producer co-operatives within command economies: evidence for the case of Poland," Cambridge Journal of Economics, 1985, 9, p. 116.

10 Cable, J.R. & Fitzroy, F.R., "Productive efficiency, incentives and employee participation, some preliminary results for West Germany," Kyklos, Vol. 33, 1980, p. 104.

11 Zwass, Adam, "The economies of Eastern Europe," M.E. Sharpe Inc., 1986, p. 15.

[12] Hungary: A Decade of Economic Reform, P.G. Hare, H.K. Radice, & N. Swain, G. Allen & Unwin, 1981, p. 21.

[13] Kornai, Janos, "Contradictions and Dilemma," The MIT Press, Cambridge, Mass., 1986, pp. 136-137.

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