WAGE CONTROLS DURING THE TRANSITION FROM CENTRAL PLANNING TO A MARKET ECONOMY

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Wage controls have been integral to the stabilization programs of the formerly socialist countries of Central and Eastern Europe that are now moving toward market economies. The usual rationale for such restraints in "heterodox" stabilization efforts has been the need to break the momentum of inflationary expectations. In economies in transition the pervasive weakness of governance of state enterprises supplies an added imperative: the controls are needed to hold the line against pressures for excessive wage increases, which must ultimately be paid for by decapitalization of firms, reduction of tax revenues, or accumulation of enterprise debt.

Examination of the design and enforcement of various systems of wage control leads to the conclusion that wage controls inevitably distort decisions on employment and work effort. These distortions, moreover, are the result of the same features of state enterprises that necessitate wage controls in the first place. Ultimately, the only way to avoid such distortions is to remove uncertainty about the timing of privatization, to ensure that workers and management have a well-defined stake in the newly privatized firms, and to establish financial discipline over the enterprises.

Freeing prices to alleviate economic imbalances has been a priority in most emerging market economies. It is therefore paradoxical that wage controls have been a key component of stabilization programs in many of these countries.

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There is considerable skepticism among economists about the effectiveness of wage controls in general: they are intended to suppress market forces, introducing rigidities in the structure of wages and delaying adjustment to changing labor market conditions; they are often circumvented, and they are typically costly to administer. This pessimism is borne out by the experience of many countries with wage controls, as with other centralized means of wage determination. If wage controls are recommended during the transition to a market economy, therefore, their rationale must be predicated on exceptional circumstances.

As a brake on inflationary momentum, wage controls have figured in “heterodox” stabilization programs in Latin America and elsewhere. The object was to reduce the cost of adjusting an economy to a lower rate of inflation by controlling a publicly visible price, limiting the extent to which inflationary expectations become self-perpetuating (Bruno and others 1988; Dornbusch and Simonsen 1987). Formerly centrally planned economies have had an added and even more pressing reason for integrating incomes policies into their reform programs and maintaining them as an enduring feature of the economic regime: the weakness of governance of state enterprises by their legal owner, the state.¹

The weakness of governance has been especially serious at the “no-man’s land” stage, when central planning, with its detailed control of prices and wages, has been dismantled but before market forces have become an effective replacement. At this stage enterprise managers often owe their jobs to workers’ councils; the interests of capital, by contrast, have little representation. At the same time, the “soft-budget” problem—the perception that losses will ultimately be underwritten through subsidies and credit and that the firm will not be allowed to fail—is exacerbated when privatization is impending. Workers and managers, realizing that they have limited time to take advantage of their control of a firm, have little incentive to restrain their wage demands, since the benefits of such restraint would be reaped by the future owners and the state (Commander, Coricelli, and Staehr 1991). The extent to which this occurs depends on how privatization is implemented—particularly whether existing stakeholders such as workers and managers are given a share of the privatized value of the firm.

Excessive wage increases may undermine a stabilization and reform effort in several ways. One response to the increases is to mark up prices. In formerly planned economies, where the existing structure gives managers few incentives to adjust prices to market forces and strong incentives to follow established procedures, higher wages are particularly likely to be passed on mechanically into higher prices (Commander and Coricelli 1991; Blanchard and Layard 1990).

A second channel through which wage increases may be inflationary, even without markup pricing, is money creation. In socialist economies most government revenues are derived by taxing state enterprises, and loss-making enterprises are kept afloat through budgetary subsidies and credit creation. The
government’s access to domestic borrowing is limited by the underdevelopment of domestic financial markets, while its access to foreign borrowing is limited by political uncertainty and often by a debt overhang. Under these circumstances higher wages translate into lower profits, lower tax revenues and higher subsidies, a larger deficit, and thence money creation.

A third fear is that wage increases could come at the expense not only of lower profits and tax revenues, but also of decapitalization (Hinds 1991). The resources required to maintain the capital stock, and especially to undertake the new investment needed to adapt to a changing environment, may instead be paid out in higher wages. In effect the workers and managers may eat up the enterprise’s capital stock before privatization even occurs.

So, to restrain inflation and to prevent enterprise decapitalization during the transition, some mechanism of wage restraint is indicated. But any system of wage controls entails some distortions, and the very features of a reforming socialist economy that necessitate controls also imply strong pressures to circumvent any system, however ingenious, that can be devised. The precise effect of the wage controls will depend on the behavior of enterprises; in particular, implicit property rights that workers have in the firms where they work (a feature captured in many models of state enterprises) are both a motive for wage restraints and a force to undermine them.

These considerations are crucial in devising a mechanism for wage control that will work in these economies. This article first looks at some models of behavior of worker-controlled firms that might shed light on the kind of response wage controls might elicit. In this context the article then discusses the design of controls—that is, how to set the norm for the allowed increase in wages—and their enforcement—that is, how to reward compliance and penalize noncompliance.

The Behavior of State Enterprises

Predicting the effects of wage controls, and indeed of any policy in an economy in transition, depends on choosing a suitable model for the behavior of state enterprises. Under central planning enterprises’ behavior need not, in principle, be modeled at all, because input and output decisions are made by the planners; up to a point, allocations are dictated by production targets and by central allocations of labor, raw materials, and other inputs. There are then only “ostensible enterprises,” which can be treated as part of the state hierarchy rather than as independent decision centers (Beksiak 1989). Even under these circumstances, there is some scope for enterprise managers to take actions—implicitly, a form of bargaining—that would bring pressure to soften production targets or to inject additional resources (Schaffer 1989).

The reforms that were begun in Yugoslavia and Hungary in the 1960s and in Poland in the early 1980s, gave more autonomy to the state enterprises,
although government controls continued in the form of state orders for goods, central control of raw materials, and so on (Balcerowicz 1989). Under the new arrangements, enterprise councils, in which the workers were represented, played a major part in enterprise governance. The Yugoslav experience gave rise to models of labor-managed enterprises, dubbed the theory of the "Illyrian firm" (Ward 1958; Vanek 1970). In these models there is a tendency for labor to be unemployed relative to other inputs because firms maximize profits plus wages per worker.

Theories of labor-managed firms may be challenged on the grounds of their realism: is it useful to model state enterprises as though they cared only about income per worker, and not at all about employment? One way to rationalize a concern over employment is to suppose that state enterprises serve the interests of their incumbent workers (Lane 1991). In this case risk aversion by the workers could result in overemployment as well as underemployment in the short run—although the model of the Illyrian firm would become relevant over a longer time horizon, as attrition takes effect. To distinguish this modified model from the classical model of the Illyrian firm, we call it a model of the worker-controlled firm. Enterprises may care about their employment for other reasons as well: employment may, for example, affect managers' discretionary income.

The framework of the theory of the worker-controlled firm can be extended by considering the possibility that the enterprise is not fully autonomous but is subject to some state control. The enterprise's decisions can be modeled as the outcome of bargaining between a worker-dominated enterprise and the government—where the government is concerned with the revenues that it obtains from the enterprise (Dinopoulos and Lane 1992).

A more complete picture of enterprise behavior would also take account of the asymmetry of information between enterprises and the central authorities. The authorities cannot fully and costlessly monitor the enterprises' costs and opportunities, and it is really this inability that gives state enterprises scope for bargaining with the authorities—as well as necessitating that enterprises be given some autonomy (Schaffer 1989). A more comprehensive model would also take account of uncertainty about the property rights pertaining to ownership and control of the firm. Uncertainty is pervasive during the transition to a market economy, a kind of limbo characterized as "neither plan nor market." One aspect is uncertainty about both the timing of privatization and the workers' and management's stake in the firms after privatization. This may lead to decapitalization of the firm (see Commander, Coricelli, and Staehr 1991): if workers in a labor-dominated firm believe that the firm is likely to be privatized in the next period, it is rational for them to prefer the certainty of higher wages now to the uncertainty of investing to maintain or upgrade the capital stock—in other words, uncertainty about whether it is they or the firm's future owners who will reap the benefits
of such investment. The resulting deterioration in the capital stock may have substantial social costs.

The authorities can use two instruments to limit decapitalization of the state enterprises pending their privatization: punishments for excess wages, associated with wage controls; or rewards for maximizing the value of the state enterprise, associated with the distribution of shares to workers. The appropriate mix of such punishments and rewards obviously depends on political economy considerations and must be taken in the context of the choice of privatization strategy.

Design and Enforcement of Wage Controls

Wage controls, then, are an important ingredient in the mix of policies designed to constrain wages below the average product of labor and to discourage decapitalization of the firm. The ultimate objective—paramount in a formerly centrally planned economy—is to protect government revenues and preserve the value of the state enterprises.

The design of wage policies contains three main elements. First is the selection of the norm for wage increases: precisely what is to be controlled—specific wage rates, the firm's total wage bill, or its average wage—and how is it to be adjusted in response to inflation and perhaps other variables, including the firm's output, value added, or profits? Second is the coverage of wage policies in terms of enterprises, distinguished by type of ownership or size. Third is the enforcement of wage controls, which involves the choices of penalties for non-compliance. The main characteristics of the wage controls adopted in several Central and Eastern European countries in 1990 and 1991 are summarized in table 1.

Determining the Norm for Wage Increases

Can a wage policy be designed that will achieve its objectives with minimum distortions? The central issue here is the method for determining the wage norm—that is, what increase in wages to permit under the wage law. Table 1 illustrates the salient features of rules that have been adopted in Bulgaria, Czechoslovakia, Hungary, and Poland. Numerous variations on the theme have been proposed, and the implications of each should be considered.

Specific Wage Ceilings. One type of wage rule is a ceiling on the percentage increase in each wage rate. This rule is sometimes applied as a wage freeze, but it could also allow for partial indexation to inflation (generally not full indexation, because that may result in indeterminacy of the price level). One drawback of a specific wage constraint is that, if it is effective, it completely ossifies the wage structure. Any exceptions allowed—on the basis of equity (catch-up for the disadvantaged groups) or efficiency (relative wage adjust-
Table 1. Wage Policy in Four Eastern European Countries, 1990–91

<table>
<thead>
<tr>
<th>Country</th>
<th>Control mechanism</th>
<th>Period</th>
<th>Target</th>
<th>Actual</th>
<th>Target</th>
<th>Actual</th>
<th>Profit link</th>
<th>Tax-based</th>
<th>Tax rate (percent)</th>
<th>Private sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>Equal, absolute increases</td>
<td>6 months</td>
<td>None</td>
<td>+1</td>
<td>−39(Q1)</td>
<td>−55(Q1)</td>
<td>No</td>
<td>Yes</td>
<td>min, 60 if &gt;1%</td>
<td>Exempt</td>
</tr>
<tr>
<td></td>
<td>(adj. Q2)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>max, 400 if &gt;5%</td>
<td></td>
</tr>
<tr>
<td>Czechoslovakia</td>
<td>Ceiling on wage bill</td>
<td>Quarter</td>
<td>None</td>
<td>−3</td>
<td>−10(Q2)</td>
<td>−20(Q2)</td>
<td>Yes</td>
<td>Yes</td>
<td>200 if &gt; 3%</td>
<td>Exempt</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>750 if &gt; 5%</td>
<td></td>
</tr>
<tr>
<td>Hungaryd</td>
<td>Ceiling on wage bill</td>
<td>Year</td>
<td>−3</td>
<td>−3</td>
<td>−10</td>
<td>−7(Q2)</td>
<td>Yes</td>
<td>Yes</td>
<td>50</td>
<td>Exempt</td>
</tr>
<tr>
<td>Poland</td>
<td>Indexation of wage bill in</td>
<td>Month</td>
<td>−30</td>
<td>−30</td>
<td>+3</td>
<td>−15(Q3)</td>
<td>Yes</td>
<td>Yes</td>
<td>100 if &lt; 3%</td>
<td>Exempt</td>
</tr>
<tr>
<td></td>
<td>1990, and average wage in 1991</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>200 if &gt; 3%</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>500 if &gt; 5%</td>
<td></td>
</tr>
</tbody>
</table>

Q=quarter.

a. Indicates the tax rates applied to wage increases above the ceilings. For instance, "100 if < 3%" means that the tax rate is 100 percent for an increase of wages no more than 3 percent above the ceiling.

b. For government employees, wages were controlled directly. For state enterprises and cooperatives, a ceiling was placed on the total wage bill. This ceiling provided a margin for wage increases above the absolute minimum wage.

c. The wage bill included bonuses.

d. A mandatory wage scale was removed in January 1989. Thereafter, most enterprises (except some in services) were free to set individual wages subject to an overall wage bill ceiling related to enterprise performance. For 1990 increases of the wage bill above value added were taxed at the corporate tax rate. For 1991 wage increases up to 18 percent were not taxed. Wage increases between 18 and 28 percent were taxed at the corporate rate, while wage increases above 28 percent implied a taxation of the entire increase. Labor shedding was further encouraged by exempting wage increases up to 5 percent when employment was reduced. In 1992 wage restrictions were abolished for state enterprises.

e. Mandatory wage scales were eliminated in January 1989. Commercialized firms were entitled to partial exemptions.

ments for workers with scarce skills)—may open the floodgates to lobbying for more exceptions. Exceptions would also allow enterprises to avoid the controls by reclassifying workers, at once weakening the controls and imposing administrative costs on the firms themselves.

WAGE BILL CEILINGS. A ceiling on the total wage bill, as opposed to the wage rate, leaves the enterprise more flexibility in determining relative wages. The rule also allows for partial indexation. An advantage that has made it popular in several countries (see table 1) is that it can be administered through the tax authorities, since wage costs must be reported in calculating an enterprise’s profit tax liability.

A wage bill ceiling implies that an enterprise’s wage rates can depend inversely on its total employment: a firm that sheds workers can raise wages, while one that hires additional workers must pay lower wages to its existing workers to fall within the constraint. To this extent, a wage bill ceiling creates an incentive for layoffs, especially where state-financed unemployment benefits are generous: workers as a group may be able to increase their incomes substantially through layoffs. This may not be undesirable, given the widespread featherbedding that is typical under the “guaranteed full employment” policies associated with central planning.

But, by the same token, unemployment is regarded as a problem in these economies and, in addition, much of workers’ wealth is tied up with their stake in the enterprise that employs them, which may make them particularly reluctant to agree to layoffs. Furthermore, the incentives for layoffs associated with the wage controls would not result in an efficient distribution of employment across firms. So it is not clear that these layoffs would occur in practice: to the extent that enterprises serve the interests of their incumbent workers, the result might be stagnation in employment—few layoffs, but no new hiring either (Lane 1991). This result would be consistent with the experience of some countries where wage controls have been adopted. Declines in employment have been small in relation to the concomitant declines in output (Blanchard and others 1991), and unemployment has been associated mainly with new entrants to the labor force rather than with layoffs.

AVERAGE WAGE CEILINGS. An alternative would be to impose a ceiling on the average wage paid within a firm. The incentive to lay off workers is thus removed, leaving latitude for firms to hire more labor if profitable opportunities for expansion arise, provided that new workers are paid no more than the average wage of incumbent workers. The drawback is that the rule equally encourages firms to pad their work force with employees whose wage is below the firm’s average, leading to uneconomical hiring of unskilled workers.

ADJUSTMENT FOR INFLATION. Most wage controls adopted in reforming socialist economies in the early 1990s included some adjustment for inflation. In
these countries inflation was either already high, as in Poland, or was expected to reflect a discrete price adjustment, as in Czechoslovakia; without some wage indexation, wage controls would have entailed an unacceptably large drop in real wages. Indexation has been the subject of an extensive literature in market economies, which can only be alluded to here (see, for instance, Gray 1978; Dornbusch and Simonsen 1983).

Most incomes policies provide for only partial indexation, adjusting wages by only a fraction of the inflation that has occurred. Wage controls with full indexation would not be a nominal anchor for the economy, because they provide no check to a wage-price spiral. The precise choice of indexation coefficient is largely a macroeconomic question: if inflation is ongoing, a lower coefficient lowers real wages; it also dampens the effects of shocks on prices and wages but may exacerbate the effects of shocks on output. There is also an important political dimension: how large a decrease in real wages would be acceptable? In most Eastern European economies, unusually low coefficients of indexation were chosen in relation to those adopted in many market economies. This can be explained by the sizable targeted reduction of real wages, considered necessary to eliminate excess demand in economies characterized by shortages in goods markets. Policymakers in these countries also recognized that, before prices were liberalized, the statistical level of real wages was in some measure fictitious, because many goods were often unavailable for purchase at the official prices (Lipton and Sachs 1990).

Another issue is the choice of the type of indexation: backward-looking adjustment to the inflation that has occurred, or forward-looking indexation based on projected inflation. To reduce inertia in the inflationary process, which could be particularly damaging in countries characterized by large jumps in the price level as a result of price liberalization, forward-looking indexation appears desirable. However, given uncertainties surrounding inflation forecasts, forward-looking indexation may result in large changes in real wages. Bulgaria, Czechoslovakia, and Hungary have opted for a forward-looking rule; Poland, for a contemporaneous indexation.

ADJUSTMENT FOR OUTPUT. Some consideration has been given to the idea of allowing firms to increase their wage bills in step with improvements in productivity—in its simplest form, making the permissible wage bill proportional to output. Rewarding productivity increases would both spur effort and help win workers’ acquiescence to organizational changes that may increase productivity. The measure would also allow firms to expand to take advantage of productive opportunities, without sanctioning unproductive increases in employment.

The principal argument against linking wage increases with productivity is that the practice would encounter the same pitfalls that have beset production targets—drawbacks that have been fundamental to the failure of central planning. Rewarding enterprises for their production regardless of quality or marketability provides a built-in incentive to emphasize quantity at the expense of
quality. But too often a substantial proportion of output is unusable and the need to produce an appropriate mix of outputs is ignored. Furthermore, the pressure to use inputs that increase output, even if marginal cost of these inputs exceeds the value of their marginal product, leads to misuse of other resources such as capital, raw materials, and energy. Wage controls designed to permit higher wages to firms with higher production would create many of the same incentives and thus many of the same effects, this time under pressure from the workers. Moreover, in an economy in transition, output-based wage controls could further weaken the resolve of loss-making enterprises to scale back production and shut down unprofitable lines. There would also be administrative costs, because such productivity-based controls would put the government back into the business of monitoring the physical side of the enterprises’ activities.

A ceiling based only on sold production would appear to avoid the problem of distorted quality and product mix, but it would not avoid misuse of other inputs. It would shift risks associated with demand fluctuations onto the workers. And enterprises could circumvent the measure’s intended market test by agreeing to purchase outputs from one another.

ADJUSTMENT FOR VALUE ADDED. Allowing the wage bill to be adjusted according to the change in the enterprise’s value added would encourage productivity without creating incentives to produce unstable, low-quality, or low-price outputs or to misuse raw materials. It would also provide a method of weighing different outputs for a multiproduct firm.

But a system of wage ceilings adjusted to value added also has some serious limitations. For one thing, it would still provide an incentive for decapitalization unless some appropriate adjustment were made for the use of capital during production. Another, more fundamental drawback is that a firm with market power can increase value added by increasing prices. In fact, a wage ceiling adjusted to value added requires that the firm be able to pass on wage increases in higher prices. This could still serve some useful purpose, in effect helping to harden the enterprises’ budget constraints by ensuring that the only way they can offer higher wages is to raise the necessary additional revenues by borrowing, arrears, or subsidies. However, there is an associated danger: if the increase in value added of the individual firm is partially indexed, any wage increase would have to be accompanied by a greater-than-proportional price increase, implying a pass-through of more than 100 percent; any wage increase that does occur would thus be more inflationary.

Another drawback of wage controls based on value added is that, even more than productivity-adjusted wages, they shift the risk associated with an enterprise’s production and sales revenues onto the workers. As well as reducing some of the risk-bearing role that firms typically perform in market economies, the policy introduces wage differentials among firms that may be regarded as inequitable, because they do not correspond to differences in the skill or effort of workers. Making the rule stick—a credibility issue crucial to any system of
wage controls—is also likely to be especially difficult for a system in which workers' allowed wage depends on actual sales performance. If the adjustment is contemporaneous, wages would initially be based on sales forecasts and would have to be clawed back if sales fell short of projections; if the adjustments are retroactive, they would be for the total change in value added. In either case, workers' remuneration in one period would depend on sales performance in the recent past. Telling workers in firms whose sales had fallen that their wages must fall correspondingly—saying, in effect, C'est dommage, mais c'est la loi—would be no easy matter, for governments or managers. The danger then is that a value added wage adjustment would in practice become one-sided: wages would increase for workers in enterprises whose value added had risen but would not decrease for those in firms whose value added had fallen.

**ADJUSTMENT FOR PROFITS.** An adjustment based on the enterprise's profits, usually in the form of a share of profits paid as a premium or bonus, is a common feature in many formerly centrally planned economies. In providing a channel through which workers can benefit from changes in productivity, such premiums may spur workers to make greater efforts on their own part, to monitor the effort of their colleagues, and to cooperate with changes in organization and management. Moreover, because at present the profits of state enterprises are typically an important part of the tax base, the temptation to underreport profits is strong; allowing a portion of taxable profits to be paid out in premiums may encourage more honest disclosure.

But excessive reliance on an adjustment for profits in an incomes policy carries some disadvantages. Even more than a value added adjustment, a profit adjustment shifts risks onto the workers, with the attendant endangering of credibility; it does, however, have the advantage of setting an explicit floor for wages, because premiums out of profits are typically not allowed to be negative. Premiums out of profits may encourage inertia in employment, because, if new workers are hired, profits paid in bonuses will be spread thinner, while incumbent workers who are laid off lose not only their wage but also their share of profits (Lane 1991). Another potential problem is decapitalization: firms that expect to be privatized would try to increase their short-term profits payable in bonuses, at the expense of their long-term productivity. However, if profits have to be reported for tax purposes in order to be paid out to the workers, at least the state budget reaps a share of the decapitalization.

This discussion of different rules that have been considered for setting wage norms illustrates a basic "trilemma": strict wage controls entail rigidity in wages that may be undesirable; but rules that allow enterprises more flexibility also give them scope for circumventing the controls, weakening control of inflation, and creating distortions; and trying to avoid the distortions by adapting controls to the details of the enterprise's circumstances impairs credibility. Adapting controls to avoid distortions may increase the strength of lobbying for further exceptions to the rules by eliminating the system's claim to uniformity,
could result in wage controls of amazing complexity, and, in some cases, could amount to reintroducing central planning through the wage control system.

What is the solution? Clearly, a case can be made for adopting a simple system—such as an average wage rule with a modest premium paid out of taxable profits—while recognizing that some distortionary consequences are unavoidable. Meanwhile, effort should be concentrated, not on devising a more sophisticated incomes policy, but on solving the ubiquitous problem of weak enterprise governance which at once necessitates the wage controls and at the same time is to blame for many of their distortionary effects.

What about the coverage of wage controls? Layard (1991) argues that, in the context of an anti-inflation policy it is better to have an across-the-board wage policy, with no exceptions for private firms. But this solution may not hold in a reforming socialist economy, where the need for wage controls is related specifically to the problem of governance of the state-owned enterprises. Private enterprises do not face that problem: in these economies they are generally smaller, owner-managed firms, and the interests of the owner are well represented in the decision process. Few private enterprises have any degree of market power, so they are less likely to be able to grant excessive wages. The private sector may be able to achieve higher productivity by paying "efficiency wages"—that is, by paying higher wages than the state sector but with the threat of unemployment if workers shirk their duties (Dinopoulos and Lane 1991). This conjecture is consistent with anecdotal evidence that workers in the private sector typically earn more but are expected to work harder. The potential benefits both to workers (higher wages) and firms (higher productivity) should not be discouraged. Finally, if the private sector is more productive, it should be free to offer higher wages to draw workers out of the state sector into private firms where they will be more productive. Exempting the private sector from wage controls may therefore speed economic transition (see Lane’s discussion of this issue in Coricelli and Revenga 1992).

A case might also be made for exempting smaller firms from wage controls, on the grounds that controls would place a proportionately greater administrative burden on them and that their wages are more likely to be subject to some degree of market discipline. In most formerly socialist economies, smaller firms are more often privately owned (and vice versa), so in practice an exemption based on number of employees would be roughly equivalent to an exemption of private firms.

**Enforcing Controls**

For a wage policy to be effective, it is not enough to specify a norm for the permitted increase in wages. The rule must also be enforced, by providing rewards for compliance, penalties for noncompliance, or both. In Central and Eastern Europe, the main instrument for enforcing wage policy was a tax on excess wages, levied on enterprises that paid wages exceeding the specified...
norm. In Bulgaria, Czechoslovakia, and Hungary, the tax penalty was reinforced by a “social pact”—a consensual agreement between the government and workers' organizations; in Poland, where such a consensus-based approach was not achieved or even sought, workers nonetheless did not disagree—at least at first—with the need for a real wage cut.

The countries of Central and Eastern Europe that launched reform programs in 1990–91 were initially successful in moderating wage increases—achieving, in fact, a sharp initial drop in real wages in all countries except Hungary. In Bulgaria, Czechoslovakia, and Poland, wages were set well below the program ceilings in the first few months following the implementation of the programs. This behavior initially boosted profits and thus swelled government revenues, highly dependent on profit taxes in these economies (Lane 1992). Figure 1 illustrates the behavior of real wages in Poland during 1990 and 1991. Real wages dropped to around half their December 1989 level in the first few months of 1990, as a result of wage controls and other policies. When this decrease in real wages occurred, average wages were substantially less than their norm, but they exceeded the norm during the second half of 1990 and most of 1991.

After this initial period of moderation, enforcing the wage policy became more difficult, especially in Poland. By the end of 1990, average wages had climbed above the program ceilings. Firms were willing to pay steep tax pen-

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**Figure 1. Average Real Wages in Poland, 1990–91**

![Average Real Wages in Poland, 1990–91](image)

Note: Average wages charged to costs, deflated by the retail price index.

Source: International Monetary Fund calculations based on data from Central Statistical Office, Poland.

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alties in order to award wage increases. During 1991 tax penalties became largely irrelevant as firms fell into arrears for such payments. The financial condition of an enterprise ceased to be an important factor in determining wage increases. Indeed, large tax penalties were incurred by enterprises that were making losses on a before-tax basis. This phenomenon, which implied that firms were being decapitalized, became widespread (see Pinto, in Coricelli and Revenga 1992).

Maintaining wage moderation became difficult for two main reasons. First, the imminent change in the enterprises’ ownership associated with privatization provided a strong incentive for incumbent workers and managers to decapitalize their firms, and none at all for workers to restrain their wages, since they would expect any resulting increase in the enterprise’s value to accrue to the government or to the future owners, rather than to themselves through premiums paid out of profits. Uncertainty about privatization, or delays in its implementation, would also lead workers to place greater value on the certainty of higher wages now than on the possibility of premiums paid out of profits in the future.

The second problem encountered in the attempt to enforce wage policy was the weak financial discipline characteristic of these economies (Lane and Folkerts-Landau 1992). If enterprises can run tax arrears or can borrow to pay their excess wage tax without regard to their creditworthiness, a tax on excess wages cannot effectively restrain wages. This is particularly true for enterprises that are not viable in the longer term: they can borrow now to pay higher wages and the resulting excess wage tax, knowing that they will never have to pay because they expect eventually to go bankrupt in any event.

The anticipation of ownership changes and the weakness of financial discipline that create a need for incomes policies thus blunt the teeth of those policies at the outset. So, paradoxically, tax-based wage restraints work best when they are not really needed—that is, when they are imposed on firms that care about their profits and therefore have an incentive to keep wage increases down in any case.

The moderation of wage increases observed at the beginning of the stabilization programs in Central and Eastern Europe may therefore have been associated largely with the tightness of macroeconomic policies; the tax penalties associated with wage policy may actually have been of limited relevance, because wage ceilings were not binding. Later, as macroeconomic policies eased up, wage controls were needed to counteract the resulting wage pressures and decapitalization of the firms, but by the same token the tax-based policy became ineffective; this was especially so in Poland.

The success of the enforcement of wage policies differed across countries: Czechoslovakia and Hungary, for instance, did not experience the serious difficulties with enforcement that Poland did in 1991. The comparative success of enforcement in Czechoslovakia and Hungary may have reflected macroeconomic policies that attenuated the pressures for wage increases. In Hungary it...
might also be ascribed partly to the decentralized approach to privatization that may have given managers a stronger stake in the long-term performance of the firm. In Czechoslovakia the tighter preexisting state control of the economy may have aided in enforcement. Finally, the consensus-based approach followed in both countries may also have elicited more cooperative behavior from the workers.

For enforcement to be effective and durable, wage policy apparently must contain elements other than tax penalties. Fines and other penalties on non-compliant firms or their managers are the obvious alternative, but, when ownership is uncertain and financial discipline weak, fines run into many of the same problems as taxes. Even if fines were levied on the managers personally, they could be compensated from the firms' finances, and threatening noncompliant managers with jail seems a bit extreme and unlikely to be credible.

The continuing lack of hard budget constraint on state enterprises poses an irreducible barrier to any wage policy that imposes penalties on the enterprises. The shortness and uncertainty of the time horizon resulting from impending privatization is also a fundamental problem. One way to tackle the latter is to change the reward structure by distributing shares to workers to give them a stake in the firms' future profits and to reduce their incentive to decapitalize their firms before privatization occurs. This measure could be strengthened by debarring workers in firms not complying with wage targets from receiving shares. The main limitations of such measures are that they would not completely solve the incentive problem unless the workers are given all of the shares in the enterprise—which may not be desirable for other reasons—and that they would be nugatory for unviable enterprises, whose present value is very low or negative and whose shares are therefore nearly worthless.

Another route to effective enforcement, using penalties rather than rewards, involves administrative changes affecting the control of firms. For instance, the state could take full control of enterprises that do not comply with the wage policy, abolishing any legal power of the workers' councils in the management of firms. Placing a substantial number of enterprises under direct state control in this manner, unless soon followed by privatization, would be a backward step, however, and would return a significant part of the economy to another, familiar set of inefficiencies associated with central planning. It is also questionable to what extent abolishing the formal role of the workers' councils would curtail the workers' real bargaining power unless the new managers were given a sufficient interest in the enterprise's profits. To be acceptable in a democratic environment, such measures would also have to be part of a general, consensual agreement between the government and workers' representatives at the national level. Therefore, although a combination of rewards and penalties may make for more effective enforcement of wage policies during the transition, and a consensus-based approach may help to strengthen the legitimacy of wage policies, these are no substitute for measures that deal with the
more fundamental problems of enterprise governance and financial discipline, which would continue to undermine any acceptable method of enforcement.

Conclusion

The need for wage controls in reforming socialist economies springs largely from the fact that the interests of the ultimate owners of the state enterprises are currently not being represented. The uncertain timing of the transformation of ownership compounds the ownership vacuum, while the continuing softness of budget constraints implies that enterprises can accumulate arrears and obtain other financing, enabling them to pay higher wages even if they are insolvent. At the same time, it is precisely these aspects of these economies that make any design of wage controls distortionary and enfeeble enforcement through the tax system. A more sophisticated wage control system is unlikely to alleviate these problems; a simple, transparent policy is most likely to be effective.

More fundamentally, the flaws of wage policy cannot be tackled through wage policy itself; rather, they are inherent in the current economic environment. In this regard, it is essential to resolve uncertainty about the timing of the privatization process and about the workers’ stake in the privatized firms, with a view to reducing the incentives for decapitalization. Policy must also establish financial discipline over the enterprises to prevent them from paying excessive wages by borrowing without the means or intention of repaying. Until such reforms—which are themselves exceedingly difficult to accomplish—have progressed, any incomes policy, although necessary, must inevitably be both weak and distortionary.

Notes

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1. Wage controls did not begin with the reform programs of the early 1990s; in Poland and Hungary they were introduced as centralized wage setting ended, in the 1980s and 1970s, respectively.

2. However, this comparison is qualified by the fact that real wages had been unusually high in December 1989 because of seasonal factors such as seasonal bonuses.

References

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