

Digitized by the Internet Archive  
in 2011 with funding from  
Boston Library Consortium Member Libraries

<http://www.archive.org/details/disorganization00blan>

DEWEY

HB31  
.M415  
no.96-30

18

**working paper  
department  
of economics**

***DISORGANIZATION***

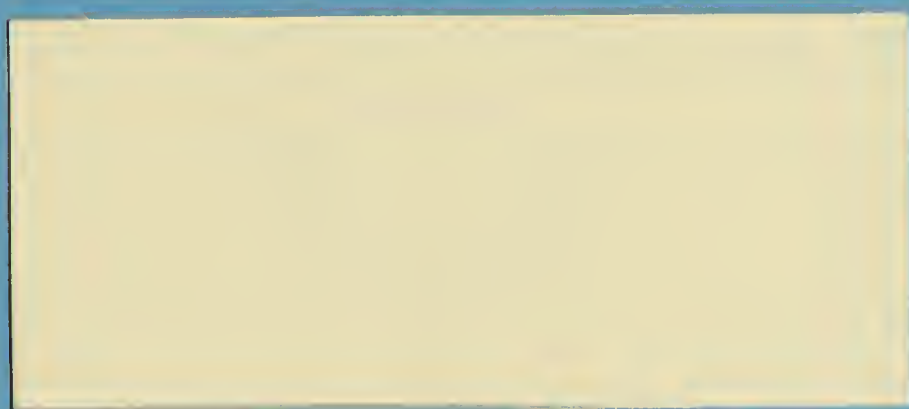
**Olivier Blanchard + Michael Kremer**

**96-30**

**October, 1996**

**massachusetts  
institute of  
technology**

**50 memorial drive  
cambridge, mass.02139**



***DISORGANIZATION***

**Olivier Blanchard** + Michael Kremer

**96-30**

**October, 1996**





## Disorganization

Olivier Blanchard

Michael Kremer \*

---

\* Department of Economics, MIT, Cambridge, MA 02138. (blanchar@mit.edu) and (kremer@mit.edu). We thank Susan Athey, Abhijit Banerjee, Simon Commander, Bill Easterly, Avner Greif, Dani Kaufmann, Gian-Maria Milesi-Ferreti, Wolfgang Pesendorfer, Julio Rotemberg and Andrei Shleifer for discussions and comments. We thank Maciej Dudek and Andrei Sarychev for research assistance. Michael Kremer thanks the Research Department of the International Monetary Fund, where some of the initial work for this paper was conducted.

## *Disorganization*

---

### **Abstract**

Under central planning, many firms relied on a single supplier for many of their inputs. Transition has led to decentralized bargaining between suppliers and buyers. Under incomplete contracts or asymmetric information, such bargaining can be inefficient, and the mechanisms that mitigate this problem in the West can only play a limited role in transition. For example, the scope for long-term relations to reduce opportunistic behavior is limited when many existing firms are expected to disappear or change most of their suppliers in the future. The result has been disorganization, and a sharp decrease in output. The empirical evidence suggests that disorganization has played a more important role in the former Soviet Union than in Central Europe.

Figures 1 and 2 show the evolution of official measures of GDP in the countries of the former Soviet Union, since 1989. The two figures give a striking picture, that of an extremely large decline in output. In 10 out of the 15 countries, GDP for 1996 is expected to stand at less than half its 1989 level.

The evolution of these official measures reflects in large part a shift to unofficial, unreported activities. But studies which attempt to adjust for unofficial activity still conclude that there has been a large decline in output. For example, a recent study, by Kaufmann and Kaliberda [1995], puts the actual decline in GDP from 1989 to 1994 for the set of countries of the former Soviet Union at 35%, compared to a reported decline of about 50%.<sup>1</sup>

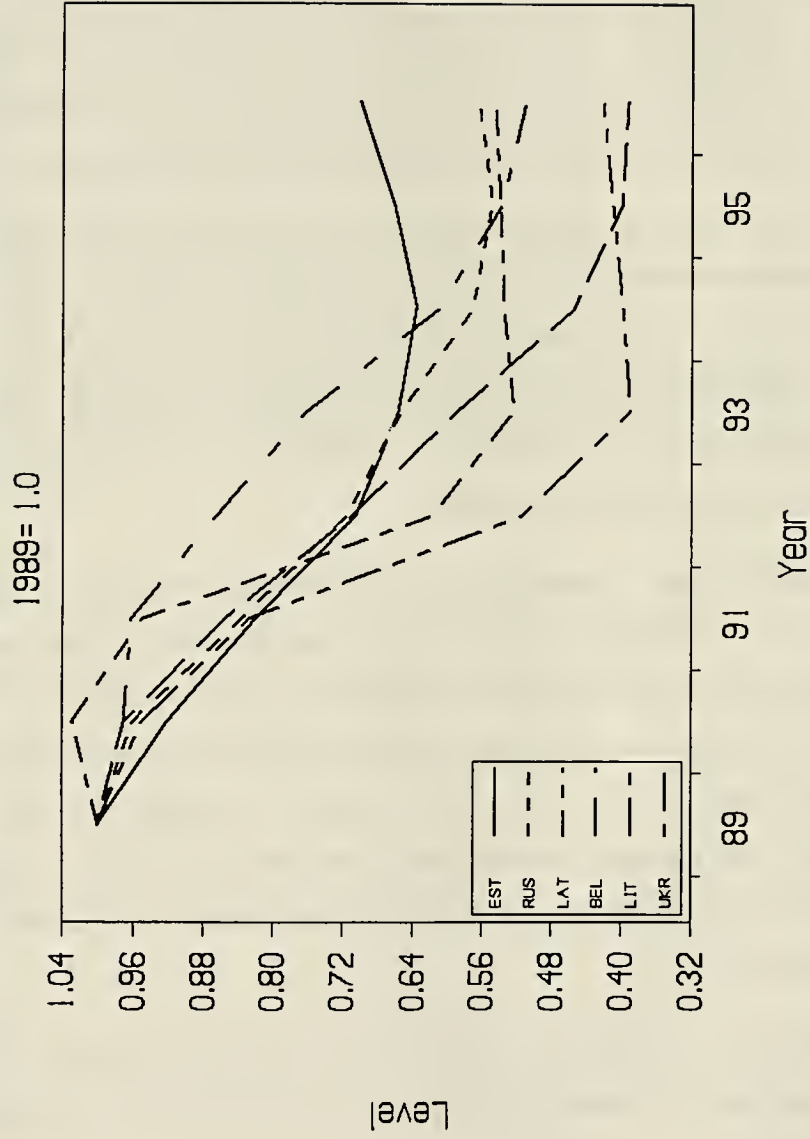
This large decline in output presents an obvious challenge for neo-classical theory. Given the myriad price and trade distortions present under the Soviet system, these countries surely operated far inside their production frontier before transition. With the removal of these distortions, one would have expected them to operate closer to the frontier, and thus output to increase. And one would have expected that the development of new activities would shift the production frontier out, leading to further increases in output over time. This clearly is not what has happened.

In this paper, we explore one explanation for the decline of output, which we believe has played an important role. The best word to describe it is disorganization.

---

1. Estimates for a number of other studies are given and discussed in European Bank for Reconstruction and Development [1996], Annex 11-1.

Figure 1. The Evolution of GDP In Russia, Belarus, Ukraine and the Baltics





Its logic goes as follows:

- Central planning was characterized by a complex set of highly specific relations between firms. (Following standard usage, we shall call a relation “specific” if there is a joint surplus to the parties from dealing with each other rather than taking their next best alternative.) There were typically fewer firms in each industry than in the West.<sup>2</sup> For many inputs, firms had or knew of only one supplier from which to buy. For many of their goods, firms had or knew of only one buyer to whom to sell.<sup>3</sup>
- Specificity opens room for bargaining. Under asymmetric information or incomplete contracts, the result of bargaining may be inefficient. A complex set of highly specific relations can thus lead to a poor aggregate outcome, with large effects on total production.
- Through various institutions and arrangements, economies develop ways of limiting the adverse effects of specificity:  
Under central planning, the main instrument was the coercive power of the central planner to enforce production and delivery of goods.  
In the West, for some goods, there are many alternative buyers and sellers, eliminating specificity altogether. And for other goods, the scope for adverse effects of specificity is reduced by arrangements ranging from vertical integration, to contracts, to long-term relations between firms.
- Transition eliminated the central planner, and thus the main instrument

---

2. One reason is that, in the West, (non natural) monopolies and associated monopoly rents create incentives for entry of new firms. There was no such mechanism under central planning.

3. The buyer was often a centralized trade organization, which disappeared altogether during transition.

used to limit the adverse effects of specificity under the previous regime. But the mechanisms which exist in the West could not operate right away. New buyers and sellers cannot be created overnight. The role of contracts is reduced when many firms are close to bankruptcy. At the same time, transition has created the anticipation that many state firms will disappear or change suppliers, thus shortening horizons and the scope for long-term relations to avoid the adverse effects of specificity.

- The result has been the breakdown of many economic relations. Trade between the republics of the former Soviet Union has fallen by far more than seems consistent with efficient reallocation. Despite price liberalization, many firms report shortages of inputs and raw materials. Firms lose crucial workers/managers, who may have been their only hope for restructuring and survival. Cannibalization of machines is widespread, even when it appears that machines would be more productive in their original use. This general disorganization has played an important role in explaining the decline in output.

Our paper is organized as follows:

- In sections 1 to 3, we show through three examples how specificity, together with either incompleteness of contracts or asymmetric information, can lead to large output losses. We show how the effects depend both on the degree of specificity in the relations between firms, and on the complexity of the production process. We show also how the emergence of new private opportunities can lead to a collapse of production in the state sector, and to a sharp reduction in total output.
- In section 4, we argue that the mechanisms used in the West to deal with

specificity take time to develop and have therefore played a limited role in transition. We also discuss the policy implications of our theory, and argue that it makes a —limited—case for gradualism.

- In section 5, taking measures of reported “shortages” of inputs by firms as indicators of disorganization, we show that disorganization appears to have played an important role in the former Soviet Union, but a more limited one in Central Europe.

Before starting, it may be useful to do some product differentiation.

Our analysis is based on standard ideas in microeconomics, from asymmetric information, to hold-up problems under incomplete contracts, to the breakdown of cooperation in repeated games as the horizon shortens or as alternative opportunities arise.<sup>4</sup> The potential importance of specificity for macroeconomics has been emphasized recently by Caballero and Hammour [1996]. Our contribution is to point to the potential importance of these problems in the context of transition.

Our analysis complements other explanations of the decline in output in transition. Most explanations start from the need for state firms to decline and transform, and for new private firms to emerge. Some argue that the output decline may reflect efficient reorganization and unmeasured investment in information capital, as firms try new techniques and workers look for the right jobs. (Atkeson and Kehoe [1992], Shimer [1995] for example). In contrast, we see the evidence

---

4. On this last topic, see for example Wells and Maher [1995] for breakdowns of cooperation within households, and Banerjee and Newman [1993] for an example in the context of development.



as reflecting in large part inefficient disorganization. Other explanations combine reallocation with some remaining distortion, explaining the decline in output as a second-best outcome. Perhaps the most widely accepted explanation argues that efficient reallocation would have implied a decrease in real wages of some workers inconsistent with either actual wage determination or political concerns about income distribution; as a result of these constraints, employment and output have decreased (see Blanchard [1996]). We read the evidence from the former Soviet Union as showing that there is more at work, namely disorganization. Two theories are related to ours. The first, developed by Murphy et al. [1992], emphasizes the adverse effects of partial price liberalization. The second, developed by Shleifer and Vishny [1993], focuses on the role of corruption, and emphasizes the adverse effects of rent extraction by government officials. We shall point out the relations as we go along.

## 1 A chain of production

This and the next two sections develop three examples, all three aimed at capturing different mechanisms through which specificities can lead to a large decline in output during transition. The first is also the simplest. It goes as follows:

- A good is produced according to a Leontief technology and requires  $n$  steps of production. Each step of production is carried out by a different state firm (A point of semantics here. We shall use “state” firms to denote the firms which existed under central planning and produced under the plan, whether or not they have been privatized since the beginning of transition. We shall use “private” firms to denote the firms which have been created

since transition.) One unit of the primary good leads, after the  $n$  steps, to one unit of the final good. Intermediate goods have a value of zero. The price of the final good is normalized to one.

One may replace “production” by “distribution” here: an interpretation with a Soviet Union flavor is that of a good having to travel through  $n$  provinces/republics, to go from the primary producer to the final distributor.

- The supplier of the primary good has an alternative use for the input equal to  $c$ . One can think of  $c$  as a private opportunity, perhaps the production of a much simpler good, avoiding the division of labor implicit in the chain of production;  $c$  may therefore be much lower than 1. (It is straightforward to introduce similar private opportunities for the intermediate producers along the chain of production. But the point is made more simply by ignoring this possibility.)
- Each buyer along the chain knows only the supplier it was paired with under central planning, and vice-versa. The end of central planning thus leaves  $n$  bargaining problems. We assume that there is Nash bargaining at each step of production, with equal division of the surplus from the match.

The characterization of the solution is straightforward and is obtained by working backward from the last stage of production. The value of the surplus in the last bargaining problem, between the final producer and the next-to-last intermediate producer is equal to 1 (by assumption, the good is useless before the final stage). Thus, the next-to-last intermediate producer receives  $(1/2)$ . Solving recursively, the first intermediate producer receives  $(1/2)^n$ .

The surplus to be divided between the first intermediate producer and the supplier of the primary good is equal to  $(1/2)^n - c$ . If  $c < (1/2)^n$ , the surplus is

positive and production takes place along the chain. If instead  $c > (1/2)^n$ , the primary producer prefers to take up his private opportunity. Thus, the appearance of even mediocre private opportunities will lead to the collapse of production in the state sector: the decrease in total output may be as large as  $1 - (1/2)^n$  in our example (what matters here is not the absolute level of private opportunities, but their level relative to opportunities in the state sector.) The more complex the structure of production (the higher  $n$ ), the smaller the private opportunities needed to trigger the collapse of the state sector.

Avoiding the adverse effects of specificity in complex structures of production is a problem faced by firms in the West as well. Even in the West, many goods are sufficiently specific that firms can only get them from one supplier, or sell them to one buyer. We shall discuss in Section 4 below the mechanisms which alleviate the adverse effects of specificity in the West, and why they have played a limited role in transition. But a few points are worth making here already.

The source of the inefficiency and of the collapse of output in our example is a hold-up problem: each intermediate producer must produce its intermediate good before bargaining with the next producer along the chain. Once he has produced the intermediate good and has no alternative use for it, his reservation value is equal to zero.

The inefficiency would therefore disappear if all the producers could sign an enforceable contract before production took place. In this case, production would take place so long as  $c$  was less than 1, and the producers as a whole would receive  $1 - c$  of the output. The source of the problem is thus the combination of specificity, which gives rise to the bargaining problems, and incomplete contracts.

The assumption of incomplete contracts seems quite reasonable in the case of the former Soviet Union. The legal system is still in construction. Contract enforcement is notoriously weak. Firms often have few valuable assets, making it hard to punish them for deviating from the contract.

Another natural solution is vertical integration. In our example, even partial integration (which effectively reduces the number of bargaining problems down from  $n$  to a smaller number), alleviates the problem, and full vertical integration (where one decision-maker decides whether or not to produce) eliminates it. Even short of vertical integration, long-term relations between producers can also alleviate the problem. If they are engaged in a long-term relation, producers may be willing to pay their supplier more than the price we derived above, making it more likely that production takes place in the chain. As we shall argue in Section 4 however, the nature of transition is such that it reduces the scope for vertical integration and for long-term relations to induce such behavior.

## 2 A state firm and its suppliers. I

In our second example, the source of inefficiency is not incomplete contracts but asymmetric information:

- A state firm needs  $n$  inputs in order to produce. If all inputs are available, the firm can produce  $n$  units of output. Otherwise, output is equal to zero.
- Each input is supplied by one supplier. Each supplier has an alternative use for his input, with value  $c$ , distributed uniformly on  $[0, \bar{c}]$ . Let  $F(\cdot)$  denote the distribution function, so that  $F(0) = 0$  and  $F(\bar{c}) = 1$ . Draws are independent across suppliers.

We can again think of  $c$  as a private sector alternative, such as small scale production or sale of the input to a foreign buyer. The distribution of  $c$  is known, but the specific realization of each  $c$  is private information to each supplier.  $\bar{c}$  can be thought of as indicating the degree of development of the private sector, which we assume is very low pre-transition, and increasing over time thereafter.

- The state firm maximizes expected profit. It announces a take-it or leave-it price  $p$  to each supplier (given the symmetry built in the assumptions, the price is the same for all suppliers). If the price exceeds the reservation prices of all suppliers, production takes place in the state firm. Otherwise, it does not, and all suppliers use their own private opportunity.

We can now characterize expected state, private, and total production as a function of  $\bar{c}$  and  $n$ . We must first solve for the profit-maximizing price set by the state firm. Given price  $p$ , expected profit is given by:

$$\pi = (F(p))^n (1 - p)n$$

The first term is the probability that production takes place. The second is equal to profit if production takes place. Maximizing with respect to  $p$  yields the profit maximizing price:

$$p = \min\left(\bar{c}, \frac{n}{n+1}\right)$$

The firm never pays more than the maximum alternative opportunity,  $\bar{c}$ . But, if the maximum alternative opportunity exceeds  $(n/(n+1))$ , the firm does not

increase its price. Increasing the price would increase the probability that production takes place, but would decrease expected profit.

Given this price, expected state production,  $Y_s$ , is equal to:

$$Y_s = n \min\left(1, \left(\frac{n}{n+1} \frac{1}{\bar{c}}\right)^n\right)$$

Expected private production,  $Y_p$ , is equal to the probability that state production does not take place, times the conditional expected sum of alternative opportunities (conditional on at least one private alternative being larger than the price offered by the state firm).  $Y_p$  can be written as:

$$Y_p = \frac{n\bar{c}}{2} \max\left(0, 1 - \left(\frac{n}{n+1} \frac{1}{\bar{c}}\right)^{n+1}\right)$$

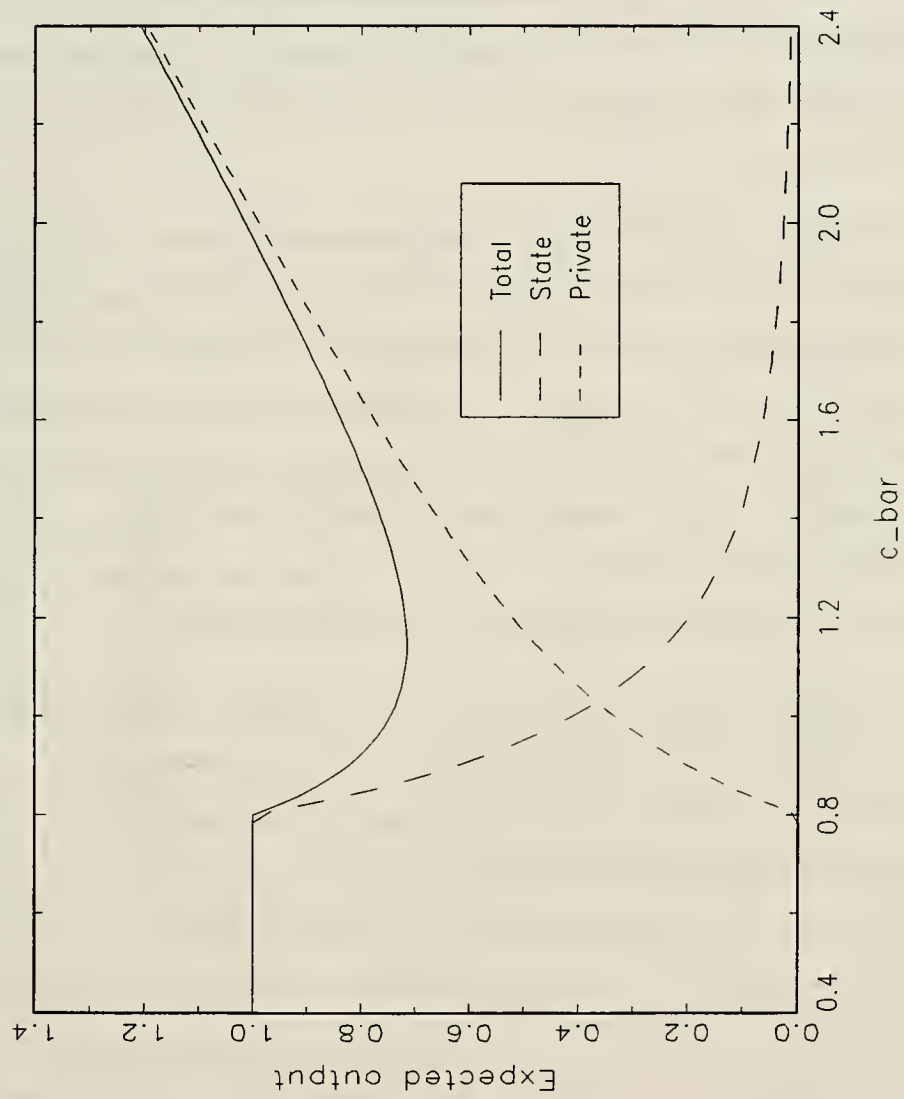
Expected total production is in turn equal to

$$Y \equiv Y_s + Y_p$$

The best way to see what these equations imply is to look at Figure 3, which plots the behavior, for  $n = 4$ , of expected state, private and total production (all three normalized by the number of inputs,  $n$ ) for values of  $\bar{c}$  ranging from 0.4 to 2.4.

To interpret the figure, it is useful to keep the efficient benchmark in mind (which would be the outcome if the monopsonist was fully informed about the alternative opportunities of each supplier and thus was fully discriminating, or if there were markets for inputs which revealed these alternative opportunities). So long as  $\bar{c}$

Figure 3. Behavior of expected state, private, and total output; n=4



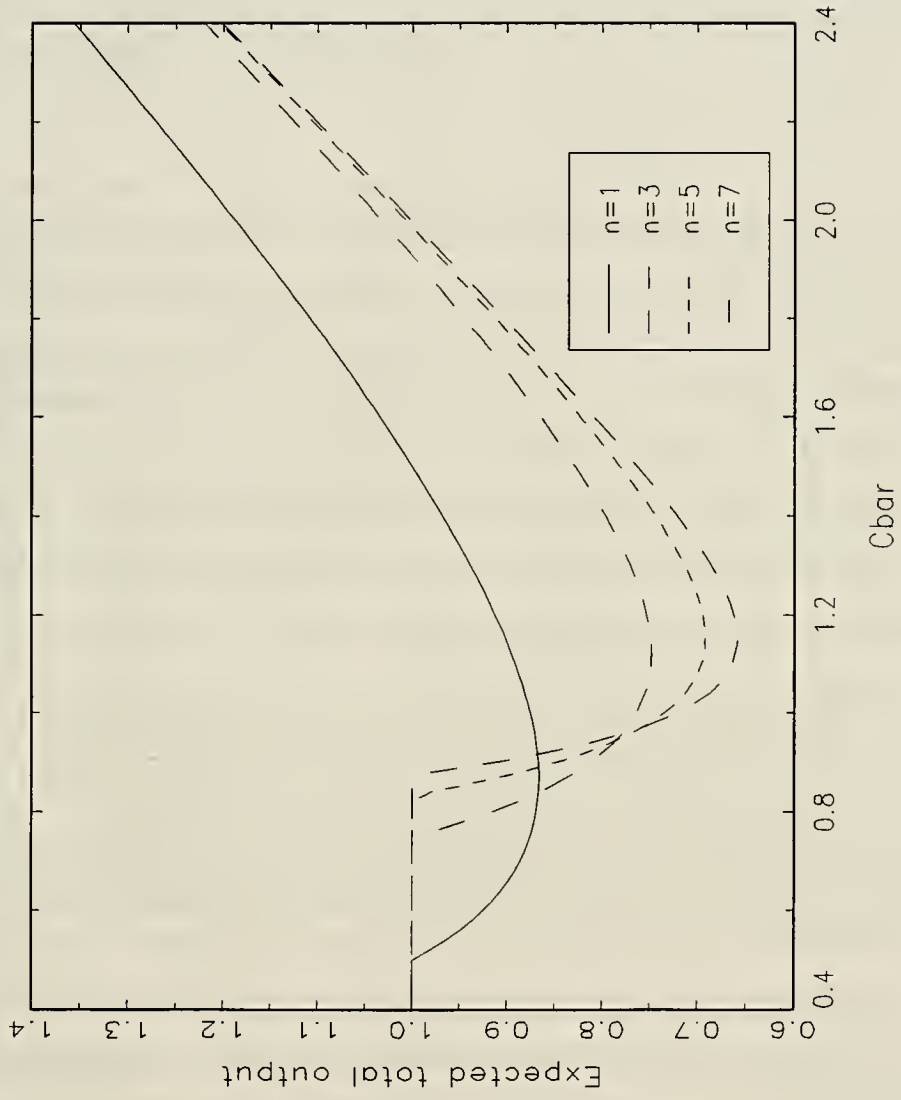
was less than one, production would always take place in the state sector. As  $\bar{c}$  increased above one, it would sometimes be efficient not to produce in the state sector: expected production in the state sector would decrease, but total expected production would increase. Eventually, as  $\bar{c}$  became very large, most production would take place in the private sector, with expected total production increasing linearly with  $\bar{c}$ .

In contrast with the efficient outcome, increases in private opportunities lead initially to such a large decrease in state production that the net effect is a decrease in total production. Total production starts declining when  $\bar{c}$  exceeds  $(n/(n+1)) = .8$ . For  $\bar{c}$  equal to 1, the efficient outcome would be that production still only takes place in the state firm, with total production equal to  $n$  (1 in the figure, as output is divided by the number of inputs). The actual outcome is a production level of only 0.75. It is not before  $\bar{c}$  has reached a value of about 2.0 that total production is again equal to its pre-transition level.

Complexity of production in the state sector increases the size of the decline in output. We can think of  $n$  as an index of the complexity of the production process. Figure 4 shows the effects of alternative values of  $n$  on the evolution of expected total production (again normalized by the number of inputs) as a function of  $\bar{c}$ . The larger  $n$ , the higher the price that the state firm offers: for  $\bar{c}$  large enough so that the minimum condition does not bind,  $p = n/(n+1)$ . Thus, the higher  $n$ , the higher the value of  $\bar{c}$  required to trigger the collapse of the state sector. But, also the higher  $n$ , the smaller the probability that production takes place in the state firm for  $\bar{c} \geq n/(n+1)$ , and thus the greater the initial collapse of total production as  $\bar{c}$  increases. As  $n$  approaches infinity, the price offered by the state firm approaches one, and state production collapses as soon as  $\bar{c}$  increases



Figure 4. Behavior of expected total output for different values of  $n$



above one: the probability that at least one supplier will have a realization of  $c$  greater than one goes to one. Thus, as  $n$  approaches infinity, the path of state production (normalized by the number of inputs) approaches one for  $\bar{c} < 1$ , and  $\bar{c}/2$  (the expected value of private production) for  $\bar{c} > 1$ . When  $\bar{c}$  increases above 1, output falls by fifty percent.

Putting our results in words: Pre-transition, suppliers have such poor alternative opportunities that the state firm can offer a price at which there is no better alternative than to supply. As transition starts, and alternatives improve, some suppliers now have more attractive opportunities. They start asking the firm for more. Not knowing which suppliers are bluffing and which are not, the firm has no choice other than to offer a given price and take the risk of not getting the inputs. The result is an initial decrease in total production as opportunities improve.

Let us take two sets of issues at this point:

(1) This example is closely related to the analysis by Murphy et al. [1992] of the effects of partial price liberalization. In their model, the fact that some prices are held fixed while others are left free can also lead to an inefficient diversion of output from state to private firms (Young [1996] argues that a similar perverse mechanism is relevant in China). Our argument is that the same perverse effects occur even under full price liberalization. The presence of reported shortages (see section 5) in a number of former republics a number of years after nearly complete price liberalization suggests that there is indeed more at work than partial price liberalization. The implications of the two models for policy are also potentially quite different. The Murphy et al. [1992] model implies the desirability of full price liberalization. In our case, even under full price liberalization, output may

be lower during transition than it was under central planning.

(2) We have assumed that the sellers had private information, and that the seller set the price. What is essential here is that there be private information, and that the uninformed party have some bargaining power. Suppose for example that the firm has private information about the value of final production, but that, now, suppliers make price offers to the firm. Assume that they have no private opportunities, and choose the price so as to maximize their expected revenue. If the sum of the prices charged by suppliers is higher than the actual value of final production, production does not take place. It is straightforward to show that, in this case, the probability that suppliers collectively ask for too much and that final production does not take place is positive. It is also easy to show that this probability increases in the number of suppliers: the more complex the production process, the more likely is state production to collapse, even in the absence of private opportunities.<sup>5</sup> This result is closely related to results on the adverse effects of corruption on output. We have assumed that the price setters were suppliers. But, absent the rule of law, they may be government officials selling permits to operate the firm. There is therefore a close parallel between our argument that decentralized bargaining between firms has led to a decline in output, and the argument made by Shleifer and Vishny [1993] that political decentralization has

---

5. More formally, assume that if all inputs are supplied, output is equal to  $n\epsilon$ , with  $\epsilon$  distributed for example uniformly on  $[0, 1]$ . Now consider the problem facing supplier  $i$ . Denote the sum of the prices set by all other suppliers as  $p_{-i}$ . Supplier  $i$  maximizes  $(1 - (p_{-i} + p_i)/n) p_i$ , and thus chooses a price equal to  $p_i = (n - p_{-i})/2$ . In the symmetric equilibrium  $p_{-i} = (n - 1)p_i$ , so that the common price is equal to  $p = n/(n + 1)$ , and the state firm produces with probability  $1/(n + 1)$ .

led to competition among rent extractors, with large adverse effects on output.<sup>6</sup>

### 3 A state firm and its suppliers. II

The third example shows how specificity and complexity can combine to create coordination failures, and a collapse of output.

In this model, technology is again Leontief in  $n$  inputs. Because the interpretation is more natural here, we think of the  $n$  suppliers as the  $n$  crucial workers in the firm. But this is not essential. The essential difference between this and the previous model is in the timing of decisions. In the previous model, if state production did not take place, suppliers could still take up their private opportunity. Here, suppliers have to decide whether or not to take their private opportunity *before* they know whether production is taking place in the state firm. This difference in timing introduces problems of coordination between workers, which we now examine.

The model is as follows:

- A state firm needs  $n$  workers in order to produce efficiently. Assume that its technology is Leontief in those workers (who are therefore the workers who are difficult to replace; we can think of the other workers as having been solved out of the production function).

If all workers stay, the firm produces  $n$  units of output, equivalently 1 unit of output per worker. If one or more workers leave, the firm can hire replace-

---

6. Empirical evidence on the number and the size of bribes needed to run a business in Ukraine today is given by Kaufmann and Kaliberda [1995].

ments; replacements are however less productive. If the firm has to hire one or more replacements, output per worker is equal to  $\gamma < 1$ .

Thus  $n$  measures the complexity of the production process. The parameter  $\gamma$  (which was implicitly put equal to zero in the first example) is an inverse measure of the specificity of existing workers.

- Each worker has an alternative opportunity given by  $c$ , distributed uniformly on  $[0, \bar{c}]$ . Draws are independent across workers. The distribution of  $c$  is known, but the specific realization of each  $c$  is private information. We can think of  $\bar{c}$  as representing the opportunities open to the most qualified workers after transition, from opening their own business, to working for foreign consulting firms, and so on.<sup>7</sup>
- The wage paid is equal for all workers (this follows from the assumption that alternative opportunities are private information, and the symmetry in production), and is equal to output per worker. This assumption simplifies the analysis, and is reasonable in the case of many former state firms, but the analysis would be qualitatively similar as long as wages increased with other workers' participation.
- Workers must decide whether to take up their private opportunity before they know the decisions of other workers, and thus the level of output and the wage per worker in the state firm. We assume that they are risk neutral, so that their decision is based on the expected wage.

---

7. An alternative interpretation of this model is as a model of shirking, where workers have different costs of effort. If all workers put effort, output per worker is one. If some do not, output per worker is equal to  $\gamma$  instead. Under that interpretation, one may interpret the model as applying to all workers.

Thus, if all workers decide to stay, output per worker, and therefore the wage, is equal to one. If one or more workers take up their private alternative, some replacement workers must be hired, and output per worker and the wage are equal to  $\gamma$ .

It is clear that the solution to the problem facing each worker has the following form: Stay if  $c$  is less than some threshold  $c^*$ , otherwise leave. To characterize  $c^*$ , think of the decision problem facing one worker. If he leaves and takes up his alternative opportunity, he will receive  $c$ . Suppose he decides instead to stay. Given that, by symmetry, the  $(n - 1)$  other workers also have a threshold equal to  $c^*$ , the probability that they all stay is given by  $(F(c^*))^{n-1}$ . Expected output per worker, and thus the wage he can expect to receive if he stays, is thus equal to  $(F(c^*))^{n-1} + (1 - (F(c^*))^{n-1})\gamma$ . The threshold level  $c^*$  is such that he must be indifferent between leaving or staying, so that:

$$c^* = \gamma + \min\left(1, \left(\frac{c^*}{c}\right)^{n-1}\right)(1 - \gamma) \quad (3.1)$$

Expected output per worker, and thus the expected wage, are given in turn by:<sup>8</sup>

$$w = \gamma + \min\left(1, \left(\frac{c^*}{c}\right)^n\right)(1 - \gamma) \quad (3.2)$$

---

8. Note the different exponents in (3.1) and (3.2),  $(n - 1)$  versus  $n$ . Each worker knows his own alternative opportunity when choosing whether to stay or not, and thus the uncertainty comes from what the  $n - 1$  other workers will do. The expected wage is the unconditional expectation of the wage and depends on what all  $n$  workers do. The difference between  $c^*$  and  $w$  goes to zero as  $n$  is large.

The solution to equation (3.1) can be one of three types, depending on the value of  $\bar{c}$ . These three cases are represented in Figure 5, which plots both sides of equation (3.1) on the vertical axis against  $c^*$  on the horizontal axis. The figure is drawn assuming values of  $n = 5$ , and  $\gamma = .2$ . The left-hand-side of the equation is represented by a 45-degree line. The right hand side is represented by a curve which is initially convex, turning flat at  $c^* = 1$ .

- For low alternative opportunities, there is only one equilibrium, in which all initial workers decide to stay, leading to a level of output per worker equal to one.

In Figure 5, the only equilibrium corresponding to the case where  $\bar{c} = .3$  is at point A.

- For intermediate alternative opportunities, there are two equilibria (the equilibrium in-between is unstable using standard arguments), one in which all workers stay and output per worker is one, and one in which most workers are likely to leave, where  $c^*$ , and in turn expected output per worker, are close to  $\gamma$ .

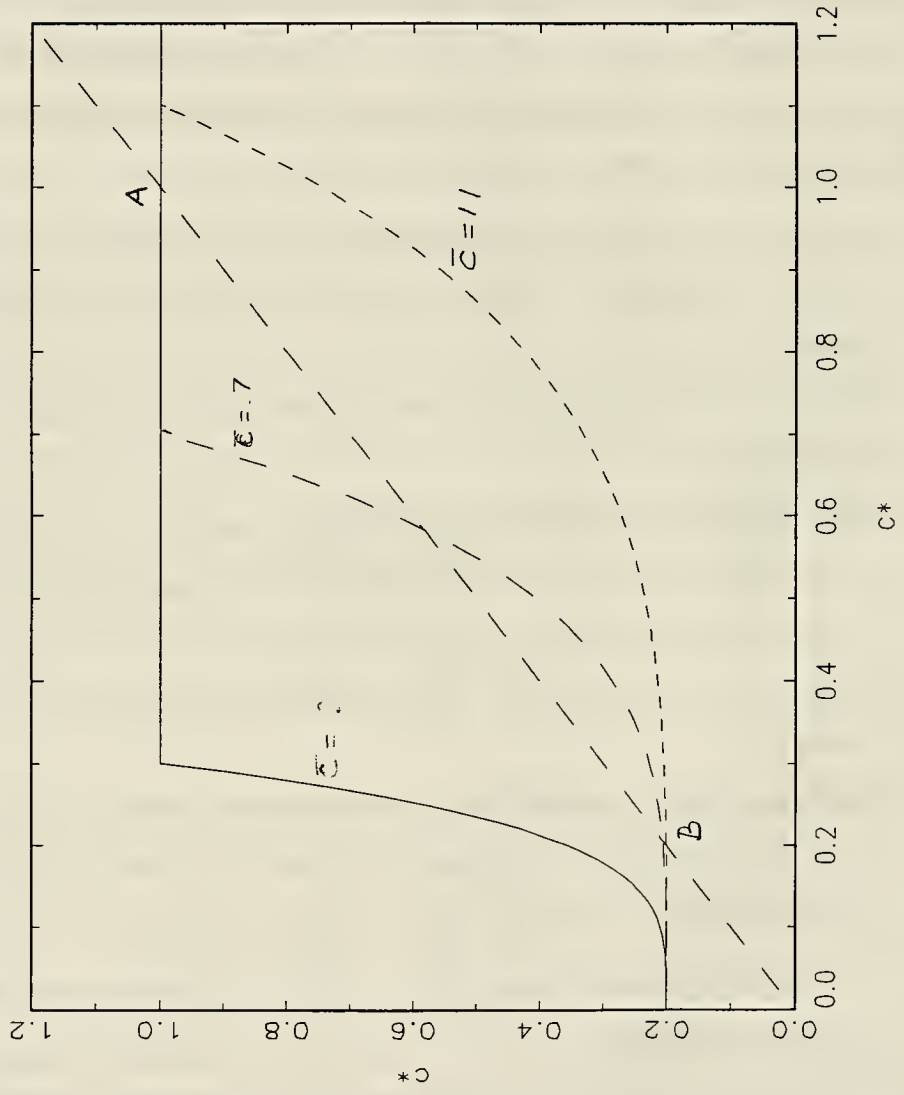
In Figure 5, for  $\bar{c}$  equal to .7, the two equilibria are at points A and B. At A,  $c^*$  is 1. At B,  $c^*$  (and the expected wage from (3.2)) is very close to .2: the probability that at least one worker will leave is very high.

- For higher alternative opportunities —for  $\bar{c} > 1$ — there is a unique, low activity, equilibrium.

In Figure 5, for  $\bar{c} = 1.1$ , the only equilibrium is at point B, where  $c^*$ , and the expected wage, are both equal to a value close to .2: production in the state sector is very unlikely.

We want to emphasize two separate aspects of these results:

Figure 5. Equilibrium  $c^*$  for alternative values of  $\bar{c}$





(1) The first is the existence, over some range, of multiple equilibria. This result is not due to private information. To see this, note that even when workers have an alternative opportunity equal to a known value  $c$ , then, for values of  $c$  between  $\gamma$  and  $\bar{c}$ , there are two equilibria, one in which all workers stay in the state firm (the efficient outcome), and one in which all workers take up their alternative opportunity.

Is one equilibrium more likely to prevail? The arguments here are standard. On the one hand, the equilibrium with high production is Pareto superior. The game is one of pure coordination, so if the workers can talk beforehand, they should be able to coordinate on the equilibria which is better for all of them. On the other hand, if each worker believes that there is some probability that some other worker will irrationally refuse to participate, then the high-equilibrium can unravel. As  $n$  becomes large, even a small probability that one worker will irrationally refuse to participate can lead to the rational collapse of output.

This aspect of the model captures the fact that complex production processes, which require the contribution of many specific workers (or/and many specific suppliers) imply complex coordination problems. A reflection of these problems is the potential presence of multiple equilibria. The argument was first made by Bryant [1983] in the context of Western Economies. But the prevalence of specific relations (and we shall argue in the next section, the lack of mechanisms designed to handle such coordination problems) makes it more relevant for countries in transition. Some firms may disappear simply because they are expected to, either by their suppliers or their essential workers.

(2) The second aspect derives from the combination between private informa-

tion and interactions between decisions given the timing of decisions. It is the rapid collapse of state output as soon as the probability that at least one private alternative exceeds the wage under efficient production in the state firm becomes positive. For example, for the case where  $\bar{c} = 1.1$  in Figure 5 (so that the expected value of private opportunities is only equal to .55, compared to 1 in the state firm if workers stay) the probability that all initial workers stay in the state firm is nearly equal to zero, and expected production per worker in the state firm is very close to .2, a highly inefficient outcome.

To see why output collapses, note that as soon as  $\bar{c}$  is greater than one, there is a chance that a worker will leave. The wage that remaining workers can expect to receive is thus reduced in proportion to the probability that at least one worker will leave. In turn, this reduction in the expected wage prompts more workers to leave, and so on. The effect of higher values of  $n$  is to magnify the interactions between the workers' decisions. For example, for  $\bar{c} = 1.01$ , expected output per worker in the state firm is equal to .92 if  $n=2$ , but falls to .21 when  $n=3$ .<sup>9</sup>

This aspect of the model appears to capture a number of aspects of transition. It captures the idea that crucial managers may leave a firm, despite potentially large payoffs from turning it around, because they are not sure that others will stay around long enough. If we return to an interpretation of the model with sup-

---

9. To see the role of timing decisions, these results can be compared to those which obtain when workers decide whether or not to take their private opportunity *after* having observed the decisions of others. In that case, the probability that all workers stay in the state firm is equal to  $(1/\bar{c})^n$ , and expected output per worker in the firm is equal to  $\gamma + (1/\bar{c})^n(1 - \gamma)$ . For  $\bar{c} = 1.01$ , expected output per worker in the state firm is equal to .98 if  $n=2$ , and .97 if  $n=3$ .

pliers rather than workers, the model is consistent with anecdotal evidence that suppliers are often very reluctant to supply state firms, because of the difficulties of getting paid. If they are not paid on delivery but only if the firm succeeds in producing and selling its production, then, just like workers in our example, suppliers become residual claimants. (this raises the issue of why state firms do not pay their suppliers on delivery. More on this in the next section.) The probability that one of them will not supply leads all of them to be leary of supplying, leading to collapse of the state firm.

#### 4 Managing specificity

We have shown through three examples how specificity and complexity may have combined to lead to a large decrease of output during transition. But these examples raise a general issue. If anything, the production structure in the West is even more complex than it is in the East. Why aren't problems arising from specificity as severe in the West?

We have already hinted at some of the answers:

(1) First, in the West, many goods are traded in thick markets, markets with many buyers and many sellers. And while for many intermediate goods, firms deal with only one supplier, there are likely to be other potential suppliers, and shifting suppliers may be difficult but not impossible.

For many goods however, thick markets cannot be created overnight. There are just not enough suppliers or buyers in the economy to start with; new firms must be created, a process which takes time. Opening the economy to foreign trade

increases the potential number of buyers and sellers can clearly help here. Indeed, one of the arguments for imposing convertibility and low tariffs in Poland in 1990 was indeed to limit the monopoly power of domestic firms by increasing competition, an argument closely related to ours (Sachs [1993]).

(2) Second, there is more scope for contracts to handle problems created by specificity.

The potential role of contracts in solving or alleviating problems of specificity is clearest in our first example. In that model, if producers can sign binding contracts before production takes place, then they will avoid hold-up problems, and achieve an efficient outcome. Total output will not decline when private opportunities improve.

There is little question however that the scope for contracts to alleviate problems such as hold-ups is more limited in the East. The deficiencies of the current Russian legal system have been pointed out by many (for example Greif and Kandel [1994]): Contract enforcement is weak (in our example, producers have an incentive ex-post to renege and offer a lower price to their suppliers. Contract enforcement is therefore crucial). Firms have few assets which can be seized, and thus less to lose from breaking a contract. This last aspect takes us to the next point.

(3) Most state firms in transition are short on “cash” (more precisely have limited liquid assets, and limited access to credit.)

The potential role of cash in reducing problems coming from specificity is clearest in our third example. Consider the case where there are two equilibria, one in which existing workers stay and productivity is high, and one in which they leave,

forcing the firm to hire less efficient replacements. A commitment by the firm to pay each existing worker a wage of one, independently of what the other workers do, will lead all workers to stay, and will sustain the efficient equilibrium, at no cost to the firm.

Thus, firms with “deep pockets” can alleviate some of the problems arising from specificity.<sup>10</sup> But state firms in the former Soviet Union typically do not have such deep pockets: wages typically exhaust most of revenues, firms have limited access to credit, and many are close to bankruptcy. Under these conditions, they have no easy way of convincing their workers to stay or their suppliers to supply. This argument points to the role of foreign direct investment: foreign firms typically have deep pockets. They can pay suppliers on delivery; they can credibly promise to pay their workers even if things go wrong. They can therefore avoid the problems of coordination faced by state firms.

(4) While state firms were often more vertically integrated than in the West, the type of vertical integration needed to alleviate problems of specificity during transition is different from what it was in the past.

The reason to vertically integrate under central planning was the imperfect ability of the central planner to enforce timely delivery of some inputs, leading firms to protect themselves against such disruptions. Sachs [1993] gives the example of an industrial firm installing piggens to raise pigs and insure the delivery of food to their workers in the face of food shortages.

The type of vertical integration needed in transition, as well as later on, is likely to

---

10. See Holmstrom [1982] for a related point.

be different. It is most needed for those inputs with a high degree of specificity, and thus a large potential for serious bargaining problems. Piggens are not the answer anymore: markets in agricultural goods have eliminated the problem. But the problem may now be a specific engine part, which was easy to get under central planning but is now available from only one firm, raising issues of specificity and bargaining.

Thus, the existing structure of vertical integration can only play a limited role in transition. And creating new vertically integrated structures of production both has sharp limits and takes time. The arguments here are standard. First, chains of production interlock. When suppliers have more than one buyer, which supplier integrates with the buyer? Second, if vertical integration is to be achieved through the purchase of existing firms, the bargaining problems we saw become relevant, this time not in the determination of input prices, but now in the determination of the purchase price of firms. If  $n - 1$  of the firms in our first example vertically integrate, the remaining hold-out firm has an incentive to hold out for a large part of the rents, and thus a high purchase price. Thus, no firm will want to be the first to be vertically integrated. This suggests much of vertical integration needs to proceed through the development of new activities within the firm. This, like the development of new firms, takes time.

(5) Fifth, but we think most important, the very nature of (any) transition is such that there is limited scope for long-term relations in solving problems arising from specificity.

In stable economic regimes, such as under central planning in the Soviet Union in the past or in Western market economies today, long-term relations can play

an important role in reducing inefficiencies arising from specificity. To see this, take for example our third model, and assume that workers who decide to take up a private opportunity cannot work for the state firm in the future (one can again replace “workers” by “suppliers” in what follows). This may be either for technological reasons (they have to move to another city) or because it is the optimal punishment from the point of view of the state firm. Then, if private opportunities are temporary, workers will think twice about leaving. More formally, they will use a much higher threshold, a higher value of  $c^*$ , for deciding whether to take up a private opportunity. The result will be a higher probability that workers stay, and higher expected production overall.

In that context, the value of  $c^*$  will depend crucially on the probability that the firm is still there and relies on the same workers in the future. If this probability is low, then workers will behave opportunistically, in a way close to that characterized in the previous section. But by the nature of transition, this probability is indeed likely to be low in transition: Transition implies that many state firms will disappear, and that, even if they survive, they will have to change operations as well as many of their suppliers.

In a neo-classical benchmark, if it took time for new more productive firms to arise following transition, state firms would continue producing until they were replaced by new, more efficient firms. The argument we have just developed suggests that the mere anticipation that more efficient private firms will eventually appear can lead to a reduction in productivity in the state firms. It may also explain why the pre-official transition period in the Soviet Union was characterized by increasing disorganization and decreasing output, as the shortening of horizons led to more opportunistic behavior on the part of firms. There is indeed

some evidence that the degree to which state firms felt they had to satisfy the plan decreased in the Soviet Union with the increased likelihood of reform in the mid-1980s.<sup>11</sup>

This line of argument may explain also some of the difference between the experiences of China and Eastern Europe during transition. China's lower level of industrial development, and its explicit policy of decentralizing industry to many small factories implies that problems of specificity were less in the first place (Qian et al. [1996]). And the ability of the Chinese government to maintain political control meant that centralized allocation was not fully replaced by decentralized bargaining. And China's commitment to maintain state firms, using subsidies if necessary, may have lengthened horizons, allowing for a larger role of long-term relations between firms and their suppliers, and thus avoiding the collapse of state firms in the face of new private opportunities. This last point naturally takes us to a discussion of the policy implications of our theory.

(6) Policy implications.

Suppose that in a neo-classical benchmark (i.e absent the effects we have focused on so far), absent subsidies, many state firms can be expected to disappear over time. The argument we have developed implies that, once the implications of specificity are taken into account, this may well lead to the immediate collapse

---

11. This argument can also explain the opposition of industry to laws requiring firms to provide workers advance notification of plant shut-downs and why some firms decide simply to pay their workers severance pay rather than providing notice. Ellickson [1989] notes that at the time of the collapse of the nineteenth century whaling industry, the norms of cooperation that had evolved among whalers began to break down.



of those firms. Shorter horizons may lead suppliers to behave more opportunistically, leading to the collapse of state production. By the same argument, a commitment by the government to subsidize state firms for some time may avoid their immediate collapse.<sup>12</sup>

Should a government commit to subsidizing state firms, and thus avoid a collapse of state production at the beginning of transition? This will depend on the expected path of private opportunities, on the time path of  $c$  in our example. If efficient private firms (firms with values of  $c$  equal to or greater than productivity in the state firms) are expected to develop quickly, then a commitment to maintaining state firms for a long time is likely to be overly costly. It may be better to accept the fall in initial output, in exchange for higher production soon after. If however, the development of an efficient private sector is expected to take more time (if  $c$  is expected to be high enough to create problems of bargaining, but low enough that state production dominates private production for a long time), it may then be justified to commit to subsidize state firms for some time, and avoid their immediate collapse in the face of mediocre private opportunities.

There are clearly other implications of subsidies we have not taken into account

---

12. Think of subsidies by the government as affecting the probability that the state firm will be alive at any point in the future. A high enough probability will lead suppliers to increase the threshold at which they take up their private opportunities. Technically, the commitment of the government must be such that there is a positive probability, however small, that the state firm survives forever. The argument is standard: if it were known that a firm was going to disappear with certainty at some future point in time, things would unravel, and the firm would collapse at the beginning.

here: subsidies may reduce the incentives of state firms to adjust. Subsidies have to be financed, and through the tax channel, slow the growth of new private firms. And in the end, political economy considerations may well still lead to the conclusion that the only way to stop subsidies is to stop them at once. But our theory provides at least one respectable argument in favor of gradualism. When the emergence of efficient private firms is likely to be slow, a commitment by the government to subsidize state firms for some time may avoid their immediate collapse, and avoid a large inefficient decline in output at the beginning of transition.

## 5 Empirical Evidence

As we went along, we gave anecdotal evidence of disorganization. In this section, we attempt to give more formal evidence about the relative importance of disorganization, both over time and across countries in transition. To do so, we rely on measures of reported shortages of raw materials and intermediate products by firms. Two remarks are in order here

What firms mean when they report “shortages” is admittedly unclear. And it is also not clear whether the breakdowns in supply which occur in our three examples should be called shortages. There are, however, no measures of “breakdowns in supply”, while there are measures of reported shortages. And it is plausible that firms facing breakdowns in supply as in our examples would report them as shortages. Thus, we are reasonably confident that reported shortages are a decent proxy for disorganization.

We focus on shortages rather than some of the other implications of our examples because most alternative theories of the output decline do not naturally predict shortages.<sup>13</sup> There is one exception: shortages may reflect the effects of partial price liberalization, along the lines of Murphy et al. [1992]. In most republics however, prices have now been mostly liberalized, so that partial price liberalization probably plays a limited role in explaining shortages at this point.<sup>14</sup>

We read the available evidence as suggesting that disorganization has played a limited role in the major Central European countries, some role in Russia and the Baltics, and a major role in the other republics.

(1) Since 1992/93, the OECD has carried out a survey of firms in manufacturing in a number of Central European and Baltic countries, asking them about factors limiting production in manufacturing. The strength of these data is that they come from roughly identical surveys. Unfortunately, they do not cover the early period of transition, where disorganization is likely to have been relatively more important. The evidence from these surveys is summarized in table 1:

*Table 1. Percentage of firms experiencing shortages of materials.*

---

13. Phenomena such as wage compression in state firms compared to private firms (for example Rutkowski [1996] for Poland, Kollo [1996] for Hungary), the collapse of inter-republican trade, cannibalization of machines, "spontaneous privatization" and the carving up of firms, are also consistent with our story. The problem is that they are also consistent with other explanations, including efficient reorganization. The volume of trade may well have been too high. Cannibalization of machines or of firms may be efficient, and so on.

14. For a survey of progress on price liberalization as of 1995, see European Bank for Reconstruction and Development [1996].

	min percent	max percent	1996-1 value
Czech Republic 93-1 96-1	3	9	5
Hungary 92-1 96-1	6	11	5
Poland 93-3 96-1	3	6	5
Bulgaria 93-1 96-1	15	33	25
Romania 92-1 96-1	8	39	15
Latvia 93-1 96-1	21	32	21
Lithuania 93-3 96-1	13	43	17

*Source: OECD Short term indicators, 2/1996. Business survey annex.*

In the three major Central European countries, shortages of materials have played a very limited role since 1992-1993. The numbers are comparable to those obtained from similar surveys of firms in Western Europe. Numbers from Berg and Blanchard [1994] show that, even in 1990 in Poland (the first year of transition), disruptions were not an important part of the story. The proportion of firms citing "supply and employment shortages" as a limiting factor in production was 62% in October 1989, 37% in January 1990 (the month of the "big bang"), but down to 10% by April 1990.

The evidence from those Central European countries which are doing less well suggests a larger role for disorganization. In Bulgaria and Romania, two of the countries with the largest drop in output, supply shortages played an important role more than two years after the beginning of transition. The same is true of the Baltic states.

(2) Table 2 gives corresponding numbers for Russia, since 1991 (from a sample of about 500 industrial firms, with a response rate of 30-40% over time).

*Table 2. Proportion of firms in industry mentioning the following constraints as limits to production. Russia, 1991-1995*

	Insufficient Demand	Shortages of Materials	Shortages of Financial Resources	Shortages of Labor
1991	4	82	18	28
1992	51	46	45	8
1993	41	23	62	6
1994	48	19	64	5
1995	47	22	64	8

*Source: Russian Economic Barometer, 1996*

The most striking number is the proportion of firms experiencing shortages of materials in 1991. This however is the last year before full price liberalization (which took place in January 1992).<sup>15</sup> The numbers however remained high in 1992, and are still high by standards of market economies.

Another piece of evidence, which speaks more directly to disorganization, is the proportion of work time in firms lost to full stoppages of production, by reason. The time series are given in table 3.

<sup>15</sup>It would be interesting to find out how the proportion of firms experiencing shortages evolved pre-1991. The survey used above starts in 1991. We have searched for earlier ones, so far without success.

*Table 3. Percentage of working hours lost due to full stoppage of production, and reasons for it. Russia, 1992-1995.*

	Percentage of hours lost	By reason		
		Lack of demand	Lack of materials	Other
1992	10	59	40	1
1993	10	50	39	11
1994	18	53	35	13
1995	7	37	53	10

*Source: Goskomstat Rossii, various issues. 1992 is August only. 1993 is the average over 4 quarters. 1994 is the average of May and October. 1995 is the average of the first two quarters.*

Lack of materials appears to be the main factor in explaining work stoppages during the period 1992-1995.

(3) Shortages of materials appear to play still a more important role in the republics of the former Soviet Union. Table 4 gives some numbers for the Kyrgyz republic. The numbers are from a survey of firms by the ILO and are for 1993, thus a year after price liberalization in the Kyrgyz republic, and one year after the collapse of trade between the Kyrgyz republic and the other republics of the former Soviet Union. (1993 is however a period of very high inflation —23% a month on average—. High inflation is typically associated with disruptions in trade, and this may account for some of the shortages reported by firms.)

Table 4. Main business problems of firms in industry. Kyrgyz republic, 1993

	Shortages of materials	Low demand	Other factors
Food processing	57	13	30
Textiles	36	17	47
Non metallic minerals	26	32	42
Fabricated metals	31	22	47
Wood and paper	63	16	21
Other	43	21	36

Source: Windell et al. [1995] Proportion of firms, in percent.

These numbers are in sharp contrast to those for, say Poland or Hungary. Shortages of materials seem to be playing a central role. We are now collecting more evidence from the other republics. So far, the evidence appears consistent with that in Table 4.

The shortages in Table 4 seem to reflect mainly internal disorganization, rather than the collapse of trade between republics. The same survey gives for each industry the proportion of materials coming from domestic and non-domestic sources. The correlation across sectors between the proportion of firms citing shortages and the share of materials coming from non-domestic sources is roughly equal to zero.

Can one explain the differences between Central Europe and the former Soviet Union? Our discussion suggests a number of potential explanations. Specificities may well have been higher in many of the republics of the Soviet Union than in,

say, Poland or the Czech Republic, leading to a larger collapse of both intra- and inter-republican trade. Distance from the West, and thus the volume of trade, and the scope for foreign firms to alleviate problems of specificity, may also have played an important role. These are however speculations at this point.

## 6 Conclusions

Transition was conceptualized in a recent World Bank *World Development Report* [1996] as a movement "From Plan to Market." If our argument is right, then a more accurate, if less succinct, title would have been "From Plan and Plan Institutions to Market and Market Institutions." Transition may cause the existing organization of production to collapse, leading to a large decline in output until new institutions can be created.

The evidence suggests that disorganization has played a limited role in Central Europe, a more important one in the Baltics and Russia, and an even more important one in the other Republics. Put another way, disorganization appears to have played a more important role in countries where the output decline has been the largest.

While political economy and other considerations may well lead to the conclusion that the only way to stop subsidies is to stop them at once, our analysis provides some support for gradualist policies in dealing with state firms. If the emergence of new efficient private firms is likely to be slow, there may be a case for subsidizing state firms for some time at the beginning of transition.



---

## References

- Atkeson, A. and Kehoe, P., 1992, Social insurance and transition, mimeo.
- Banerjee, A. and Newman, A., 1993, Occupational choice and the process of development, *Journal of Political Economy* 101(2).
- Berg, A. and Blanchard, O., 1994, Stabilization and transition in Poland; 1990-1991, pp. 51-92, in *The transition in Eastern Europe*, Volume 1, O Blanchard, K. Froot and J. Sachs eds, NBER and University of Chicago Press, Chicago.
- Blanchard, O., 1996, *The economics of transition in Eastern Europe*, Oxford University Press, Oxford, Clarendon lectures, forthcoming.
- Bryant, J., 1983, A simple rational expectations Keynes-type model, *Quarterly Journal of Economics* 3, 525-528.
- Caballero, R. and Hammour, M., 1996, The macroeconomics of specificity, *mimeo*, June MIT.
- Ellickson, R., 1989, A hypothesis of wealth-maximizing norms: Evidence from the whaling industry, *Journal of Law, Economics and Organization* 5(1), *mimeo* LSE.
- European Bank for Reconstruction and Development, 1996, *Transition report, 1995*.
- Greif, A. and Kandel, E., 1994, Contract enforcement institutions: historical perspective and current status in Russia.
- Holmstrom, B., 1982, Moral hazard in teams, 13, 324-340, *Bell Journal of*

Economics.

Kaufmann, D. and Kaliberda, A., 1995, Integrating the unofficial economy into the dynamics of post-socialist economies; a framework of analysis and evidence, mimeo, World Bank.

Kollo, J., 1996, Employment, wage setting in three stages of Hungary's labour market transition, *mimeo*, Budapest.

Murphy, K., Shleifer, A., and Vishny, R., 1992, The transition to a market economy; pitfalls of partial reform, *Quarterly Journal of Economics* 107(3), 889–906.

Qian, Y., Roland, G., and Xu, C., 1996, Coordinating changes in M-form and U-form organizations, mimeo, Stanford University.

Rutkowski, J., 1996, High skills pay off: the changing wage structure during economic transition in Poland, *Economics of transition* 4-1, 89–112.

Sachs, J., 1993, *Poland's jump to the market economy*, MIT Press, Cambridge, Mass.

Shimer, R., 1995, Microfoundations of the optimal speed of transition, mimeo, MIT.

Shleifer, A. and Vishny, R., 1993, Corruption, *QJE* 108(3), 599–618.

Wells, R. and Maher, M., 1995, Time and surplus allocation within marriage, Stanford Graduate School of Business WP 1372.

Windell, J., Anker, R., and Sziraczki, G., 1995, Kyrgyzstan: Enterprise restructur-



ing and labour shedding in a free fall economy, 1991-1994, ILO labour market papers 5, 1995.

Young, A., 1996, Transition in China, mimeo, Boston University.









Date Due

OCT 15 1969





