Finanzwissenschaftliche Diskussionsbeiträge

Wirtschafts- und Sozialwissenschaftliche Fakultät, Universität Potsdam

Special Series

On the Integration of Industrial and Social Policy in the Transition Process

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Industrial and Social Policies in Countries in Transition

No. S-2

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June 1998

Finanzwissenschaftliche Diskussionsbeiträge
Special Series: Industrial and Social Policies in Countries in Transition

University of Potsdam, Faculty of Economics and Social Sciences

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ISSN 0948 – 7549

On the Integration of Industrial and Social Policy in the Transition Process

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Abstract: Industrial policy measures can be a reasonable supplement to economic and social policy actions during the period of transformation of centrally planned economies. This paper shows the interplay between industrial and social policy. Special attention is given to the timing and sequencing of the transformation prooss. This approach is closely modeled on the example of New Zealand.

1. Introduction

Nine years after the political and social overthrow the countries of Central and Eastern Europe still experience a difficult adjustment process towards democracy and market economy. Also those countries which started the transformation with a shock therapy ('big bang') are still far from achieving their goals of transformation. The transformation of the socialist regimes into mixed market economies proves to be a complex task. Even if one ideally assumes that at the end of this transformation process an efficient market system should be achieved in which political interference is as little as possible and which realises a sufficient allocation and distribution at the same time, still, during transformation it is necessary to take direct and correcting interventions. In this period, economic and social policy particularly have the task to strengthen the peoble's trust in and acceptance of the market economy, as the transformation cannot be finished successfully without their agreement.[1]

Discretionary interventions in the economy and its structure are part of the economic and social policy measures, which are often taken together with distribution and redistribution

[1] On the acceptance of the transformation see Müller/Petersen (1995).

policy. These measures are also used excessively in countries, which traditionally belong to the category of market economies. And in some isolated cases, such interventions were so strong that the respective countries – with exception of the basic principle of democracy – actually did not differ from centrally planned economies. The presently most popular example is New Zealand, which in 1984 introduced a transition process (mostly referred to as restructuring process) – being close to bankruptcy of the public treasury. While this transition was started fairly unnoticed by the world's general public, it could have been used as a model for the necessary structural reforms in the formerly planned economies.[2] Until today, other Western countries (especially Germany and France) are paralysed by structural inefficiencies, so in these countries, efficiency oriented restructuring seems to be overdue.

Industrial as well as social policy belong to the most controversial areas of economic policy. In an efficient market system there is actually no space for industrial policy measures of the state. The concept of consumer and producer sovereignty implies that individual preferences finally determine allocation. In contrast, merit and bureaucratic interventions in the course and structure of the economy always imply the arrogance of knowledge (Hayek) on the part of politicians or bureaucrats. Also social policy has gone far beyond the actual goal of avoiding absolute or relative poverty. In many countries, social policy dominates the area of social security, which quite often could be organised much more efficiently by means of private provisions and insurance markets.[3] If one wants to outline a vision of what the end of a successful transformation should be like, then an efficient market regime would have to be built on a constitutional and legal framework, which induces much less political interventions and, at the same time, ensures a reasonable basic provision for low income groups.

Politics, developed and pursued in flexible and dynamic societies can be quite a model, but in any case, they are to be adjusted to national and ethnological mentalities.[4] Though theoretical[5] as well as empirical foundations exist concerning the time horizon and the sequencing of transition measures, with respect to the individual process of transformation always the trade-off between efficiency and social justice is of importance.[6] Probably it will never be possible to solve this contradiction of objectives, still, with a reasonable political valuation, welfare

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[2] See Petersen (1997).

[3] See Petersen (1989).

[4] See also Funke (1993).

[5] On a theoretical attempt of explanation see Glaeser/Scheinkam (1996).

[6] For details see Petersen (1993) and Müller/Petersen (1998).

losses of a necessary redistribution policy (in the sense of a basic provision) can be limited. As the countries in transition are in a period of catching-up, similarly to developing countries, they can learn from successful examples, while this does not hold any more for the leading countries. For the latter, only innovation strategies can support the protection of already achieved standards, which might be developed successfully only by the Schumpeter type of entrepreneurs. In a situation in which strategies of learning are promising politicians and bureaucrats can control successful processes of adjustment. In this case, the above mentioned arrogance of knowledge à la Hayek does not apply.

Therefore during the period of transformation, industrial policy measures can be a reasonable supplement to economic and social policy actions, at least as long as the vision just outlined is not lost out of sight. Next we want to turn to the interplay between industrial and social policy. In doing so, an intuitive empirical rather than theoretical approach is pursued with regard to the timing and sequencing of the transformation process. This approach is closely modeled on the example of New Zealand.

2. Social and industrial policy – explanation of terms

Before we can look more closely at the interplay of industrial and social policy, the terms as well as the personal normative point of view have to be made clear. The theory of social policy (or social economics) can be divided into the economics of distribution and the economics of security. Their common task is to ensure an adequate social security for the members of society. The economics of distribution basically deal with the transfer of income and wealth, hence with an individual redistribution, which can be carried out voluntarily between individuals (family members or possibly also strangers) or compulsory because of state regulations. From a theoretical point of view, the economics of distribution should serve the goal of equity of demand, and thus provide a basic standard of living for all members of the society in need. In contrast, the economics of security deal with risk compensation between the members of a risk sharing association, hence with an insurance problem. In highly developed economies, where working insurance systems have evolved which represent an exceptional area of competitive policy with state regulations and price control, risk compensation could mostly be carried out by private insurance companies.

Therefore, the normative viewpoint taken here means that the state should withdraw to a great extent from issues of security economics and instead concentrate on realising the objective of

equity of demand by means of a basic provision strategy. This is to be done in the sense that a politically decided social-cultural subsistence level must be defined which takes into account possible negative incentives for citizens on welfare who are fit for work. Then, security economics would support the goal of justice of ability, which actually is consistent with pareto-efficient solutions.[7]

With regard to industrial policy, a more detailed description is necessary in order to make clear what the connections with social policy are like. In a broad definition industrial policy can be characterised as state interventions in enterprises' decision processes not only in the industrial but primary and tertiary sectors. Included are all measures which influence production, research and development as well as infrastructure. In addition, measures for improving human capital and regional economic structures are to be mentioned.[8] In this context, mostly state regulations, subsidies (financial assistance) and tax allowances are used as political measures in order to control the input of resources. Of these measures, the former and the latter have the advantage that they do not affect the national budget directly.[9] The objective of the use of these measures is either to preserve existing industrial structures or to create new structures which are able to resist international competition.[10] While the former objective quite often dominates in Western industrialised countries leading to considerable inflexibility and rigidity,[11] the latter should be pursued during the transformation process in order to reemploy those factors of production which mostly have become redundant during the period of shock therapy.

Such an acceptable industrial policy includes three components: First, a long-term stable framework should be fixed, which is able to ensure the markets' working. Second, by means of macroeconomic stabilisation policy, trade liberalisation and liberalisation of financial markets, the conditions for successful adjustment processes have to be established. Third, strengthening the technological basis in order to increase the speed of adjustment by supporting research and development activities as well as innovative abilities and adequate

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[7] For details see Petersen (1998) and Müller/Petersen (1998).

[8] See Oberender/Daumann (1995, p. 18).

[9] This means, they influence the economy while they cannot be found as government expenditures in the budget. This is particularly true for tax allowances (also called tax expenditures), while regulations are taken into the budget's account only with administrative costs.

[10] See Axt (1994, p. 576).

[11] In this context, the never ending debate on the 'business location of Germany' is referred to; see Petersen (1996).

education.[12] The main task of such an industrial policy is the promotion of economic growth. In doing so, the necessary structural change has to be achieved with as little as possible social costs. Therefore, a fundamental correction of past mistakes is to be taken, without which it is not possible to realise competitiveness on global markets. Here, the main task of economic restructuring is to increase the demand for labour[13] to keep unemployment within acceptable limits. For this, governments basically can take actions of regulation and subsidisation which especially have to be aimed at supporting markets rather than substituting them.

In the case of incomplete information with regard to future chances of individual sectors and products and with strong interest group pressure of so far dominating sectors, it is not easy to conduct an economically and socially reasonable industrial policy. In reality, such policies often cause bad investments and inefficient allocation as well as a substitution of markets by bureaucracy. The main problem of a sectoral industrial policy is its internal inflexibility. Once chosen paths are kept by all means, then under permanently changing general conditions formerly acceptable approaches become growth impediments and job killers instead of promoters of growth and job creators.

Anyhow, industrial policy goes much farther than just being a discriminative sectoral policy. It is also responsible for creating favourable infrastructure surroundings in which enterprises can work. This the more, since global competition increases and retreating to domestic markets leads to welfare losses. Still, opening domestic markets hastily for international competition may lead to a breakdown of rising enterprises and even whole branches of industry – though it is basically common opinion, that sustained growth only takes place when markets are opened. A well-balanced degree of protection has to avoid this.[14]

Deciding between various alternatives of relatively open markets with protecting some areas only and totally closed markets is not easy. Both strategies may result in negative consequences: In the former case, industry loses the domestic market and unemployment increases. In the latter, distortions are preserved which negatively influence efficiency.

As with many problems of economic and social policy, one is confronted with a dilemma, which finally can only be solved by qualitative political decisions, taking into account potential opportunity costs. These opportunity costs, representing the social costs of

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[12] For details see Jacob (1995, p. 18) and Axt (1994, p. 587).

[13] See Hughes/Hare (1992, p. 99).

[14] See Benini (1994, p. 11).

transition, determine timing and sequencing of the transformation processes. This way, also industrial policy can be aimed at fast or slow adjustment. Anyhow, it is not possible to realise all necessities of adjustment within one shock of change of Big Bang. Therefore, actual restructuring processes differ very much in terms of individual actions taken and their sequencing. Especially political viewpoints on what can be expected of the population and also the interests of the forthcoming adjustment processes' potential losers are decisive for observed differences.

3. On the problems of efficiency objectives and social justice

Though industrial policy is to be disapproved from a pure market economic viewpoint, during the transformation process it still has an important role. Together with social policy industrial policy has to maintain the population's acceptance and confidence in the rapidly changing society's environment. The refusal of market mechanisms is not only a phenomenon of formerly socialist countries, rather it is a time and again returning ideological fashion in Western industrial countries as well. Hence, economists have a missionary task for life. No "theory of institution would be complete if it excluded ideology".[15] It does not help social and industrial policy if prevailing ideologies are totally ignored. Anyhow, it has to be avoided that ideology becomes the only determining factor of influence. If the society agrees upon the rules of the allocation processes' course, individual market outcomes must not be denied as being socially unjust.[16] The issue of social justice refers to the rules of the game rather than to market outcomes.

While the social policy's task is to directly balance the loss of income achievable with employment at least at a minimum income level, the industrial policy's objective is to return or rather keep employees who have or rather would become redundant. Though the main objective of industrial policy is the creation of conditions favourable for a self-supporting economic growth, it also results in social security for employees. This social policy side effect is welcome and without problems as long as industrial policy actually improves future prospects and realises the creation of additional jobs. By that, also those employees who have already been dismissed during the structural change, get a chance again to find new

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[15] North (1984, p. 34).

[16] See v. Hayek (1981, p. 149ff.).

employment in order to realise once more a higher standard of living, once a new job is started.

But if industrial policy serves to preserve old and obsolete structures rather than to promote structural change, it becomes questionable also with respect to the issue of social justice. If social policy is orientated according to justice of needs[17] and a minimum standard of living, unemployed persons are set back to just this standard, while employees in artificially maintained enterprises still receive performance-oriented (and thus higher) wages – though they are actually also without useful work (unemployment on the job). A particularly demonstrative example is the German mining industry which certainly, due to its cost disadvantages, cannot be regarded as a prospective industry. While an additional 250,000 unemployed persons were counted at the beginning of 1997, the protesting miners, whose individual jobs are subsidised with much more than DM 100,000 per year, managed to safe their jobs for the long-run.

Subsidies which originally were meant to serve structural change (adjustment subsidies), become a permanent maintenance of sectors whose economic potential then becomes sustainably destroyed, when these subsidies are granted indefinitely.[18] Production capacities are not reduced in time in these sectors, so also in Germany many of these old industries are strongly at risk. Especially because of regional policy motives and in order to avoid regional mass unemployment such industries are maintained. The costs of such policies are transferred to small and medium sized enterprises and the rest of the society resulting in negative incentives for them. Finally, more jobs are destroyed than maintained in old industries, while at the same time taxes and payroll fringe costs increase dramatically leading to a capital drain off. Such a policy contradicts the objectives of justice of needs as well as justice of ability. Those members of the society who are unlucky enough not to belong to these problematic large-scale industries are released into unemployment and those society members who actually do not do anything useful are still paid according to performance criteria.

The example of a permanent assistance of some industries (especially mining and shipbuilding industries) is of particular importance for the countries in transition. Because of ideology and policy megalomania large-scale projects in the area of heavy industry as well as the manufacturing of means of production had priority in real socialism. In contrast, the

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[17] For the exact definition of this term see Petersen (1998).

[18] For ther German subsidies policy see Boss/Rosenschon (1997).

production of consumer goods was neglected. The politically directed specialisation within the bloc of socialist countries aimed at consolidating the countries' mutual dependence and also led to inefficient, one-sided and monopolistic economic structures with which the countries in transition were released from the centrally planned economy. Until today, the transformation processes are burdened with the dominating heavy industry, which proves to be anything but competitive. Its settlement or total restructuring – being the only useful medium- and long-term alternative – could result in an unbearable and possibly the transformation endangering short-term shock on the labour market. In any case, indefinite assistance cannot be justified, though, even after 9 years of transformation such assistance is still recognisable.

If large-scale state enterprises, which might not be ready to privatise yet, receive assistance (e.g. also by means of a renunciation of actually due taxes), they have to be limited in time, as otherwise necessary adjustments are prevented. Thus, industrial policy only has to serve efficiency objectives, while the social policy's task is to cover demand at a minimum level. Then, the society's members are treated equally and discrimination is minimised. Temporarily, more employees are dismissed, but at the same time, for each unemployed person the opportunity of getting a new job in the near future is improved. Hence, a preserving industrial policy does not only lead to welfare losses but also results in questionable distributional effects

4. On the time horizon and the sequencing of transformation measures

The time horizon as well as the optimum sequencing of the individual transformation activities very much depend on the social effects of these adjustment measures. Such effects are not only imminent unemployment but necessary adjustments of behaviour according to a fundamentally changed economic system. If there are no experiences concerning risks and opportunities of open and regulated markets, then the outcomes of such markets will not be satisfying at once. Especially financial and insurance markets are highly complex and can be only tolerably controlled with a lot of eagerness to learn and experience. Thus, with respect to all adjustment measures one has to take into consideration that first learning effects have to occur which can help to improve the effectiveness of market economic measures gradually.

Therefore, Western as well as Eastern countries have to expect the transition processes in the formerly socialist countries to last much longer than originally assumed and hoped for. The time issue of the systemic change has become one of the most important points of discussion between economic specialists and politicians. After all, the question is whether a shock therapy (big bang) or a step by step approach (gradualism) is more suitable for a successful course of the transformation. On no account, shock therapy means that all necessary reforms have to be implemented effectively at one point of time – so to speak over night. It just refers to an intense concentration of strategic institutional and especially stabilising actions during the first phase of transformation.[19] Due to its nature, a complete system change needs a lot of time and can therefore only succeed with several stages taken step by step. In contrast, gradualism tries to introduce a market economy with many small steps in order to avoid the shock of comprehensive bundle of simultaneous measures. The problem of reform pace is immediately connected with the sequencing problem – so to speak the question on the optimal order of transformation measures. To the layman it might be surprising that a sequencing problem also occurs when implementing a shock therapy. This is due to a fundamental misunderstanding of the options of transformation.

The economic discussion on big bang and gradualism is concentrated on the question of how many and which actual actions have to be taken at the very beginning of the process. "The question of big bang or not big bang is, therefore, not relevant for the transformation as such, but only for the switching-over from the system of central control to one of self regulation, since the liberalization of goods and factor prices, the dismantling of subsidies, and the introduction of full self-responsibility for enterprises can principally be achieved in a single act."[20] Hereby, the question of the politics' and science's ability to design and conduct the transformation as was planned is closely linked.

With few exceptions, most economists favour a high concentration of regulatory and stability policy measures at the beginning of transformation, for which a number of quite plausible reasons are given. The most important refers to the social costs of the system change, as they are by far higher than short-run obtainable profits during the first transformation phase (see figure 1).

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[19] See Delhaes/Fehl (1991, p. 441).

[20] Apolte/Gradalski (1992, p. 10).

From the point of view of the shock therapy advocates, this strategy is able to build a 'crucial mass' of reforms, so the transformation develops to a self-sustained process and it becomes irreversible despite high costs and increasing resistance in the population. Also in the case of a gradualist approach, the necessary stabilisation measures first lead to high social costs and disappointments in the group of losers, while positive effects occur only after a certain period of time. The trade-off between the higher short-run costs of a fundamental change and the long-run utility is no reason against but for the big bang.[21] Also the transformation countries' experiences confirm, that a nearly enthusiastic support of reforms and their political acceptance at the very beginning of transition drastically decrease, as first difficulties and burdens arise.

Figure 1: Costs and returns of the system's transformation

Short-run costs and returns during transformation			
Costs of transformation		Returns of transformation	
Individual costs	Aggregate costs	Individual returns of redistribution	Aggregate returns of allocation
Losers of transformation: - Unemployed persons - Losses due to inflation - Non-adaptable party members - Adjustment costs of ability potentials - Costs of information and search	- Costs of information and search - Costs of frictions due to temporary coexistence of differing economic systems' institutions - Costs of sabotage because of party members and bureaucracy's interests - Costs of inconsistent transformation strategies	Winners of transformation: - Risk-taking entrepreneurs - Pioneering entrepreneurs - Mobile labourer - Managers in transformed enterprises, in which adjustment takes place	- Dismantling market disequilibria - Efficiency increases due to rising productivity - Performance incentives and control on markets - Dismantling bureaucracy impediments - Dismantling trade restrictions

Source: According to Kartz/Thieme (1991, p.417).

The change of paradigms in the regulatory framework calls for a fundamental change of individual and collective patterns of behaviour and thought. But population, enterprises and institutions are only willing to change their behaviour if they are convinced of the reforms'

[21] On the trade-off see Coricelli/Milesi-Ferretti (1993, p. 389ff.).

irreversibility. When reforms are delayed or frittered away their credibility can hardly be conveyed.

The opposition of pressure groups, newly organising themselves over time and built of actual or only supposed losers of the transformation, is not to be underestimated. Bureaucracy is afraid of losing its privileges as the allocation of the means of production and of consumer goods is taken over by markets. Hence, allocation basically withdraws from the bureaucracy's area of influence. Heavy industries, which used to be particularly privileged in the socialist countries, have hardly any chance to survive in modern market economies. Their formerly omnipotent lobbies have to expect a loss of power and influence. The more slowly reforms are implemented, the greater the risk of an opposition against these reforms strong enough to stop the transformation altogether.

Advocates of the gradual strategy point out, that a slow and rather controlled approach reduces social adjustment costs of the transformation. Actually, the opposite has to be feared, as an excessive regulation of the transformation, in order to avoid costs, might result in a number of opposing reactions by the private sector of the economy, which again may lead to new regulations, so to speak to a whole spiral of regulations.[22] Thus, it can be assumed, that aggregate economic and social costs increase the faster, the longer institutions and regulatory elements of both economic systems exist simultaneously. Also the degree of interdependencies between the economic and society systems' parts supports a simultaneous introduction of strategic reform areas. E.g., the price system can only be reorganised successfully, when the demand surpluses, typical for socialist countries, are cut back simultaneously. But this requires monetary and wage policies aimed at stability. Without separation of government and central bank, without the abolition of so-called soft budget constraints in enterprises, and without containment of the state's budget deficit financing, it is not possible to conduct stabilisation policy.

Another argument in favour of shock therapy refers to the macroeconomic situation of the respective economies. Because of hyperinflation, the breakdown of the government budget and the disastrous supply on consumer goods' markets, it was necessary to take a quick, wide and especially consistent approach. In countries, in which reformers were startled when first costs and problems of the big bang occurred and therefore decided to change to a more gradual approach, the shock therapy quickly became a 'shock without therapy'. A prominent

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[22] See Falk/Funke (1993, p. 189), Buch/Funke/Heinrich/Raiser (1994, p. 299).

example is the implementation and sudden stop of Shatalin-Plan in Russia.[23] Not least Hungary's experiences since 1968, those of Poland since 1980 and the Soviet Union's under Gorbatshev's leadership with partial economic reforms leading to an alarming tiredness and scepticism of reforms among the population, make clear the advantages of a rapid approach. Even though these reforms were not aimed at a system change but rather represented a search for the 'third path', their objective was the slow implementation of market economic features. The outcome was the collapse of the economies.

By realising the big bang, so to say a combination of such basic decisions such as the admission of private ownership of the means of production, the release of prices and the stabilisation of the monetary sector at the beginning of transition, the transformation process is anything but completed. For many years to come further reform steps have to be taken, especially with respect to the state sector's privatisation, the restructuring of the social insurance system, and the environment's redevelopment.[24]

Despite the general agreement among economists concerning the scope of transformation measures, the question of the sequence of various reform parts is very controversial. This is partly due to differing opinions about shock therapy but also occurs because of varying beliefs regarding the role of individual economic and society subsystems and the relevance of their relations.

There is agreement among economists with regard to the priority of institutional reforms. But authors' opinions are already divided on stabilisation and price liberalisation. Like Gelb, Gray and Nuti, also Apolte and Cassel are in favour of a price and market liberalisation conducted as quickly as possible, since it shall induce economic adjustment pressure on enterprises and public institutions. In addition, they lead to a fait accompli, which first comes along with temporary disadvantages for the economic agents concerned, but also results in immense advantages, e.g. with respect to market supply.[25] It is not conceivable to liberalise prices, so far unrelated to scarcities, without a great adjustment inflation.

By means of a quick liberalisation of markets it is possible to achieve a rational structure of relative prices as quickly as possible. Domestic supply receives positive incentives by a currency devaluation and a monetary reform. In addition, a fixed nominal exchange rate can

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[23] See Oppenländer (1992, p. 46). A similarly impressive example is the Bulgarian collapse in 1996-1997.

[24] Also Kloten (1991, p. 24).

[25] See Apolte/Cassel (1991b, p. 49).

act as another nominal anchor of stabilisation. But a hasty foreign trade liberalisation may lead to an import explosion, intensifying balance of payments' imbalances and quite a reduction of domestic production, thus finally resulting in decreasing tax revenues.[26] On the other hand, a quick foreign trade liberalisation opens up domestic monopolies.[27]

Particularly controversial and by politics often neglected issues of the transformation's sequencing are privatisation, redevelopment and restructuring of state enterprises as here industrial as well as social policy interests are quite mixed with each other. Portes clearly points out the importance of the changes in the corporate legislation. "It is much harder to change the expectations and behaviour of firms than of households. Thus policy should initially have put less emphasis on the 'monetary overhang' and household behaviour, much more on the necessary changes in corporate control and financial environment for state firms and on transforming the banking system."[28] The privatisation experiences of the German Treuhandanstalt concerning the formerly state-owned enterprises in the new federal states of Germany can neither prove nor disprove the necessity of a pre-redevelopment or its inadmissibility as a condition for a successful privatisation. Certainly, there is no general answer on this issue. For each precise case an individual decision has to be made, which takes into consideration the specific situation of the country, sector and respective firm. Anyhow, a long-run industrial policy strategy could prove to be very helpful, though, such a strategy cannot be recognised so far.

In most transition countries of Middle and Eastern Europe, the reforms of the social insurance system either have not been tackled so far or they were started relatively late only. It is quite understandable that social reforms are tackled rather late. At the beginning of the system's upheaval total priority was given to the economies' stabilisation. The implemented shock therapy resulted in a sudden increase of price levels and the collapse of domestic production, having corresponding effects on labour markets. This first crisis called for strength and readiness to make sacrifices on part of the population. During this period, existing systems of social security took most burdens which were due to so far unknown and exploding unemployment and vastly spreading poverty, though these systems certainly were very inefficient and did not fulfil the requirements of a modern market economy. Still, at this time they were a very important buffer for social problems. Despite various reservations, they were

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[26] See Bird/Bird (1992, p. 10f.).

[27] See Apolte/Cassel (1991a, p. 129f.).

[28] Portes (1992, p. 663).

the only existing possibility of reception for increasing social dissatisfaction of losing groups, especially the unemployed. It can only be speculated on what would have happened if also social security systems were reformed more comprehensively and radically at such an early stage of transition. But it can be doubted whether this would have been possible at all, in view of accumulating tasks in the area of macroeconomic stabilisation and the change of institutional and legislative general conditions while personal and technical capacities are very limited.

Anyhow, the delay of reforms of social security systems is connected with high opportunity costs. If one takes Poland as an example, so to speak a country which is mentioned once and again as a model for a successful transformation, then the critical observer cannot miss that the Polish pension scheme is in a crucial financial position without prospects of improvement, while at the same time, public health care has fallen into agony and many social classes are seized by poverty. But to conduct radical reforms during the second transformation phase will be a very difficult task. These reforms have to limit the state's social responsibilities on core areas, which especially should comprise the fight against poverty, poor assistance and necessary regulations of the insurance system. But the population of the formerly socialist countries is still used to the state's supposed generosity concerning social issues. Politicians are afraid, social cuts could lead, from their point of view, to undesirable voters' behaviour and thus strengthen radical groups. Also in the countries of transition social policy proves to be an ungrateful area of political activity. Commitment in this area promises quick success in elections and popularity for decision-makers, but this holds only as long as means for social expenses are not scarce and higher rather than smaller amounts can be distributed. As soon as a country's social security system gets at its financial limits, such that a conversion or even a reduction of social allowances becomes necessary, then, at the next elections, voters can withdraw their votes from the government. In any case, the politicians' aversion to radical reforms of social security systems has to be broken sooner or later. A further neglect of this important area of economic policy during transformation is inconceivable without negative effects on the whole system change. Rather, previous successes of transformation were strongly endangered.

It can be doubted, that there is only one optimal sequence of reforms. "The optimal policy depends on circumstances that differ across countries, and reflect their diverse historical backgrounds, economic, legal and political institutions, entrepreneurial traditions, and attitu-

des towards markets and incentives."[29] Finally, it basically depends on the respective initial situation of the country in question, which path is wanted most and promising success.

Nevertheless, in the following we try to outline the intuitive-empirical sequencing mentioned in the introduction. In general, it is based on New Zealand's experiences. Also the 'revolution of New Zealand' was not based on a 'blueprint', developed by theoretical economists at a 'drawing-board'. Instead, politicians, who were members of a socialist part, rather instinctively acted correctly from today's point of view, even though restructuring brought about many losers, who certainly disseminate a completely different point of view. Still, the crucial point is, that the number of winners is higher than the number of losers. For this relation, elections are a good even though no perfect approximation.

5. The experiment of New Zealand

In mid 1984 New Zealand was close to the state's bankruptcy. This is why the conservative Prime Minister Muldoon declared new elections. Labour won these elections and the first government Lange (Prime Minister)/Douglas (Minister of Finance) came into power (1984-1987). One of the first political actions taken by Roger Douglas were to pull down interventionist barriers. Similarly to the Thatcherism in Great Britain, Rogernomics were born. By this approach all campaign promises were broken, resulting in reproaches at Douglas of undemocratic behaviour also at the side of the approving population.[30] Nevertheless, by taking advantage of the surprise effect, these radical reforms could be realised without substantial opposition of Labour's left wing and the trade unions. The implementation of the period of transformation was equivalent to a shock therapy. Hence, New Zealand became the first empirical proof for the superiority of an initial big bang rather than a hesitating gradualism.

First in the centre of political activities were the restructuring of the public sector and the public education system (State Sector Act 1988 and Public Finance Act 1989). By means of the 1989 Reserve Bank Act New Zealand's central bank became also formally independent and was now obliged to the objective of value of money stability only. After a strong collapse of the still new and unstable stock exchange in 1987, in 1989 a transition crisis was emerging

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[29] Calvo/Frenkel (1991, p. 147).

[30] See Jones (1996, p. 17 and 52ff.).

with declining economic growth and strongly increasing unemployment, despite achieved price stability. Because of the aggravating transition crisis in 1990, Labour finally lost power and the conservative party got back into power (Bolger National Government). Now those system elements got under pressure for reforms, namely the reforms of labour market and welfare state, which Douglas was afraid of tackling out of consideration for his voters.

State expenditures were simultaneously cut down on their core tasks and reformed. Especially the principles of New Public Management (NPM) were introduced, with emphasis on the state budget's output orientation. In addition, new methods of budgeting, accounting and controlling (accrual accounting, public property accounting etc.) were implemented. As a result, payments of state employees turned out to be much more performance oriented, though without really intensifying the exchange of employees between public and private sector.

These reform measures were supplemented with the Fiscal Responsibility Act of 1994, which was to increase financial policy's transparency and consistency. In the centre is the yearly Fiscal Strategy Report, in which especially issues of aggregate property and public deficit are analysed critically and judged according to the government's goals. These reforms not only changed the public sector's position and role substantially but also reduced its aggregate importance considerably. E.g., the share of the public sector's employees decreased plainly (from 27% in 1987 to 20% in 1995).[31] Parallel to the employment decline, government expenditures decreased as a share of gross domestic product from a maximum of 43% in 1990 to 35% in 1995, yet a medium-term share of less than 30% is aimed at.

Within OECD-members New Zealand used to be a high taxation country until the political change of power in 1984. With respect to many elements the fiscal system was similar to the British before EC-membership. Typical was especially the highly progressive income tax scale, which was also characterised by many exceptions (tax concessions). The overall high aggregated tax quota led to lasting negative incentives with corresponding migration effects of capital and finally even labour. In 1985/86, next to a simplification of corporate taxation, especially reforms of income taxation were realised. Here, tax scale progression was reduced and the basis of valuation was substantially broadened (in line of a comprehensive tax base). The adjustment measures were taken step by step until 1989. In 1986, after the introduction of a net turnover tax (Goods and Services Tax: GST) almost all other indirect taxation was

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[31] As a special example the Ministry of Transport is mentioned. Here the number of employees was reduced from 5,000 in 1986 to mere 50 employees in 1995. See Evans et.al. (1996, p. 1876).

abolished. Corporate profit tax was reduced and aggregate tax revenue structure was changed. So income tax, by far, leads to the highest tax revenues.

In a second big bang labour legislation was reformed and labour markets were liberalised by Bolger National Government. While already the Labour Relation Act of 1987 supported decentralised wage bargaining, the 1991 Employment Contract Act abolished the in 1935 introduced compulsory membership in trade unions.[32] Thus, trade unions were transferred into purely private associations without any special privileges. They lost their monopoly to carry on wage bargaining for the employees and to get industry specific area related wage agreements through. These regional and sectoral related wage agreements were replaced by enterprise specific, individual agreements.

However, employees are entitled to freely form associations. Thus, they can voluntarily join together, in order to cover enterprises or groups of enterprises with contracts. "Freedom, free voting, responsibility and flexibility of giving and taking when being in wage bargaining have strongly changed the behavioural pattern of employees and managers."[33] As a result, it can be recorded that wage structures became regionally differentiated. Earning gaps especially arose between urban and backward rural regions. But also relative earning structures differ more, so a performance oriented payment has contributed to a considerable labour productivity increase.[34]

Simultaneously with the labour productivity's increase, the number of unemployed declined. Between 1991 and 1995 202,900 new jobs were created, 65,600 in 1995 only. Most new jobs were created in the service sector, of which more than two third are full-time employment contracts. Therefore, declining unemployment and rising labour productivity were the main causes of real economic growth, which amounts to an average of 4% yearly since 1991, while in average, it was at a mere 1.4% between 1976 and 1990.[35]

The fundamentally new individualistic philosophy of New Zealand's government revealed itself in the reforms of the welfare state, which was and still is built to a great extent on the

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[32] See Kasper (1996, p. 33). In order to characterise this situation another quotation is given: "Payment was hardly related to performance. Among employees the prevailing view was, they would be paid merely for being present at their job". (See Evans et.al. (1996, p. 35). Therefore, New Zealand's conditions were in general very similar to those of the GDR's final phase, which also was brought to a standstill by the state's bankruptcy.

[33] Kasper (1996, p. 41).

[34] See OECD (1996, p. 57ff.).

[35] See Budget & Fiscal Strategy Report 1996 (1996, p. 7-8).

model of a basic care system, as the British example. This way, the major elements of social security – unemployment benefit, health care, family equalisation of burdens, and pension scheme – are financed by a pay as you go system out of current tax revenues. Simultaneously with labour market reform, the social security system's benefits were reduced by about 9%.[36] Even more far-reaching were the effects of the considerable tightening-up of conditions for claiming social transfers.[37] Nearly all social transfers are connected with an individual income situation check up (income test), according to the final principle, so in general, increasing market income comes together with an accordingly reduced benefit.

New Zealand's social security system does not distinguish between unemployment benefits and welfare transfers. Unemployment benefits are calculated as a fixed share of a male employee's average earnings adjusted to marital status.[38] The period of entitlement is unlimited. Thus, unemployment benefits amount to the same for singles and families with the same number of family members, so it can be understood as basic security in the sense of a subsistence level of income. Recently a model was presented, according which unemployed persons shall be called to municipal jobs (work-on-the-dole-plan). Planned are two working days per week, for which a small hourly rate shall be paid. If the job is refused, entitlement to welfare payments is forfeit.

To a great extent, the health care system's basic elements continue to exist, though much more far-reaching reform proposals were made. Reforms especially emphasised the health care system's decentralisation as well as the separation of consumer and supplier.[39] Parallel to the organisational reform models of self-participation were implemented. Now, only holders of a Community Service Card are entitled to a limited access to ambulance health care services. Among these holders are people who receive social transfers, chronically sick persons, low income families who receive family support, students, and pensioners who are not subject to the special income tax surcharge. The others have to pay for a significant part of their costs for physicians and medicine. Also this feature shows the orientation according to a basic security model. The corresponding can be said with respect to sickness benefits. It is paid as a flat rate, which can be received indefinitely but does not show any relation to past income.

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[36] See Evans et.al. (1996, p. 1878).

[37] See Stephens (1996, p. 452).

[38] For a married couple with two children, this percentage amounted to 66% until 1991 and was then reduced to 60%; for singles the share was reduced from 57% to 50%. See Stephens (1996, p. 466).

[39] For details see OECD (1996, p. 114ff.).

Here, an 'income test' is effective too, and labour income as well as yields on assets are taken into account according to marital status.[40]

In New Zealand age balance of burdens is organised by a pension system, which guarantees the same basic pension to all retirement pensioners. Like the other social security systems, also pensions are tax financed according the pay as you go system. Simultaneously with gradually raising the age-limit from generally 60 to 65 years of age, further crucial cuts were taken into the pension scheme. By means of all these measures, it was possible to reduce the 1985 superannuation in relation to the pension's continuance by about 40%. Presently, the weekly pension for a married couple amounts to $ 313 (about $ 1,356 per month). This is more or less equivalent to a level of 70% of the average income.[41] The weekly pension for a single pensioner presently adds to $ 204 (about $ 884 per month).[42] This is equivalent to 65% of the pension payment for a married couple or a level of supply, as percentage of average income, of about 45%. Pensioners (with an income of less than $ 26,000) receive a Community Service Card as a transfer in kind. This card not only entitles to subsidisation of sickness costs. Also grants conditional to income are given to pensioners, who do not receive income other than the pension and who are living in rented flats. And in the case of personal plights financial assistance is given.

If one takes the election results of October 1996 as an approximation for the reforms' acceptance, then it can really be spoken of an impressive vote in favour of liberalisation. Alliance, as the only party standing for a distinct return to a closed society, lost eight percentage points compared with the 1993 elections and thus achieved only 10% of voters. With 38%, National Party, governing since 1990, remains most popular. Labour as well as the New Zealand First Party, which was founded by a dissident of the National Party (Winston Peters), basically accept the reforms. Only with respect to health care provision (Labour) and restrictions of foreign direct investments as well as the legislation on immigration (New Zealand First) these parties went for modifications. Votes for Labour amounted to 28% and for New Zealand First 13% of votes were counted.

When relating the election's individual results to overall reforms, it becomes obvious, that only 10% of all voters totally reject the taken reform path (voters of Alliance). Labour and

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[40] See Stephens (1996, p. 464f.).

[41] See Bayliss (1996, p. 18).

[42] See Bayliss (1996, p. 8).

also New Zealand First reject some details only. This means, altogether 51% of all voters do not accept the reforms as a whole, while 49% totally approved of them.

6. The essence: Intuitive sequencing

The essence of New Zealand's experiment is, that the change from an exaggerated and rigid welfare state towards an efficient social state with a basic security system made it possible to return the country's necessary dynamics, in order to make the country able to survive successfully under the conditions of global competition. Of course, there have been losers and, as the wages' differentiation according to performance was increased, obviously income distribution has become more uneven. But this results in additional career development incentives and increased savings and capital accumulation, which makes it possible to invest in new jobs. In addition, New Zealand has become far more attractive for foreign direct investors. If one simplifies New Zealand's sequencing and timing, then the transformation was started with macroeconomic stabilisation policy and the goods market liberalisation (see figure 2). When capital markets are liberalised and an autonomous central bank is established, then the great privatisation can be started, which realistically is to be carried out stepwise.[43] By means of the currency's free convertibility and a stabilisation goal of monetary policy the initially implemented macroeconomic stabilisation is maintained. The subsequent reform measures concerning the public sector, labour markets and social security affect obsolete possessions of numerous strong pressure groups. In this context, exaggerated heavy demands on the state are to be overcome. Here, it is necessary to point out the prohibitive consequential costs of the outdated systems to the population. Finally, regulations over present exceptional areas of competitive policy are to be checked and open competition will be implemented. Here as well, opening up and internationalising the economy is helpful in order to achieve a new interpretation of relevant markets and to overcome national (and supposedly natural) monopolies. Timing and sequencing is summarised in figure 2.

Without doubt, exceptions will have to be made for individual sectors and branches of industry. But the vision, given above, must not be lost sight of.

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[43] Here it is quite possible to refer to the German examples of Lufthansa (national airline), Bundesbahn (railways), and Bundespost (postal service).

Figure 2: Intuitive timing and sequencing

General Policy Areas	Institutional Adjustment	Individual Measures
1) Macroeconomic stabilisation	• Demonopolisation and external economic liberalisation • Creating competition legislation	• Budget consolidation • Controlling monetary growth • Abolition of foreign exchange control
2) Liberalisation of goods and services markets	• Small privatisation of producing businesses • Legal protection of property	• Releasing prices • Removal of price subsidies
3) Liberalisation of capital markets - working money and capital markets - regional/international mobilisation of the factor capital	• Creating dual banking system • Starting great privatisation step by step	• Formal privatisation • Actual privatisation
4) Independence of monetary policy	• Creating autonomous central bank • Defining stabilisation goal	• Currency convertibility (flexible exchange rate, controlled floating if necessary)
5) Reform of public sector	• New Public Management • Outsourcing • Tax reform (low tax rates with broad tax base)	• Accrual Accounting • Performance-agreements • Implementing comprehensive direct and indirect tax
6) Reform of labour markets	• Abolition of wage defining monopoly (including abolition of bilateral monopoly) • Admission of free wage bargaining	• Freedom of contract for entrepreneurs and employees • Right to strike, only at the level of individual firms • Models of equity wages
7) Reform of social security	• Strengthening private insurance business (old age, sickness, unemployment) • Strengthening family bondage for social security	• Defining basic security for loss of market income and in-kind benefits in health care
8) Definition and (new) regulation of competition policy's exceptional areas	• Creating monopolies and mergers commission and supervisory offices	• Supervision of bank and insurance businesses • Regulation of leadership bound economic areas

7. Summary: On an efficient industrial, agricultural and social structure

Not only in countries in transition but many Western industrial countries industrial policy is mainly used as a strategy preserving present structures in order to avoid a short-term and supposedly intolerable increase of unemployment. In return for subsidies there is a directly measurable success. When such a policy gets out of hand, then subsidy volume accumulates over decades. As a result, long-run costs of such a strategy come to light.[44] Because of high taxation and social security tax burdens, also not subsidised small- and medium-sized firms loose their international competitiveness. The countries in transition are only able to achieve the necessary flexibility and dynamics when they manage to embed a considerate industrial policy, which is certainly temporarily essential in order to maintain the society's acceptance, in a middle- to long-run strategy being in a position to induce the imperative structural change.

In this context, the agricultural sector can be helpful as well, as this sector's employment might be maintained at an excessive level for some time when market and subsistence production are combined. Therefore, the agricultural sector somehow is a buffer to, at least partly, cushion the transformation's social effects.

Hence, beneficial and disastrous effects of subsidies very much depend on the amount spent and the time limit they are granted for. (1) The amount of subsidies is to be limited. Only then, they can actually discriminate and thus fulfil their incentive function. When all and everything is subsidised, subsidies lose their controlling function. (2) They have to be limited in time and degressively scaled in order to avoid long-run effects of habituation and take along. Similarly to the area of social security, these effects just result in a very demanding behaviour on public institutions ("entitlement behaviour"). (3) They can only be granted during the period of catch-up, as only at this stage the state's bureaucracy disposes of the essential control information. Because of the lack of information about future paths of development, the state's control substantially looses its operative capability in mature industrial societies. Here, the state's task is to promote the private sector's innovative ability by means of a flexibly defined general framework and a moderate policy of taxation. Thus, at

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[44] For the respective German figures see especially Boss/Rosenschon (1997).

the end of the above outlined sequencing, state intervention must be reduced to a great deal. This is revealed in strongly decreasing quotas of government expenditure, taxation and social security contributions.

During periods in which unemployment is due to a lack of capital rather than a lack of demand, objectives of distribution policy are to be thrust into the background. After all, the excessively egalitarian ideas of socialism led to the states' bankruptcy. The necessary incentives for an increased accumulation of capital are to be achieved by a stricter differentiation of income and wealth distribution, which is returned to all the population in form of investments in new jobs and comfortable housing conditions.

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