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**Article**

## Transition, Convergence, and Labor Market Adjustment in Prospect and in Hindsight

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## Hartmut Lehmann and Mark E. Schaffer Transition, Convergence, and Labor Market Adjustment in Prospect and in Hindsight

### CONVERGENCE

The perspective that we both took at the start of transition was that of “convergence”, but in a broader sense than the standard notion of “technological catching-up”, in which countries away from the world technological frontier can grow rapidly – “beta convergence” – by adopting already-existing innovations. This broader sense was quite natural for us, given our backgrounds in comparative economic systems and political/social history.

We both started our academic training outside the economics discipline. At the time that the socialist regimes collapsed and we became active in the economics of transition, we each had a background of some years of study in the nature of these polities and economies. HL lived and studied for two years in Poland in 1972 and 1973, majoring in Slavic languages and East European history. In the 1980s and early 1990s, he studied economics at Berkeley and at the London School of Economics (LSE); his PhD from LSE was partly on labor market adjustment in East Germany and Poland as the transition from a centrally planned towards a market economy unfolded. MS’s undergraduate degree at Harvard was in international relations and social theory, and a large part of his PhD at LSE, completed in 1990, analyzed the workings of planned economies in general and the Polish “market socialism” experiment of the 1980s in particular; his PhD supervisor at LSE was Stanisław (Staszek) Gomulka, who went on to play a key role as an advisor to the Polish governments of the early transition period. Hence we both took a broad social science perspective to looking at transition rather than a narrow economic perspective. While HL was influenced in his approach by the variant of the “new” macroeconomics of labor markets developed and taught at LSE and with a focus on highly developed capitalist economies (see Layard et al. 1991), we were both influenced by Staszek’s perspective on convergence and catching-up. Convergence and labor market adjustment were the two themes that both of us thought about while discussing transition in our shared office at LSE in the early nineties.

A longstanding theme in the analysis of centrally planned economies (CPEs) was the distinction between “static” and “dynamic” efficiency. Prior to the growth slowdown in CPEs in the 1970s–1980s, this presented an apparent puzzle: the socialist system had

many obvious dysfunctionalities and inefficiencies (“static inefficiency”), yet many of the countries that had adopted this system grew rapidly (“dynamic efficiency”). Convergence, and the limits to convergence, explain this puzzle. The opportunities for rapid growth by industrializing and adopting technology from already-industrialized countries enabled relatively backward countries that adopted the socialist system to grow rapidly. Specific features of the CPE system enabled catching up to proceed relatively rapidly: planning enabled high investment rates and rapid capital accumulation, and directed investment into areas that were particularly growth-enhancing, e.g., energy and transport infrastructure, and education/human capital (Carlin et al. 2013).

Eventually, however, as countries approach the technological frontier, catching-up slows down, and this is the natural interpretation of the 1970s–1980s growth slowdown. At this point, the static inefficiencies of central planning start to dominate, and we see the emergence of an “equilibrium technological gap” (Gomulka 1986, 1988). The result is a set of countries that are growing at rates not far from the rate at which the technological frontier is growing, but where productivity levels are quite low.

We can extend this perspective in three ways. First, the transition countries of Central and Eastern Europe (CEE) and the former Soviet Union (FSU) were fairly heterogeneous in terms of their productivity levels at the start of transition. From a historical perspective, however, heterogeneity in productivity levels in 1990–1992 was substantially less than heterogeneity at the time these countries adopted central planning. The FSU countries that adopted central planning in the late 1920s ranged from those that were poor and where industrialization had not proceeded very far (e.g., Russia, Ukraine) to those that were extremely poor and where industrialization essentially hadn’t yet started (e.g., Central Asia). The countries that adopted planning in the late 1940s (including the Baltics) were even more heterogeneous, ranging from very poor (e.g., southeastern Europe) to those that just prior to the Second World War were moderately rich, and belonged to the club of highly developed economic regions in Europe (e.g., Czech Republic, and of course the regions of Germany that became the German Democratic Republic). The rapid catching-up followed by growth slowdown was experienced by countries that started out relatively poor. Countries that were at or near the frontier in 1938 moved away from the frontier; by 1990 these once-rich countries were now relatively poor compared to those of a similar income in 1938 (Carlin et al. 2013).

Second, the experience of central planning endowed these countries with a range of characteristics that differentiated them from other countries with similar income levels. The list is long and well known: state ownership of assets, a relatively undeveloped service sector, a size distribution of firms with a near absence of microfirms and small and medium-sized



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enterprises (SMEs), trade patterns that conformed to planners preferences, a set of peculiar economic institutions that were appropriate for a planned and not a market economy, etc. But it is important to note that not all these were handicaps: compared to market economies with similar economies, these countries had high levels of human capital and fairly good energy, transport, and communications infrastructure.

Third, the convergence perspective can be extended beyond just “technology”. At the start of transition, the poorest of these countries had moved closer to the technological frontier, and the ones that were relatively rich when they adopted planning had moved away from it. But in terms of economic institutions, the long detour of central planning moved them all away from the institutional setups of their neighbors. The same applies, of course, to the political institutions these countries adopted during the communist era. Here again, though, there was great heterogeneity, and institutional and social memory was long-lasting. The economic, political, and social institutions of the market economy were still within living memory in the CEE countries – in some of these countries, these institutions had existed only in embryonic form, though; at the other extreme, Central Asian countries had never experienced these institutions and had industrialized entirely in their absence.

All of this was more or less apparent to us in 1990–1992, when we started working on the economics of transition. Our perspective was to look at transition economies (TEs) in terms of the removal of a set of institutional and political constraints. In the narrow technological sense, we expected – in the medium term, after the immediate output drops and “transitional recessions” – a resumption of “catch-up” productivity growth (or, in the case of the previously rich TEs, a reversal of fall-behind slow growth). This would follow from the adoption of near-frontier technology, where technology is broadly defined as “know-how” – not just technical innovations, but the institutions of a market economy. In the shorter run, we also expected large improvements in allocative efficiency – the elimination of shortages and queues, increased availability of consumer goods including imported goods, etc. But we also thought the path of transition would be influenced by the peculiar inheritances of central planning, including the positives of human and physical infrastructure as well as the more obvious negatives. And we also expected some heterogeneity in transition experiences across countries.

### **EXPECTATIONS IN THE SHORT, MEDIUM, AND LONG RUN**

We begin by describing the expectations about the short, medium, and long run that we held at the beginning of the transition.

In 1990–1992, taking Poland as our principal point of departure and taking a five-year perspective, we

both saw great gains from the rapid entry of new private firms and the growth of the new private sector. We also predicted big gains from the recreation of the SME sector, which clearly had better development conditions than in the interwar period. Finally, we thought we would see great gains in allocative efficiency given the massive reallocation of capital and labor across and within sectors. That this reallocation was connected to substantial costs for large segments of the existing workforce is a point to which we will return below. In hindsight, our expectations for the short run were largely fulfilled – these gains were very large and very visible across a wide range of transition economies.

With respect to the medium run – say, over the next 10 to 15 years – we thought two closely related developments would have a major impact on the performance of the CEE transition economies: privatization and foreign direct investment (FDI). We both considered privatization of large firms as an important condition for further improvements in allocative and dynamic efficiency of these economies. FDI, on the other hand, brings frontier technology to economies and often creates positive externalities through technology spillovers to domestic firms.

At the beginning of the transition, however, we were overoptimistic in one important respect: we extrapolated too readily from CEE countries to the FSU transition countries. Although we were well aware of the heterogeneity of the starting points of these countries, and our optimism was well-founded with respect to the Baltic states, we were too optimistic about the direction and speed of change in the rest. The political process in the latter group of countries often led to state capture by small groups that came predominantly from the former nomenklatura and to institutions little conducive to the free development of private enterprise. Only where privatization went hand in hand with the establishment of institutions that prevent “grabbing” hands did privatization lead to truly big gains in total factor productivity (see, e.g. Estrin et al. 2009). In 1990–1992, we were, in effect, too euphoric about the collapse of communism, and saw more transition countries picking the fruits of a liberal democratic society than actually did. Where these fruits did not appear, privatization of large SOEs did not result in big gains in allocative and dynamic efficiency, nor were there large inflows of FDI. On the other hand, where these fruits did appear, the efficiency gains for privatized firms were dramatic, also because FDI inflows were large.

Over a 25+ year horizon we had grand illusions that were in large part disappointed. At the beginning of transition we expected that – although they would not all completely converge to the most advanced West European economies – some countries would come close, and the rest would be on a clear path that would bring them to the technological frontier in due course. Instead what we observe across the region are “dual economies,” a phenomenon that is typical for middle income countries in the developing world.

Large firms are the most productive, being integrated into European supply chains. Hence, we can speak of a convergence success when it comes to large firms, and here our expectations were correct. But in general the SME sector today is technically very inefficient, being far from the European technology frontier, and considerably further than where, in 1990–1992, we thought it would be today. Here we can speak of a clear convergence failure: in a nutshell, the CEE countries, even after having been members of the European Union for more than a decade, have not managed to become advanced capitalist economies, but can instead be characterized as “Middle Income Countries with Previously Socialist Characteristics.”

In order for convergence to finish, this duality needs to be eliminated, meaning that the SME sector needs to be fully integrated into modern European supply chains. For this to happen, very large investments in transport and other infrastructure would be a precondition, but this requires large investment and saving rates, both of which seem unattainable and in addition hampered by low population growth in most of these countries. The vicissitudes of political and economic reforms and restructuring over the last three decades have led to a very heterogeneous but at the same time quite uniformly disappointing picture regarding the hoped-for convergence to the European technological frontier. This disappointing picture also had important repercussions in the labor market, where a large part of the workforce reaped the benefits of the end of central planning, but where at the same time, a substantial group of workers encountered large costs. Therefore, it is worthwhile to consider in detail what we thought about labor market adjustment at the onset of transition.

## LABOR MARKET ADJUSTMENT

Most labor economists who started to analyze adjustment in labor markets of transition economies saw relatively little need to focus on labor supply and thought it more important to have a close look at labor demand. This was because the empirical evidence about the behavior of households in the labor market during the socialist period seemed to imply that the standard neo-classical utility-maximization approach might be a good starting point when thinking about labor supply, even before the transition to a market-oriented economy. Whether we thought about partially reformed centrally planned economies like those of Hungary or Poland, or about the Soviet Union or Czechoslovakia where reform started only after the communists had completely relinquished power, in both types of socialist settings the vast majority of people actually chose their jobs freely. Since labor turnover was similar to that of developed capitalist economies, enterprises provided incentives especially in form of bonuses to prevent the most productive workers from leaving. To most economists, including us, it was clear at the

beginning of the transition that we could model households as continuing to supply labor in a utility-maximizing fashion. Hence, there was less need to focus on labor supply during the initial period of restructuring. Essentially, we were convinced, as were most economists, that once economic and political constraints were removed, households would pursue their interests as they did before but with more efficacy.

Much more pressing seemed the analysis of labor demand as transition unfolded. The centrally planned economy has been characterized most convincingly as a shortage economy (Kornai 1980) where all inputs were in short supply, including labor. With wages set administratively at low levels, virtually all enterprises had excess demand for labor and did not minimize costs when hiring labor. Enterprises had to “storm” towards the end of the year in order to fulfill the targets given by the central planning authority, so they hoarded workers, some of whom were fully used only during this “storming” period.

In early transition, reform policies consisted above all of price and trade liberalization as well as macro-economic stabilization policies that included large reductions of subsidies to enterprises. Suddenly, firms were exposed to the cold winds of competition and the government no longer bailed out poor performers. A crucial question that needed to be investigated, therefore, was how firms adjusted their labor demand under these conditions.

Like many economists who looked at labor adjustment in the early years of transition, we also investigated adjustment from the demand (firm) side. We analyzed job creation and job destruction and related this to ownership types, concluding that new private firms disproportionately created jobs while SOEs dominated when it came to job destruction, a finding replicated by many studies that followed ours (Konings et al. 1996). Indeed, this early study appeared to us to confirm that our early optimism about the eventual convergence of SME sector was well-founded (that we were too optimistic became clear only much later).

All communist regimes implemented an industrial development strategy that emphasized heavy industry at the expense of light industry and services. Hence, transition to a market economy also implied a massive reallocation of labor in order to produce the employment structure of a mature capitalist economy in the medium run. This massive reallocation did occur in all post-socialist economies as documented by Boeri and Terrell (2002), but was accompanied, however, by many frictions and was characterized by large costs for many of the workers who were displaced from their jobs (Lehmann 2014). While it is true that socialist economies were characterized by human capital levels superior to those in economies that had similar per capita income levels, it is also true that the human capital of many workers rapidly depreciated at the beginning of the transition. Many workers had human capital that was employed in very narrow tasks during the central

planning regime; this human capital became obsolete or was relatively non-competitive as more and more firms adopted state-of-the-art technology.

Of course, the massive reallocation of labor brought large diffused benefits to the average person in transition countries in the medium term, but at the same time, it imposed large costs that were heavily concentrated on certain groups among the workforce, in particular older workers and workers with low levels of education. Let us take as an example the Polish economy, which as the first reformer was of particular interest to us when transition unfolded. The declared goal of the undertaken reforms, which were consistently implemented across the political divide throughout the 1990s, was to increase the competitiveness of the Polish economy. But this meant, of course, that state-owned firms or privatized firms had to restructure, which also implied the shedding of redundant labor. This process of shaking out unproductive workers went on throughout the 1990s, resulting in a large drop in employment and a large rise in unemployment. Especially older and less skilled workers had great difficulties in moving out of unemployment. Successive governments reacted to this situation by allowing a large part of the older and less skilled unemployed to take early retirement or to go on disability benefits. This “deactivation” throughout the 1990s was applied to a much larger share of the Polish workforce than we considered possible when thinking about labor adjustment in the Polish economy. In general, in all transition economies (with the possible exception of the Czech Republic), there was a large share of older and less skilled workers who, once displaced from their jobs, had great difficulties in moving out of unemployment.

Working on the labor supply side, that is, implementing active labor market policies or tightening unemployment benefit regulations, could not diminish this large group of workers, since it was weak labor demand that drove this unfortunate state of affairs. Policy makers were either unable or unwilling to help this group of workers who bore the main costs of restructuring of formerly centrally planned economies. At the beginning of the transition, we could not imagine the size of this group and the severity of the costs for this large group of transition process “losers.” Whether the neglect of this type of worker in the first two decades of the transition has contributed to the rise of populism, which is particularly strong in post-transition economies, is an interesting and open research question worth pursuing.

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