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# Fundamental Issues and Policy Approaches in Industrial Restructuring

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# **FUNDAMENTAL ISSUES AND POLICY APPROACHES IN INDUSTRIAL RESTRUCTURING**

**By**

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**This paper provides the background for a policy paper forthcoming from the Industry Development Division on the World Bank's approach to industrial restructuring. The task manager for the project is Claudio Frischtak. The authors are grateful to Anthony Churchill, Carl Dahlman and Hong Tan for helpful comments.**

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## I. INTRODUCTION

1.01 The purpose of this paper is to present a conceptual framework that allows a rigorous and comprehensive analysis of the industrial restructuring problem.<sup>1/</sup> The paper utilizes this conceptual framework to identify the major barriers to efficient restructuring decisions, namely those related to lack of discipline, rigidities constraining mobility and limited availability of resources. The paper proposes a set of policy and institutional measures to ensure that whenever the need for restructuring arises, enterprises will have both the incentive and ability to undertake actions that are socially desirable and restore profitability, as well as access to the necessary capabilities and resources. In other words, the proposed measures are intended to create an *environment* which is conducive to efficient restructuring decisions. The analysis and conclusions of the paper are elaborated through numerous country examples in the main text, and more comprehensively, in the annexes.

### Brief Historical Background

1.02 Since the mid 1970s, industry worldwide has been undergoing profound changes. Successive steep rises in energy prices and growing environmental concerns during that decade led to the restructuring of energy and material-intensive industries—which often entailed being downsized and, in some instances, relocated away from major developed countries. Industrializing countries with access to raw materials—and where governments were willing to subsidize the cost of capital—appeared to profit from this initial restructuring movement by establishing greenfield and technologically updated plants. Such was the case, for example, with steel, aluminum, pulp and paper, and petrochemicals.

1.03 The dramatic increases in the prices of energy and other inputs in the 1970s were followed by inflationary pressures. The beginning of the following decade was characterized by adjustment efforts. In the U.S., these efforts were based on a tight monetary policy, which led to high interest rates and the consequent appreciation of the dollar. Combined, they contributed to lowering inflation, while softening the U.S. market for domestic producers. The recession affected a broad spectrum of industries, though hitting particularly hard the production of capital goods and consumer durables. After 1985, export-oriented industries from other OECD countries, which had been partially sheltered from the recession by catering to the U.S. market, became less cost competitive and profitable as major currencies appreciated vis-a-vis the dollar.<sup>2/</sup> By the end of the last decade, most industries in practically all OECD countries faced difficult restructuring decisions, and were forced to engage in broad reorganization efforts in order to remain competitive.

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1/ For an earlier extensive discussion of policies for industrial restructuring, see I. Lieberman, "Industrial Restructuring: Policy and Practice," Policy and Research Series, No. 9, The World Bank, 1990.

2/ The impact on the Yen appreciation on Japanese labor costs is illustrative of the post 1985 exchange rate changes. Although unit yen labor costs fell by almost 11 percent between 1982 and 1989, in dollar terms they rose by 61 percent.

**1.04** Competitive pressures were reflected also in a rise in economic nationalism in industrialized countries. Although mostly a response to job losses and a perceived threat to their manufacturing base, such nationalism is also a sign of the renewed importance of industry as the core of economic power. The formation of trading blocs and intensifying commercial conflicts are symptoms of a less benign international environment; so is a much closer attention to intellectual property and the competitive value of technology. "Industrial policy", which has been associated generally with targeted capacity creation or coordinated capacity reduction, became increasingly focused on industrial competitiveness and the restructuring of industry.

**1.05** The response of industrial country firms to a more competitive environment included changes in the structure of assets and liabilities, and aggressive cost-cutting measures. Progressively, firms attempted also to decentralize and make basic corporate functions (buying, selling, financing, developing, producing and servicing) more effective by changing their mode of internal organization, with "flatter" hierarchical team-focused structures, greater reliance on worker initiative, increased responsibilities and a less rigid division of labor. These organizational innovations were accompanied by a less parochial perception, by management and labor, of the firm's environment, and a willingness to extend the firm's boundaries through alliances ranging from pure marketing/servicing agreements to technological joint ventures, co-production and other forms of cooperation. Finally attempts to offer increasingly differentiated and quality-oriented products generated intense interest in product development and new, more efficient processes. Technological progress accelerated.

**1.06** Since the early 1980s, industrial enterprises in developing and "emerging market economies." (Central and East European and former Soviet Union countries) also have been confronted with intense rivalry in international markets, rising economic nationalism (or regionalism) and a rapidly shifting best-practice frontier. Pressed by such forces, these countries have either retreated behind protective barriers or worked to facilitate the restructuring of the industrial sector. Most often, restructuring has been delayed with governments shielding firms from the forces of competition and softening their budget constraint. Neither protection nor financial undiscipline, however, are sustainable. Increased cross-border information flows and alternative trade channels deny the possibility of closing off the economy; a generalized fiscal crisis is impelling governments to stop irrigating firms with resources. Moreover, there is a growing realization that without restructuring, industrializing and Eastern European economies will fall irremediably behind; the industries that would survive belong to a narrowing class, that is, those naturally protected from import competition and not dependent on export markets.

**1.07** The need for industrial restructuring has become most apparent as countries undertake structural adjustment programs, implement budgetary discipline and move to a more open and competitive environment. Most economic gains require firms both to reallocate and to improve the use of resources, which are predicated upon efficiency-enhancing restructuring decisions. Yet in many instances, the absence of regimes supportive of such decisions have resulted in the survival of insolvent producers and uncompetitive activities; in other cases, potentially viable firms are forced to exit.

**1.08** The future of industry in developing and emerging market economies hinges on restructuring decisions (including exit from certain activities) which enhance efficiency, are sustainable and improve the

competitive position of the industrial sector. Such decisions face a number of barriers. These barriers often are generated by either distortionary government policies or market failures. The challenge facing countries is first, how to reform policy regimes, and second, how to respond to market failures that slow down restructuring or induce inappropriate restructuring decisions (by impeding the rehabilitation of potentially viable firms or prolonging the survival of firms that should exit). In sum, how should the government improve the policy and institutional environment within which restructuring takes place?

### **Overview and Organization of the Paper**

1.09           The analytical framework developed in this paper is intended to serve as a tool to guide government actions in establishing an environment that encourages efficient restructuring in industry. It identifies major barriers to desirable restructuring decisions. These barriers are subsumed under three broad categories: *discipline, mobility and resources*. Discipline-related barriers are those that shelter firms from the forces of competition, prolong their survival, and allow managers to postpone restructuring decisions. Barriers that constrain mobility reduce the capacity of firms to move factors in response to a changing environment. Discipline and mobility have proven, however, to be insufficient to bring about relatively efficient restructuring outcomes when resources--skills, information, finance--are unavailable. For each set of barriers, the paper classifies required government actions along three dimensions: removal of policy distortions, introduction of rules and mechanisms to offset perceived market failures, and the creation of institutions to implement and enforce those rules.

1.10           This paper advances two inter-related, basic propositions. The first can be stated as follows: government measures that strengthen discipline, enhance mobility and improve the availability of resources are strictly complementary to each other. Emphasis of one set of measures to the neglect of others is likely to be ineffective, or at worst, counter-productive. Hence when resources are not available and mobility is restricted, increased discipline may aggravate financial distress, which, in turn, may force the government to relax discipline once again. In such an environment, government's intentions to strengthen discipline may in fact not be credible ex-ante. Similarly, an environment with ample resources but insufficient discipline is likely to result in their inefficient allocation and use.

1.11           The second basic proposition is that in most cases, elimination of distortionary policies are insufficient to remove a barrier; introducing new rules that address market failures and, perhaps more important, establishing institutional and administrative capabilities to enforce these rules often are as important. However, government interventions to compensate for market failures associated with the process of industrial restructuring often are controversial. Opponents of such types of government policy would argue that the market will not only provide discipline but ensure that restructuring will occur when it should. According to this perspective, government support could inhibit or crowd out possibly more efficient private sector initiatives. Even worse, government actions may generate "regulatory capture" and result in rent

seeking.<sup>3/</sup> This paper, on the other hand, argues that restructuring-related market failures are substantial and justify policies to enhance factor mobility and the provision of financial and other resources for restructuring. This alternate view also is pragmatic in its recognition that even governments that profess ex-ante to behave on a "hands-off" basis are dragged ex-post by political pressures to intervene, and that the provision of such assistance may in fact be more costly than ex-ante intervention. Policies proposed in this paper aim at precluding such an eventuality, by providing mechanisms which create incentives for potentially viable enterprises to carry out proper restructuring measures sooner rather than later. In other words, the framework is designed to minimize the risk of ex-post extensive government intervention by encouraging corrective ex-ante actions and thereby limiting or reducing the extent of distress.

1.12           The proposed government actions, however, should not be implemented without regard to requisite institutional and enforcement capabilities. Attempts to carry out policies without such capabilities can result in outcomes that are inferior to market solutions. In such cases, relying on the market is clearly preferable, unless government's capabilities can be improved. Hence, the desirability of policies should depend critically on a cost-benefit calculation that includes the government's capabilities and the potential for their improvement (para. 4.03).

1.13           The remainder of the paper is organized as follows. Section II defines industrial restructuring as non-marginal changes undertaken by firms to ensure that some or all of its activities regain competitiveness. Section III focuses on the nature of restructuring decisions. It argues that the efficiency of outcomes is bound intrinsically to the economic environment within which decisions are made. Sections IV to VI then examine such environments--markets, policies and institutions--in detail, in order to identify barriers impeding enhanced restructuring outcomes. These barriers relate to weakened discipline facing firms, lack of mobility and limited access to resources. The discussion is centered on the role of government, both in removing policy-generated barriers and in creating mechanisms and instruments supportive of more efficient restructuring outcomes. Section VII derives the main conclusions of the paper.

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3/           A typical example occurs when unconditional subsidies provided to distressed industries discourage private sector restructuring efforts and create incentives for affected enterprises to preserve the status quo in the hope of obtaining further subsidies in the future (and even expend additional resources for lobbying activities).

## II. DEFINING INDUSTRIAL RESTRUCTURING

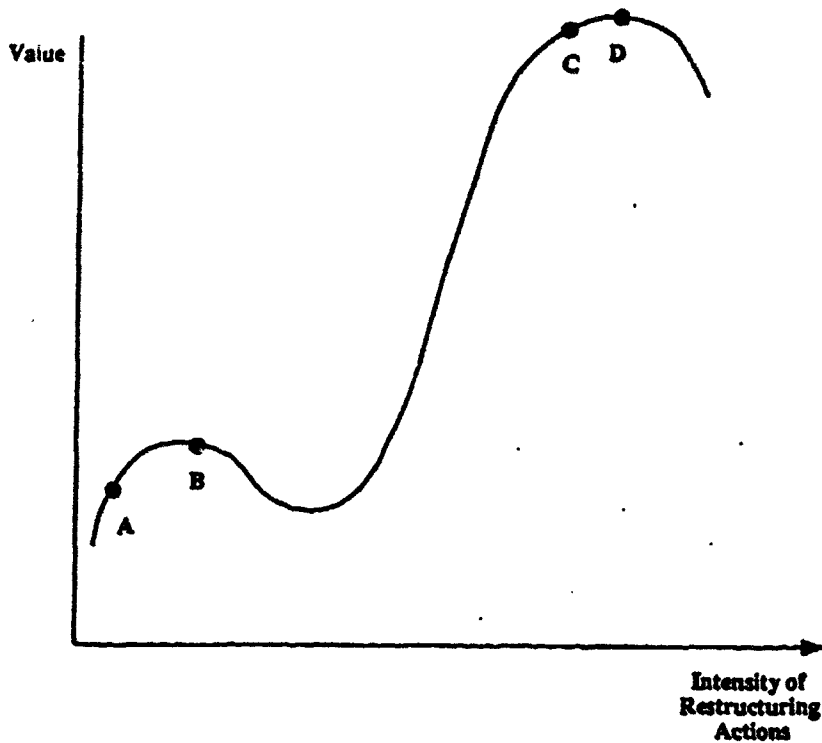
2.01 Industrial restructuring is a set of articulated actions undertaken by firms, sometimes coordinated by outside principals (banks, governments), aimed at restoring competitiveness, once it has been eroded substantially. Less often, restructuring takes place in an attempt to prevent firms from falling behind the international price-performance frontier (or the domestic frontier for producers naturally shielded from import competition). In developed countries, particularly those with dense capital markets, restructuring is also understood as an attempt to realign the firm's market value with its intrinsic (or economic) worth. Often it entails changes in ownership and management, in the structure of assets and liabilities, as well as selling off certain units or activities outside the strategic core of the firm.

2.02 Restructuring is a set of discrete, decisive measures to restore a firm's competitiveness and enhance its value. Such measures are often undertaken in reaction to discontinuous changes in the firm's environment or, even in the absence of major shocks, in response to a failure to continuously adapt to shifts in markets and technologies. A firm may in fact survive for a period of time even though paying little attention to changes around it. However, unless facing a soft budget constraint and protected from the forces of competition, it will be obliged ultimately to restructure its operations. In a limit sense, a complete phase out may be required if the distance to the best-practice frontier precludes it from undertaking a financially viable turnaround.

2.03 A firm that is in need of restructuring is one where the current dimensions of the firm (including capacity, organization technology, indebtedness, etc.) are far removed from those that maximize value. Restructuring usefully can be conceptualized as an attempt to choose a set of actions that would move the firm's value from a point near or at a local maximum to one near or at the global maximum, when the latter is relatively "distant" (i.e., not achievable by marginal actions). In Figure 2.1, the firm's value is at point A whereas the global maximum value is at point D. Actions that would move the firm from A to B, although enhancing the value of the firm and leading to a decrease in losses, do not belong to the restructuring set. Rather, these are actions that improve the value of the firm at the margin. Marginal and relatively low cost changes in employment, capacity or technology that do not address the root causes of low profitability are examples of such actions. By the definition adopted here, restructuring would be a set of decisions attempting to move the firm from A to D, or to points in D's vicinity.

2.04 Restructuring is generally accompanied by streamlining, cutting costs and restoring productivity and profits. Layoffs, particularly of administrative staff, are common at an initial stage. Overhead costs are targeted. Firms that are excessively integrated hive off intermediate activities; producers with uneconomic product scope attempt to refocus product lines, increasing the extent of horizontal specialization. It is not unusual for firms undergoing physical restructuring to have accumulated excess debt, requiring a financial workout in order to "clean" the firm's balance sheet. Such workouts redistribute claims on the enterprise and may entail equity infusions, conversion of debt into equity or equity-like instruments, and debt reduction or rescheduling. Restructuring operations may also entail redistribution of ownership and control rights over the enterprise, resulting in changes in ownership and management.

**Figure 2.1**



2.05 Consolidating the position of such firms may require other non-marginal steps beyond cost-cutting, revenue-enhancing measures and balance sheet adjustments. In a world where the market place is global, restructuring is increasingly oriented to shape firms into more flexible and responsive entities. The very nature of the firm and its objectives often are redrawn as part of restructuring. Firms are increasingly regarded as integrating loci; highly verticalized entities or producers attempting to manufacture "complete" product lines are being replaced by those able to exploit their strategic competence (in design, engineering, production planning and organization, marketing), contracting out areas of lesser capability. As a result, de-verticalization and horizontal specialization in production are often part of restructuring actions; fewer firms are attempting to "go alone", but are continuously searching for suppliers not only of intermediates but goods that complement their product line.<sup>4</sup>

2.06 Accomplishing these organizational changes requires a succession of efficiency-enhancing restructuring decisions over a considerable period of time. They are also costly, entailing expenditure of resources in areas such as technology, physical capital, retraining and relocation. More importantly, restructuring brings significant costs to decision makers with the authority to restructure, demanding from

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4/ For example, in the U.S., takeovers in the 1960s and 1970s were characterized by increased diversification and conglomeration, whereas those in the 1980s mainly entailed divestitures and increased specialization. For a lucid evaluation, see Shleifer and Vishny (1991).

them increased managerial effort, reduction in unproductive managerial consumption and even unemployment of their peers. Often the interests of decision makers and that of other parties affected by restructuring decisions, including the government, owners or consumers, do not coincide. Owners, public or private, also may have to bear significant costs, especially when restructuring results in a redistribution of ownership rights and therefore loss of political or economic power. Hence, the obstacles that hinder enterprises from taking socially desirable restructuring decisions are not small. The nature of those decisions and how they relate to the degree of efficiency with which restructuring is undertaken is the topic of the next section.

### III. ECONOMIC EFFICIENCY AND THE NATURE OF RESTRUCTURING DECISIONS

3.01 A crucial feature of the modern enterprise is that those agents authorized and entrusted to make restructuring decisions make up a small proportion of the parties that are affected by such decisions. In most cases, the interests of these agents (hereafter called "decision makers") do not coincide with those directly affected by the decisions themselves.<sup>5/</sup> Whereas decision makers generally attempt to maximize their own welfare, what is required from an efficiency standpoint is the maximization of the suitably-weighted welfare of all parties affected. This section focuses on the nature of restructuring decisions, the criteria that decision makers use to choose between alternative options, and the impact of the economic environment on the efficiency of restructuring decisions.

#### The Nature of Restructuring Decisions.

3.02 It is useful analytically to think of any restructuring decision as involving three sequential stages. Such a three-step calculation will be referred to as a *restructuring algorithm or decision rule*, and is displayed in Figure 3.1. First, the decision maker has to decide whether or not to restructure. If restructuring is preferred, then second, a choice has to be made between reorganization and exit. Third, one must decide which form of reorganization or exit is best. As with any sequential decision, an informed answer to the first question requires prior consideration of the second and third questions.

3.03 Thus, the point of departure is the decision regarding which forms of reorganization and exit yield the maximum *net benefit*, prior to choosing between reorganization or exit. In the case of *reorganization*, the decision maker picks the particular technology mix, form and magnitude of labor adjustments, extent of disposition of assets, change in capacity, new investments and reorganization of liabilities maximizing net benefit. The *net benefit of reorganization* is defined as the ex-post value of the enterprise to the decision maker net of the cost of required resources and other related expenditures, once the best form of reorganization is chosen.

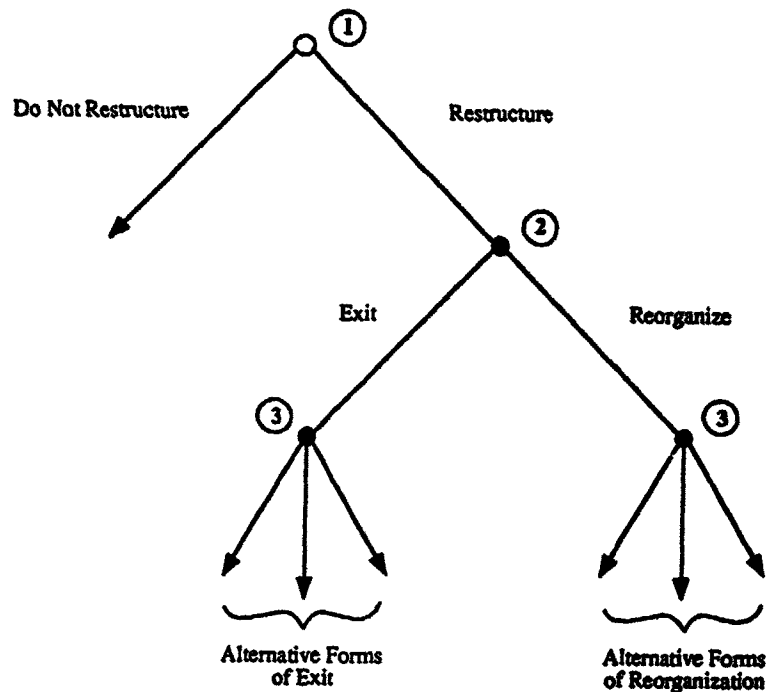
3.04 Both benefits and costs of reorganization will depend on the identity of the decision maker. If the authority for restructuring decisions lies with shareholders, the relevant ex-post value of the enterprise and the costs of reorganization are reflected in the equity value. If the authority lies with managers, the relevant ex-post value depends on the specification of managerial contracts; often it includes the values of future salaries and any shares held by managers, minus the disutility of managerial effort. If the authority lies with government officials, the benefits and costs may actually depend on ministers' personal or political agendas.

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<sup>5/</sup> For example, in an economy with widespread private property, such authority typically lies either with managers (whose interests may be in conflict with shareholders) or with owners (whose interest may be in conflict with creditors). In the majority of enterprises in Eastern Europe, the decision-making authority lies with workers councils, managers or ministry officials, each having a set of their own.



**Figure 3.1**  
**The Restructuring Algorithm**



**3.05** In the case of *exit*, options are more limited; the decision maker may have to choose between declaring bankruptcy or self liquidation. Depending on the legislation, bankruptcy itself may end up in total liquidation of assets, or in a reorganization with partial liquidation where some of the assets of the enterprise are liquidated and the enterprise re-emerges in a leaner form. Even in a bankruptcy process, the decision maker is faced with important choices. For example, the decision maker may choose between a cooperative approach (and try to strike a deal with creditors as fast as possible) and a more aggressive posture (which entails exploiting legal loopholes and delaying the process as much as possible). Since delays in the legal procedure often reduce the value of the creditors' claims, this may increase the bargaining power of the decision maker and may help extract a better deal from creditors. Also it is possible that the decision maker loses its authority if entering bankruptcy automatically transfers control rights over the enterprise from owners or managers to creditors or a trustee.

**3.06** Whenever exit takes the form of liquidation, its net benefit may include proceeds from the liquidation of assets minus payments to creditors and other parties that hold claims on the enterprise, minus any exit costs incurred by the decision maker. Exit costs may arise due to bad acquired reputation, difficulty in re-entering markets, loss of liquidation value due to fire sales of assets, or loss of value due to mothballing.

**3.07** Having chosen the preferred alternative forms of reorganization and exit, the decision maker then compares the net benefit of each and selects the one yielding the higher payoff. The final step is to decide whether to restructure or not. This decision requires the calculation of the *net benefit of not*

**restructuring.** In attempting to preserve the status quo, actions taken may include substantial rent seeking activities, asset stripping and marginal operational adjustments. When restructuring decisions are taken by shareholders, the net benefit may include continued access to soft credit provided by the government or even private banks (see Chapter IV), minus losses that need to be financed. When managers have the decision-making authority, an important element of the net benefit may be the consumption of salaries, with continued expenditure of minimal effort. The restructuring decision rule is to *choose between restructuring and not restructuring by comparing the maximum net benefits of each of these options.*

3.08 This restructuring algorithm yields the maximum payoff to the decision maker from the set of available actions.<sup>6/</sup> By itself, however, the decision rule does not say much about the efficiency implications of these actions. In order to evaluate the efficiency of restructuring decisions, one has to take into consideration not only the welfare of the decision maker but total social welfare. Social welfare can generally be defined as an appropriately weighted sum of the welfare of all parties affected by restructuring decisions. Restructuring decisions which are optimal for the decision maker may differ from those which are desirable from the perspective of social welfare. For example, while availability of soft credit may induce decision makers not to restructure, reorganization or even exit may be preferable from society's perspective when the social costs of the soft credit are taken into account. Private and social divergences may exist not only regarding the decision whether to restructure or not, but also regarding the specific form of reorganization chosen; for instance, private decision makers may choose a form that overuses subsidized financial resources and includes too little managerial effort.

#### **Efficiency and Restructuring.**

3.09 In a world where markets are competitive, free of transactions costs and information problems, and where contracts are complete and easily enforceable, prevailing prices of goods and factors reflect their economic scarcity values. Valuation of restructuring options with market prices would also reflect social values. In such a *perfect-markets economy*, a private decision maker that applies the restructuring decision rule always would choose a set of actions which is optimal from the perspective of society. Government policy would be incapable of improving outcomes that result from private decisions in such a world.

3.10 In practice, judgments about efficiency are more complicated. Any discussion of efficiency needs to refer to the *existing economic environment*, including government policies, regulations and existing endowments. Equally relevant is the degree of development of markets, the nature of market imperfections, the legal system, as well as existing contractual and other institutional arrangements.

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6/ The proposed algorithm is a simplification because it condenses what in reality is a multi-stage decision process into three stages. In particular, it does not capture the possibility that the decision maker may choose to restructure not now but later; in that case, the net benefit of not restructuring would include the effects of restructuring actions taken in the future. Moreover, the timing of restructuring also becomes a relevant variable in the decision maker's calculations. See Hayri (1992) for a model of restructuring which incorporates some of these dynamic considerations.

**3.11** Divergences between private and socially desirable actions are generated by specific features of the economic environment that differentiate it from a perfect-markets economy. Prices that decision makers face often do not reflect true scarcity values. Sometimes prices may not exist at all because markets are incomplete. It is these features of the prevailing economic environment that limit the maximum social net benefit of private restructuring decisions. If the social value of restructuring decisions is to be increased, changes in the environment are required.

**3.12** In most cases, it is not feasible to change all aspects of the economic environment that give rise to socially sub-optimal restructuring outcomes. Moreover, even feasible changes in the economic environment are in many cases costly themselves. In terms of restructuring, the rule that should be adopted in evaluating proposed changes in the environment is simple: *a feasible change in the economic environment is desirable if the adjustment: it induces in restructuring decisions have outcomes that improve social welfare, net of the cost of implementing the proposed changes.* Among desirable changes, those that result in the maximum welfare improvement are referred to as *restructuring-efficient*. To assess the scope for desirable changes in the economic environment, it is necessary to identify the *barriers* to improved restructuring decisions. The next sections will examine those barriers and their effects on restructuring decisions, and propose government policies to induce restructuring-efficient changes in the economic environment.

#### **IV. BARRIERS TO IMPROVED RESTRUCTURING DECISIONS AND THE ROLE OF THE GOVERNMENT: DISCIPLINE**

##### **Introduction**

**4.01** The purpose of this and the next two chapters is to review the essential elements of an economic environment that is conducive to efficient restructuring decisions. Barriers that prevent enterprises from taking actions that increase efficiency, and the role of the government in overcoming these barriers, are discussed. Barriers that constrain socially desirable restructuring actions are classified into three categories: those that weaken discipline, hinder mobility and limit the availability of resources.

**4.02** Government actions to remove barriers are themselves classified along three basic dimensions: actions geared at the removal of policy distortions (for example, eliminating fiscal and financial subsidies to tighten the budget constraint), actions to introduce rules offsetting perceived market failures, and actions to institute an administrative and legal capacity to enforce the rules (and derived contracts). Clearly, the efficiency of a rule is a function of the relevant enforcement capability. Table 4.1 summarizes mechanisms and instruments available to the government that would improve restructuring decisions. They are classified as measures to strengthen discipline, enhance mobility and augment resources, and are distinguished along the three dimensions which span government actions.

**4.03** The government's role cannot be delineated neatly in the abstract. It depends fundamentally on the relative efficiency of market outcomes when compared to government interventions, in the presence of identifiable market failures (associated with externalities, information imperfections, and non-convexities in production or consumption). The scope of restructuring policy should be determined by the relationship between the benefits and costs of actions designed to improve restructuring actions, when compared to market-driven solutions. Such an approach admits the possibility that the market itself may not generate restructuring-efficient decisions, and that nevertheless the net benefit of not intervening is larger than that of intervening. For example, rules which are well established in developed economies in many cases may prove to be too costly to implement in a developing country when the administrative and institutional resources are not available or too expensive to establish. Rules which appear ex-ante attractive therefore should be scrutinized closely to ensure that expected net benefits (once enforcement and other administrative costs are taken into account) are larger than those flowing from non-intervention.

**4.04** This chapter is devoted to a discussion of barriers and associated government policies in the area of discipline; those related to mobility and resources are discussed in the following two chapters, respectively. Discipline-related barriers shield firms from adjustment pressures. The importance of discipline is clear: it encourages voluntary restructuring at an early stage before enterprises start experiencing financial distress or, after its onset, it avoids the ballooning of restructuring costs associated with procrastination. The problem of lack of discipline is most often related to inadequate competition in product and factor markets, soft budget constraints, and agency problems that arise when principals cannot perfectly monitor decision makers in enterprises.

**Table 4.1: MEASURES SUPPORTIVE OF IMPROVED RESTRUCTURING DECISIONS**

	Removal of Policy Distortions	Rules to Offset Market Failures	Market-Supportive Institutions and Capabilities
<b>I. <u>Discipline-strengthening Measures</u></b> 1. Increasing competition 2. Tightening budget constraints 3. Reducing agency problems and improving imperfect contracts	<ul style="list-style-type: none"> <li>• eliminating protective trade and regulatory policies, including price controls and entry barriers (such as industrial licensing)</li> <li>• eliminating unconditional subsidies to loss-making enterprises</li> <li>• removing practices that limit managerial autonomy and accountability in public enterprises (PEs)</li> </ul>	<ul style="list-style-type: none"> <li>• antitrust policies, structural (such as deverticalization) and behavioral (such as measures against collusion)</li> <li>• regulation and supervision of financial institutions</li> <li>• privatization</li> <li>• corporatization of PEs</li> <li>• management contracts for PEs</li> <li>• rules for information disclosure</li> <li>• protection of small shareholders</li> </ul>	<ul style="list-style-type: none"> <li>• antitrust administration</li> <li>• administrative and enforcement capabilities for financial sector regulations</li> <li>• agencies that exercise ownership functions over PEs</li> </ul>
<b>II. <u>Mobility-enhancing Measures</u></b> 1. General 2. Increasing labor mobility 3. Increasing capital mobility	<ul style="list-style-type: none"> <li>• removing policy-induced entry/exit barriers</li> <li>• removing restrictive labor regulations that prohibit layoffs and relocation</li> <li>• removing regulations that restrict transfer of assets</li> </ul>	<ul style="list-style-type: none"> <li>• mechanisms to coordinate capacity reduction</li> <li>• support to firms switching business activity</li> <li>• establishing a social safety net (e.g., unemployment insurance)</li> <li>• facilitating re-entry (job placement and retraining)</li> <li>• bankruptcy laws</li> <li>• resolving coordination problems w.r.t. exit</li> <li>• legal, fiscal and regulatory frameworks for leasing</li> </ul>	<ul style="list-style-type: none"> <li>• employment agencies</li> <li>• bankruptcy courts, judicial system</li> </ul>
<b>III. <u>Resource-augmenting Measures</u></b> 1. Fostering skills 2. Increasing information flows 3. Improving financial flows	<ul style="list-style-type: none"> <li>• elimination of restrictions on direct foreign investment, technology licensing and similar transactions</li> <li>• relaxing interest rate controls</li> </ul>	<ul style="list-style-type: none"> <li>• tapping foreign expertise</li> <li>• management training programs</li> <li>• laws supporting foreign investment</li> <li>• promoting turnaround firms and skills</li> <li>• dissemination of technological and market information</li> <li>• restructuring of financial institutions in case of financial distress</li> <li>• exit subsidies</li> </ul>	<ul style="list-style-type: none"> <li>• technology development support institutions</li> <li>• trade development organizations</li> <li>• agencies to restructure financial institutions</li> <li>• mediation between creditors and large debtors</li> <li>• specialized agents for asset recovery</li> </ul>

## Competition

4.05 Lack of competition allows managers or owners of enterprises to function at low levels of efficiency with minimum managerial effort and still appropriate a satisfactory level of rents. Existence of monopoly rents raises the net benefit of not restructuring significantly above levels prevailing in more competitive environments, and makes restructuring or exit less attractive alternatives. For firms which would gain by taking "preventive" restructuring actions in view of the growing distance between best practice and their actual performance, these barriers create a "veil" on their competitive standing; for those with a weakening market position or shrinking profitability, or which already are financially distressed, these barriers function as an unwarranted and often unsustainable cushion. Protection from competition might be justified only if it is strictly temporary and contingent upon firms undertaking required restructuring actions.

4.06 Absence of competition in product markets may also exacerbate delegation problems and restrict the extent to which owners are able to rely on markets to discipline managers. To the extent that competition increases the sensitivity of profits to unit costs, it reduces x-inefficiency by permitting managerial reward to be linked more closely to effort, thereby facilitating the control of managers by owners. Lack of competition eliminates this source of discipline over managerial behavior.

4.07 *Administration and enforcement of appropriate competition policy* is therefore essential for the success of restructuring efforts. In a large number of developing economies, greater competition is contingent upon reforming industrial regulatory and trade policies, which constitute important, and sometimes binding, barriers.<sup>7/</sup> These policy-generated barriers are an important impediment to improved restructuring decisions. In view of their adverse impact, the removal of such barriers is strongly warranted, despite the considerable friction that may be caused by government attempts to recapture rents created and distributed by certain anti-competitive rules. Phasing out industrial licensing systems, for example, on the basis that they can be construed as entry barriers is not administratively costly (other than in the sense of dealing with potential unemployment of the licensing agency staff). However, the dissipation of rents may, and often does generate considerable opposition for incumbents. The political economy costs may not be trivial. Still, the identification and removal of barriers to competition should be placed high in governments' agenda for reforms enhancing the prospects for improved restructuring efforts.

4.08 The scope of competition policy supportive of improved restructuring decisions is not, however, restricted to the removal of policy distortions. Antitrust policies may be necessary as well, as there are a number of restructuring-specific circumstances which may justify an activist approach.<sup>8/</sup> Producers organized around tight vertical, horizontal and other concentrated structures, for example, may avoid

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7/ See C. Frischtak et. al., "Competition Policies for Industrializing Countries," Policy and Research Series No. 7, 1989.

8/ For a detailed discussion of antitrust policies, see, for example, Roger Boner and Reinald Krueger, "The Basics of Antitrust Policy: A Review of Ten Nations and the EEC," World Bank Technical Paper No. 160, 1991.

restructuring by exploiting their monopolistic position. The market or non-intervention outcome in this case would be inefficient, and break-up of the concern thus may be justified.

4.09 In the particular case of the emerging market economies of Eastern Europe and the former Soviet Union, and certain developing countries populated by highly integrated producers, an activist policy of deverticalization or horizontal specialization should be pursued prior to privatizing those concerns. Just as it is far easier and efficient to control for mergers ex-ante than ex-post, it becomes considerably more costly to break up firms once they are privatized and internal changes in the firm's configuration introduced.<sup>9/</sup> An active policy of de-verticalization or de-conglomeration to stimulate efficient restructuring should, however, only be pursued if these changes would not occur simply as a result of market pressures, as protective policies are removed and managers are forced to discard unprofitable units and inefficient operations.

4.10 An activist structural policy supportive of restructuring-efficient outcomes should be coupled with an aggressive attitude towards price fixing and other actions which in most countries are considered illegal on a per se basis. Again, such explicitly anticompetitive conduct often shields producers from restructuring choices that would be taken in a more competitive environment. Clearly, effective antitrust actions require governments to be endowed with adequate administrative resources. In view of their scarcity, such resources need to be targeted to a few critical restructuring-relevant antitrust areas so as to maximize intervention efficiency.

#### **Soft Budget Constraints**

4.11 Soft budget constraints provide a different type of barrier sheltering owners, management and workers from market discipline. Soft budgets refer to a situation where earnings generated by the current asset structure of the enterprise persistently fall short of expenditures and the gap is compensated by outside agents (typically the government, development finance corporations or even private financial institutions.) Whereas in most cases credit has been the most important instrument of soft budgets, price controls and fiscal instruments such as ex-post negotiable subsidies have also been widespread, especially in the emerging market economies.

4.12 Often, the causes of soft budget constraints are purely political. Governments may be unwilling to implement restructuring measures that are unpopular with their constituents or with powerful elites. However, soft budgets can also arise due to economic reasons. Banks may be willing to refinance bad loans with expectations of government bail-outs or because loan collection and bankruptcy procedures are very costly. When banks find themselves over-exposed to a sector or even to a single large firm which is in financial distress, they may be willing to "throw good money after bad" with the hope of recovering their

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9/ See the discussion on competition-oriented restructuring and the rationale for such restructuring to be undertaken before privatization, in Jean Tirole, "Privatization in Eastern Europe: Incentives and the Economics of Transition", February 1991, NBER (processed). While enterprises may undertake (internal) efficiency-oriented restructuring, they will not promote competition because this would reduce profits; government intervention therefore is required.

previous loans. This becomes an attractive option when banks' resources are underpriced due to explicit or implicit deposit insurance. Governments, on the other hand, may be willing to bail out enterprises because other distortionary measures such as protection or monopolistic supply structures in the public sector make the social surplus that enterprises generate larger than the private surplus.<sup>10/</sup>

4.13 Whereas lack of competition raises the benefit of not restructuring, the most frequent effect of soft budget constraints is to reduce or eliminate the costs to the decision maker of not restructuring. Typically these costs would include unemployment, reduced salaries, loss of decision making power, as well as other exit and re-entry costs that would arise if the enterprise were to close down or be taken to a bankruptcy court.

4.14 It is not unusual for enterprises failing to restructure to face both lack of competition and soft budget constraints. The experience of the capital goods subsector in Brazil provides an example of how the combination of a sheltered environment and soft budget constraints has functioned as a barrier to exit while eliminating incentives for restructuring. The subsector was heavily promoted in the late 1970s through extensive protection, availability of term finance at negative real interest rates, investment tax breaks, preferential credit for the purchase of domestically manufactured capital goods and accelerated depreciation in their use, and by a large public investment program with procurement directed towards creating production capabilities in its many segments.

4.15 Continued protection and provision of financial and fiscal incentives have prevented exit and enabled firms until recently to avoid taking the restructuring measures that the industry requires. In particular, financially distressed firms in the capital goods subsector have been major recipients of inexpensive financial assistance from BNDES (National Development Bank of Brazil). These funds have been provided without firm-level commitments for rationalization and have allowed the survival of non-viable firms. On the other hand, entrants that could successfully challenge established firms and force them to restructure often have been deterred by the still-prevailing reluctance of government agencies to allow new competitors in an already crowded market.

4.16 Since 1980-81, the Brazilian capital goods subsector has entered a period of decline and has been facing problems of excess capacity, low profitability, and increasing technological obsolescence. However, the subsector has not adjusted to the radical changes in the economic environment in the 1980s, namely the acute fall in public and private domestic investment and the increase in price and non-price (quality) competition internationally. The subsector is in fact an extremely large and diversified industry, even by

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10/ Ex-post, when such a wedge exists, the government has an incentive to finance losses up to an amount which equals the difference between the social and private surplus. This would entail no economic loss if it did not create any adverse incentive effects. However, the government's ex-post willingness to finance losses discourages enterprises ex-ante from undertaking costly restructuring actions. See S. Nagaoka and I. Atiyas "Tightening the Soft Budget Constraint," Industry Series Paper No. 35, May 1990 for a formal discussion and examples.



developed country standards. In important segments, the number of manufacturers is larger than those in Japan and the U.S., suggesting low degrees of both intra-industry and inter-firm specialization.<sup>11/</sup>

4.17 The case of Tanzania also illustrates the difficulties of taking efficient restructuring decisions when industrial public enterprises face a soft budget constraint. Despite a negative net worth of Tsh 65 billion in 1990 for the 72 largest public enterprises (accounting for 90 percent of the public sector industrial output) and the fact that 49 of them have been unable to pay interest (in view of the heavy debt burden carried), these firms have continued to operate. In fact, despite the critical financial position of major industrial public enterprises, no action has been taken to restructure them (except in the case of six smaller enterprises, and that in the last five years). This is due not only to the fact that these enterprises operate in a protected environment, but they also receive direct and indirect subsidies (tax exemptions, deferred payments for Commodity Import Support (CIS) goods, and Treasury loans), and preferential access to foreign exchange, credit, materials and markets. Low-interest Treasury loans, for example, have reached Tsh 184 billion by mid 1990--38 percent of which are not being serviced. The two investment banks (TIB and TDFL) also hold large non-performing portfolios of these firms. Yet far more important in terms of recurrent support has been the provision of CIS goods without counterpart payment--in 1990, for example, nine producers in the metal sectors had Tsh 12.5 billion of outstanding CIS payments versus Tsh 9 billion in outstanding bank debt.

4.18 *Tightening the firm's budgetary constraint*, can be affected, inter alia, by eliminating fiscal and financial subsidies used to bail out enterprises. For such policies to be credible, enterprises need to expect them to be sustained over time. Credibility may be increased first by reducing ex-post incentives for the government to bail out enterprises. Governments often finance loss-making enterprises because of perceived gaps between the private and social surplus that are generated as a result of distortions such as overvalued exchange rates and monopolistic supply structures. Governments' incentives to bail such enterprises out therefore can be reduced through reforms, including realistic exchange rates, trade reforms, removal of price controls, and de-monopolization.<sup>12/</sup> Second, attempts to tighten budget constraints are not credible if enterprises expect to face other significant barriers, such as lack of finance, once they start to carry out necessary restructuring actions; policies to tighten budget constraints will not be sustainable since agents will not be able to implement them. Finally, credibility is gained by leaving allocation of financial resources to financial institutions and therefore reducing the government's discretion over such funds. As long as financial institutions are well supervised and regulated, they would be more effective than governments in imposing financial discipline.<sup>13/</sup>

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11/ See The World Bank, Industrial Regulatory Policy and Investment Incentives in Brazil, Report No. 7043-BR, March 15, 1990.

12/ See S. Nagaoka and I. Atiyas, op.cit.

13/ Nevertheless, the government's role in the allocation of financial resources for restructuring depends also on the degree of development and stability of the financial system. When the financial system is under severe distress, for example, the government needs to play a larger role. For a detailed discussion, see paras. 6.21-6.23 below.

4.19 Establishing a tight budget depends critically on financial institutions' unwillingness to refinance non-performing loans. To ensure they do not, it is first of all necessary to establish an adequate system of supervision and regulation.<sup>14/</sup> Capital adequacy requirements increase the stake of owners and thereby discourage banks from making risky loans; and better asset qualification rules and requirements for banks to make appropriate provisions for loan losses increase bank vigilance in debt recovery. Whereas improved supervision and regulation increases the cost of refinancing bad loans, better bankruptcy rules increase the benefit of liquidating or reorganizing them. Thus, the legal framework for bankruptcy should provide creditors with sufficient control rights to impose reorganizations and allow for fast liquidation if necessary (see Chapter V).

#### Agency Problems and Contractual Imperfections

4.20 Economic discipline is not only related to the intensity of competition or the tightness of the budget constraint but also to how closely the interests of decision makers are aligned with those of owners (or their principals). Managers' objectives are often different from the objectives of those who employ them; employers need adequate means to control the behavior of managers, otherwise managers pursue their own interests. This control usually is applied through contracts that define the rights and duties of both parties and specify commensurate payments of income.

4.21 However, such contracts often are inadequate in resolving conflicts of interest between employers and managers, either because they are poorly defined or incomplete, or because they are costly to enforce and monitor.<sup>15/</sup> Moreover, contractual arrangements exhibit substantial inertia; once they are well established, it becomes difficult to introduce changes that improvements in efficiency would demand. Because *contracts are incomplete, costly to monitor and enforce*, managers of both private and public enterprises may slack, shirk, pursue prestige and power, share inefficiency rents with labor in the form of high wages and overstaffing, and decide not to undertake appropriate restructuring actions.

4.22 In most emerging market economies, for example, contractual arrangements are inadequate because they are often associated with a lack of definition or clarification of asset ownership rights. This prevents governments from insuring that enterprises carry out urgent restructuring measures. Ambiguity in ownership rights also encourages various agents that have stakes in the enterprise to attempt to increase the scope of their claims, even when such attempts decrease the total value of the enterprise.<sup>16/</sup> In Hungary, the

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<sup>14/</sup> See, for example, Andrew Sheng, Bank Supervision: Principles and Practice, The World Bank, EDI No. 340/044, 1990.

<sup>15/</sup> Contracts may be incomplete either because they address actions or contingencies that are not easily recognized by the contracting parties themselves or because they fail to specify a large number of contingencies, thus causing ambiguities about actions that parties are obliged to carry out. Contracts may be costly to enforce and monitor because contingencies may not be verifiable by third parties that take part in conflict resolution, such as courts or administrative bodies.

<sup>16/</sup> For a detailed discussion of this problem in the context of Russia, see A. Shleifer and R. W. Vishny, "Privatization in Russia: First Steps," mimeo, 1992.

government does not have the authority to impose major restructuring decisions; these can only be implemented with the consent of enterprise councils, most of which prefer resisting change. As a result, even though a large number of enterprises suffer from low operating earnings, high indebtedness, over-employment and outdated technology, in many cases no major actions have been taken to improve efficiency. In many of these countries, re-assertion of the ownership function requires corporatization of the state enterprises and establishment of ownership entities to whom the government delegates the ownership function. Such entities include board of directors for individual enterprises as well as other intermediate entities to monitor performance according to well defined criteria.<sup>17/</sup>

4.23 In general, even when governments have the right to impose restructuring decisions, they may not have efficient mechanisms to monitor the behavior of managers and to ensure that these decisions are correctly implemented. Imperfect or costly monitoring makes it impossible to enforce detailed contracts where managers would be liable for their actions, and therefore it becomes undesirable to write such contracts.

4.24 The most decisive way to resolve this problem for public enterprises is to privatize them. In some cases, it may be necessary for the government to carry out certain restructuring measures prior to privatization (Box 4.1). When privatization is not available as a short run option, better mechanisms to exercise the government's ownership rights over public enterprises are required.<sup>18/</sup> Contractual relations with public enterprise managers should stress operational and financial autonomy, as well as accountability in the context of a fully corporatized entity. Governments can facilitate monitoring by minimizing, wherever possible, the complexity, multiplicity and variability of managerial objectives. The simpler and more stable are management objectives, the easier it will be to measure managerial performance.

4.25 A similar problem exists in industrialized economies with diffuse ownership. Even though shareholders as a class have control rights, it is costly to exercise these rights on a day-to-day basis. Separation of ownership and control is a potential source of managerial slack as well as a potential disincentive to undertake efficient restructuring decisions. However, to the extent that managers do not maximize the value of the enterprise, share prices will be lower and takeover bids more attractive. Since takeovers often result in changed management, takeover threats often are seen as effective in disciplining managers and ensuring that they behave in the interest of owners.<sup>19/</sup>

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17/ For a discussion, see D. Kochar and A. Sood, Enterprise Reform in Central and Eastern Europe, January 1992, Country Department 2, Europe and Soviet Union Region.

18/ The ownership function includes, for example, setting enterprise objectives, appointing top managers, evaluating performance, and approving large investment decisions. For further details on Governments' ownership functions and other aspects of public enterprise management, see A. Galal, "Public Enterprise Reform", World Bank Discussion Papers, No. 119, 1991, and M. Shirley, "The Reform of State Owned Enterprises: Lessons from World Bank Lending," PPR Series No. 4, 1989.

19/ However, the empirical literature on the efficiency implications of takeovers is inconclusive. Ravenscraft and Scherer (1987) document that the profitability of acquired companies did not, on average, increase. Shleifer and Vishny (1991) argue that a substantial portion of takeovers in the 1960s and 1970s possibly reflected agency problems--managers' desire to control a larger stock of

4.26 Yet, the disciplining effect of takeovers is also predicated on the existence of competitive markets for managerial labor. Their absence makes it more difficult for employers to penalize management for not making desirable restructuring decisions. Their existence, on the other hand, induces managers to care about reputation and thereby improves managerial incentives. Similarly, lack of a market for corporate control makes managers less responsive to shareholders' value maximization objectives. As a result, the incentive effects of the threat of takeovers are greatly diminished.

4.27 The scope for direct government intervention to improve monitoring of managers in private enterprises is much more limited. Direct solutions to improve imperfect private contracts are not in the public domain, since private parties involved in existing contracts are likely to be best informed on how to recontract and ameliorate arrangements. In case of publicly-traded private firms, governments can support more effective monitoring (particularly by minority shareholders) by requiring fuller information disclosure regarding firms' performance.<sup>20/</sup>

4.28 Monitoring of decision makers in both public and private enterprises can be facilitated through a number of indirect channels. To the extent that competition in product markets increases, enterprises can be compared more easily with others to disentangle the impact on performance of external events from those within management's control. In addition, a well-functioning managerial market that is common to private and public sectors will improve performance incentives for all managers. If the passage of managers from the public to the private sector and vice-versa is facilitated, as is the case in France with the "grands corps" networks, managers have greater incentives to take improved restructuring decisions, since present and future emoluments depend on performance.<sup>21/</sup>

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assets--rather than providing a solution to them.

<sup>20/</sup> For example, in the U.S., the Securities Exchange Commission determines proper disclosure rules.

<sup>21/</sup> For a discussion of the potential benefits of managerial markets common to private and public sectors, and additional references on the French "grands corps" networks, see Paul Estrin and Virginie Perotin, "Does ownership always matter?", International Journal of Industrial Organization 9 (1991), pp. 55-72.

#### **Box 4.1: PRIVATIZATION AND RESTRUCTURING**

There are two links between privatization and industrial restructuring. The first is that privatization is potentially the most decisive way to reduce agency problems and contractual imperfections in the management of state owned enterprises. By establishing equity claims and control rights over the enterprise, privatization allows private owners to assign, change, monitor and discipline the management of the enterprise and potentially enables the ownership function to be exercised in a decentralized manner, while removing a major barrier to restructuring. The degree to which this private ownership function is effectively exercised depends on the design and outcome of privatization schemes (For details on privatization schemes, see "Privatization: The Lessons of Experience," The World Bank, Country Economics Department, 1992). In particular, private owners are more constrained in carrying out these functions in those schemes that result in very diffuse ownership structures (para. 4.25), as in some mass privatization schemes that aim at speedy transfer of ownership to the private sector. If the stock market also is underdeveloped, the new owners also cannot rely on the market for corporate control and takeover threats to discipline managers. Under these circumstances, one or more strategic buyers with concentrated ownership (i.e., that would purchase large shares of total equity) often are required to maximize the economic gains from privatization. However, while finding such buyers for each enterprise would substantially reduce agency problems, this also would slow down the pace of privatization. Hence there is a trade-off between the speed of privatization and the extent to which agency problems can be solved.

The second link relates to the following sequencing question: to what extent should enterprises be restructured prior to privatization? Pre-privatization restructuring may be undertaken whenever there is need for:

- (i) horizontal and vertical de-monopolization. It is easier to break-up monopolies when they are under Government control than when they are owned by the private sector;
- (ii) massive layoffs. These are politically sensitive actions and potential owners may be discouraged from buying enterprises with excess labor (on the other hand, precisely because massive layoffs are "sensitive," they may only be politically possible when performed through a highly decentralized process by economic agents not visibly connected with the Government);
- (iii) recontracting with creditors, suppliers, customers and labor. Heavy contractual burdens inherited from past bad management hinder privatization. Often the Government is in a better position than potential buyers to renegotiate these contracts in terms that are acceptable to claimholders. (Recontracting to reduce excessive debt levels is frequent in privatizations in some emerging market economies. Renegotiating with the labor unions and financing of severance payments were important components of pre-privatization restructuring of a steel company in Argentina.)
- (iv) restructuring environmental liabilities. Large environmental liabilities may deter potential buyers from showing any interest in otherwise sellable enterprises.

The need for pre-privatization restructuring is likely to be much more limited in small and medium sized enterprises. It also is likely to depend on the speed of the privatization schemes. In mass privatization schemes that envisage the transfer of ownership in the near future, such restructuring may be limited to those enterprises that cannot be sold even at zero price; in such cases, the privatization scheme itself may be used as a market test to identify those enterprises that need restructuring prior to privatization. This approach also enables the government to limit its involvement in debt write-offs (such an approach may be especially useful in cases where raising fiscal revenue is not a major objective of privatization). Even in such cases, the government may consider the option of selling the enterprise at a negative price--that is, with a subsidy--and let the new owners renegotiate the debt with creditors, rather than getting involved in debt write-offs directly. If the enterprise is unviable even after a debt write-off, then it should be closed down; sellable assets may be privatized in a piecemeal fashion.

Large enterprises with substantial restructuring needs may require special focus. Even in countries with mass privatization schemes, and especially if privatization is not envisaged in the near future (say within the next 6 to 12 months), governments may prefer to identify the most urgent cases and implement restructuring measures that would increase the likelihood of privatization; in such cases, waiting is likely to raise the cost of restructuring substantially.

In countries where mass privatization is not the preferred mechanism, the need for pre-privatization restructuring for enterprises that are expected to remain under state ownership in the medium term (say for the next 2 or more years) is likely to be much more widespread. The most urgent step is to establish corporate governance to solve agency problems (corporatization, management contracts, etc.). Two additional measures can help ensure that the restructuring actions undertaken in this transitional period will be relatively more efficient. First, restructuring programs should have the clear objective of eventual privatization. Linking managerial compensation to the eventual sale price of the enterprise may also help. Second, putting the enterprise under the control of a ministry that is most interested in privatization and maintaining budgetary discipline would help the elimination of soft budget constraints. Experience (especially in Mexico) suggests that often the Ministry of Finance--rather than ministries responsible for industry--can play such a role.

## **V. BARRIERS TO IMPROVED RESTRUCTURING DECISIONS AND THE ROLE OF THE GOVERNMENT: MOBILITY**

**5.01** Desirable restructuring actions may be prevented by an inability to move productive inputs. Two sets of mobility-related barriers most often impede a more efficient reallocation of inputs: those that inhibit the mobility of labor and capital, respectively.

### **Labor Mobility**

**5.02** The decision to undertake industrial restructuring leads often to substantial layoffs and increased labor unemployment, generated by closing down or downsizing inefficient plants as well as by shedding redundant labor. Even if the restructured enterprise eventually expands, it is unlikely that new jobs will be created without laying off workers in the early phases of restructuring. Hence, workers tend to suffer substantial income losses. The problem is compounded when an industrial subsector as a whole is forced to restructure, when the skills of displaced workers are no longer in demand elsewhere in the economy, when restructuring is regionally concentrated, or when the economy is in recession. In light of such anticipated dislocations and associated exit costs, workers can be expected to resist restructuring actions that involve layoffs.

**5.03** In many countries, labor market immobility also arises from specific regulatory barriers that prohibit or increase the cost of temporary and permanent layoffs. The legal and regulatory framework governing all aspects of labor relations in the organized manufacturing sector in India illustrates the extent to which such rules can hinder flexible labor use. Indian laws define working conditions and hours of work in fairly rigid terms, mandate relatively high levels of real compensation, and restrict management flexibility in hiring workers under different terms of employment. Reportedly 800 different sets of regulations apply to central public enterprises, most of them relating to compensation, benefits, and working conditions. All productive units with 100 or more employees must obtain prior government approval for retrenchment (even if only laying off a single worker) or for closure; such requests are routinely turned down by state governments.<sup>22/</sup> The legal prohibition against retrenchment or closure generates barriers that adversely influence hiring decisions, and leads many firms to take on nonregular workers who are then rotated to avoid building up a basis for regularization. Such prohibitions also lead firms to adopt very inefficient means to shut down productive capacity--payments for utilities are avoided to trigger a cut-off of supply and consequent plant shut-down, strikes or lockouts are precipitated to stop operations--with plant and workers in disarray.

**5.04** The difficulties and eventual restructuring of a large textile mill in Pondicherry illustrate the barriers posed by restrictive labor regulations and multiple unionism. Competition among the 29 registered unions represented in the firm pushed up wages in spite of declining profitability. Though rationalization of work and labor retrenchment were necessary, they were prohibited. Attempts by management to improve

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<sup>22/</sup> The preceding, and related information, is contained in The World Bank, India: Industrial Regulator: Reform Sector Report, Report No. 9264-IN. Washington, D.C.: World Bank.

efficiency were blocked in the labor judiciary (long delays in the courts, with disputes commonly dragging out for 5 years, have resulted in a backlog of some 200,000 unresolved cases at the national level). Faced with impossible demands from the unions, the proprietor fled the country and the firm's plants were closed. Exempted from labor legislation (due to its subsequent "state relief undertaking" designation), the firm reduced its workforce size, returned quickly to financial viability and has moved into high-value segments of the textile industry. The firm's turnaround is attributed largely to freedom from labor legislation and multiple unions.<sup>23/</sup>

5.05 Intra-firm mobility, on the other hand, may be impeded by work rules which restrict the degree to which employers may move workers between different tasks within an enterprise. *Regulatory barriers to both inter- and intra-firm mobility should be removed.* Yet, phasing out rules and practices reducing flexibility of labor allocation is not sufficient. With high unemployment, workers themselves may face large exit and re-entry costs and therefore may resist restructuring decisions that entail layoffs. In this context, a well-functioning social safety net increases the willingness of workers both to accept layoffs and to attempt to change jobs.

5.06 There is in fact an important link between industrial restructuring and the *social safety net*. To ensure that improved restructuring decisions will not be blocked nor involve excessive labor adjustment costs, government-sponsored measures may be needed both to *decrease exit costs* (through, for example, unemployment compensation schemes) and to *accelerate re-entry* (through job search and retraining). Unemployment compensation schemes can be critical in improving restructuring actions, first, by decreasing income losses during unemployment and hence acting as exit subsidies. These may be justified because they reduce worker resistance to restructuring decisions that involve layoffs. Second, these schemes guarantee a minimum income and therefore provide insurance against risks generated by uncertain unemployment durations. In many countries, private markets do not provide such insurance in view of moral hazard problems. Finally, labor markets are often characterized by imperfect information. When current employers are better informed about their employees than future potential employers, even productive workers may not be re-hired. Hence, in all three cases, government's provision of unemployment compensation reduces barriers to labor mobility.<sup>24/</sup> In order to prevent inefficient postponement of re-entry into productive employment, such compensation must be provided only for a limited amount of time, and preferably should be complemented by job search and training services.<sup>25/</sup>

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23/ *Ibid.*, p. 67.

24/ Riordan and Staiger show that under imperfect information, the government can improve upon market outcomes by providing adjustment assistance for workers who leave a declining industry, in "Sectoral shocks and structural unemployment", mimeo, Stanford University, 1988. See also John McMillan, "The Analytics of Industrial Restructuring", mimeo, the Rand Corporation, 1991, for a review of market imperfections that may require government intervention.

25/ For the desirability of accompanying unemployment compensation systems with a greater emphasis on retraining in the OECD countries, see OECD, Structural Adjustment and Economic Performance, 1987, especially Chapter 3 ("The Labor Market and Industrial Relations") and Chapter 9 ("Social Policies"), particularly the section on help for the unemployed.

**5.07** In Eastern Europe, for example, government welfare policy traditionally was limited to in-kind help to disadvantaged groups such as the elderly or the handicapped, with the enterprise being the main locus of social assistance. There was no unemployment compensation policy because unemployment itself virtually did not exist (as a result of constitutionally guaranteed job security). However, high levels of total employment have masked substantial levels of hidden unemployment, or redundant workers in total employment. It has been estimated recently that hidden unemployment in Eastern Europe solely due to systemic causes (overstaffing and inefficient production structures, as opposed to macroeconomic causes) accounts for between 20 and 25 percent of total public sector employment.<sup>26/</sup> As past policies of constitutionally guaranteed job security are abandoned in the transition to market economies, these high levels of redundant workers imply equally high levels of unemployment (even if temporary). Both for equity considerations and in order to facilitate restructuring, the Czech and Slovak Federal Republic, Hungary and Poland recently have introduced their own systems of unemployment compensation<sup>27/</sup>.

**5.08** While governments have a role to play in easing restructuring-related labor exit costs, policies to facilitate re-entry are equally important. The willingness of workers to leave existing enterprises depends on the expected benefits and costs of the move, which in turn are related to the expected length of the (unemployed) transition period, the search costs for a new job, and the match between existing skills and those demanded by potential employers. Hence labor exit and re-entry policies should be examined in tandem, since both types of policies affect the costs of restructuring decisions that entail job losses. Private markets often fail to deal efficiently with problems related to information dissemination, hence expected search costs may be high. Also, capital market imperfections may make it difficult for individuals to borrow and finance their training.<sup>28/</sup> For these and other reasons, job search and re-training activities have fallen at least partly in the public domain in most advanced capitalist economies. During periods of widespread restructuring activity, government action may be even more justified and urgent: the skills of unemployed workers laid off due to restructuring are likely to be more outdated than those of cyclically-unemployed workers. In industrializing and emerging market economies, governments should be strongly urged to promote, provide financing, and if necessary run employment placement facilities and subsidized training schemes.<sup>29/</sup>

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**26/** For sources of these estimates, see "Unemployment and Social Safety Nets", in The World Bank, Integrating Czechoslovakia into the Global Economy: A Transition Strategy, May 1991.

**27/** See Table 2.1, ibid. On the necessity of unemployment insurance within the East European context, see D. Newberry, "The Safety Net during Transformation: Hungary," paper presented at the conference The dynamics of policy and institutional reform in emerging democracies, Prague, mimeo, 1991.

**28/** The importance of financing constraints on training are emphasized in D. H. Metcalf, "The Economics of Vocational Training," World Bank Staff Working Papers No. 713, 1985 and Donald O. Parsons, "The Firm's Decision to Train", in Research in Labor Economics, Ronald Ehrenberg (Ed.), Jai Press, 1990.

**29/** For a detailed exposition of the need for flexibility in labor markets and of existing policies to facilitate job search and retraining in industrialized countries, see O.E.C.D., op. cit. For a critique of potentially excessive government interventionism in Nordic countries (especially Sweden), See Lars Heikensten, Studies in Structural Change in Labor Market Adjustment, Stockholm School of Economic Research Institute, 1985.



5.09 The nature of government intervention in unemployment compensation, retraining and placement services has differed widely in OECD countries, with programs varying, for example, in terms of both sponsors and targeted recipients.<sup>30/</sup> In the US, both compensation schemes and retraining/reemployment services target workers directly. The business sector's role in retraining programs, such as those established under the Job Training Partnership Act of 1983, has been limited to influencing the planning and the administration of these programs. By contrast, in Japan, assistance schemes developed under legislation for "depressed" industries and regions provide financing to firms as well as individuals. Subsidies have been given to employers who retain rather than displace workers, or to those that employ workers that have been displaced; and subsidies were also used by firms for retraining and relocation. In addition, large firms in declining industries paid substantial amounts not only for layoffs but also for relocation and retraining. In fact, relocating displaced workers to other subsidiaries of the company, in case of conglomerates or industrial groups, has been a widespread practice among Japanese firms. Whereas the Japanese approach has some advantages because current employers would have better information about their workers than employment agencies, it may prove difficult to replicate in countries where business is neither organized in large industrial groups nor has a tradition of "lifetime employment".<sup>31/</sup>

5.10 The interrelation and funding of different forms of labor assistance also vary across countries. For example, in the US, both unemployment compensation (mainly consisting of unemployment insurance) and retraining/re-employment services are complementary. The former is financed by a tax on employers; the latter through federal funds with private contributions at the state level. By contrast, in Spain, a major assistance program gave laid-off workers a choice between either collecting considerable severance payments and unemployment compensation for up to 18 months, or surrendering their severance payments to an Employment Promotion Fund which was then used to pay 80 percent of the previous wage as well as provide free training and subsidies to firms willing to hire them on a permanent basis. Hence, a major portion of placement/retraining services in Spain was financed by those workers presumably most in need of such services.

5.11 Finally, lack of alternative affordable housing is often an important re-entry barrier, preventing workers from moving to enterprises where their particular skills may be best employed. To the extent that declining industries are concentrated in one region, housing and other markets will tend to have depressed values. To enhance labor mobility and enable workers to find alternative employment opportunities elsewhere, housing subsidies or measures to encourage real estate credit may be appropriate policies.<sup>32/</sup>

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<sup>30/</sup> See Annexes for cross country examples of labor policies towards declining industries.

<sup>31/</sup> In Japan, under the "lifetime employment" system and implicit contracts with labor unions within the companies, large firms have a continued obligation to support or compensate laid-off and discharged workers. This discourages firms from laying off regular employees, and encourages them to relocate workers within the firm.

<sup>32/</sup> Although the inability to rent, buy or sell housing whenever necessary is clearly a barrier to labor mobility, even the form of rental contracts can stifle mobility. In Poland, for example, all renovations to housing must be done by the renter rather than the owner, creating an incentive for multi-year leases and thereby making rapid relocation in response to changing employment opportunities less attractive. In this instance, regulations that restrict who should bear maintenance costs should be removed.

## Capital Mobility

5.12 Both sunkness of assets and coordination problems among interdependent firms in a declining market are important barriers to capital mobility. Whereas asset sunkness can be reduced through both the development of leasing and resale markets as well as the introduction of more adequate regulations and bankruptcy laws, coordination problems often have been addressed by capacity reduction schemes.

5.13 **Asset sunkness.** When sunk costs are high, income that can be generated by sale or liquidation of assets is low.<sup>33/</sup> Low resale value, in turn, reduces the benefit of exit or of reorganizations that entail asset sales, and makes not restructuring a relatively more attractive option. The degree of asset sunkness depends to an important extent on the prevailing set of input-market institutions, especially lease, rental and second-hand markets. These markets reduce asset sunkness by providing lower cost opportunities for asset resale or exchange.<sup>34/</sup> In their absence, all expenditures for assets may constitute sunk costs.

5.14 As experts in buying, managing and selling equipment, *leasing companies* can work with the customer to figure out the most suitable piece of equipment, provide equipment management and maintenance services, and remarket unwanted equipment at the end of the lease, all at cost savings to users of such specialized services. Compared to most other markets, lease markets are relatively underdeveloped in many industrializing countries. By nature, lease contracts are more complex than buy/sell agreements or simple financial debt contracts; when legal systems are relatively underdeveloped, the hurdles involved in the design and enforcement of lease contracts may render the risks and costs of their introduction prohibitive to potential lessors. Governments can play an important indirect role in promoting lease markets by providing a legal, fiscal and regulatory framework that at least does not discourage leasing. The successful introduction of leasing requires appropriate, non-discriminatory contract and property laws, tax and investment incentive legislation, and regulations governing leasing companies.<sup>35/</sup>

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<sup>33/</sup> Asset sunkness refers to the irretrievability of costs, that portion of expenditures that can never be recouped either because of the intrinsic, technological nature of the asset or because of the length of time required to dispose of the asset and the associated loss in value.

<sup>34/</sup> Multiproduct firms that operate in several markets with similar production technologies have relatively low barriers to the movement of capital from one market to another, since input markets are internalized.

<sup>35/</sup> Rules must ensure that leasing is given at least equal treatment with other types of credit. There should, for instance, be clear legal remedies enabling the lessor to reclaim the asset without lengthy court proceedings if the lessee fails to make rental payments. While special tax advantages have been important factors in the development of the leasing industry in Australia, the U.K., and the U.S. (with the lessee trading available tax benefits associated with asset ownership to a lessor that can better use those benefits, in return for lower lease payments), France and Japan have healthy industries that developed within a neutral tax environment. Of critical importance is that tax laws be clear and not biased in favor of other types of equipment finance. The basic components of a legal and regulatory framework to encourage leasing are described in J.Hakim (ed.), Equipment Leasing, IFC Occasional Papers, Capital Market Series, 1985. For a more detailed cross-country survey of leasing, see T.Clark (ed.), Leasing Finance, Euromoney Publications, 1985.

5.15 Poorly developed *resale markets* may also make the financing of reorganizations more expensive. When assets are sunk, their value as collateral will be low. That is because when secured creditors exercise their liens on these assets in cases of default, the amount of cash that can be generated through their sale will be low. Low collateral values, in turn, make financing more costly. As a result, the degree to which existing assets can be used as collateral to raise financing for reorganizations becomes limited. Resale markets and other mechanisms that decrease the sunkness of assets therefore are desirable not only because they facilitate physical mobility *per se* but also because they may enhance access to credit that is needed for reorganizations.

5.16 Asset sunkness also depends on the prevailing *regulatory and legal framework*, such as for transfer of assets. In socialist economies, restrictions on sale or transfer of assets were widespread, and remain common in most emerging market economies. In India, land sales in major cities are subject to government approval; state governments have rarely authorized such sales. In Tanzania, access to industrial sites also is very limited, largely due to conflicting government rules and procedures regarding layout, surveying, allocation of land, and site development, as well as a cumbersome and excessively bureaucratic land titling process.<sup>36/</sup> In such instances, *enhancement of capital mobility* requires *changes in the laws and regulations that constrain or discourage the transfer of assets*.

5.17 *Bankruptcy laws* also play an important role in affecting capital mobility. The establishment of rules by the state in the area of bankruptcy is seen as one of the most uncontroversial and legitimate forms of intervention. The main function of bankruptcy laws often is perceived to be the protection of creditors' rights. However, strictly speaking, protection of such rights could be sufficiently guaranteed by rigorous and efficient enforcement of debt contracts and would not require special legislation.

5.18 The economic reason that justifies government intervention in instances of bankruptcy is the existence of significant coordination problems that cannot be solved easily through the workings of the market. The problem is that the assets of a debtor in default may have a higher liquidation value if held together than split apart. Without bankruptcy law, each individual creditor would rush to exercise her claim for fear that otherwise other creditors would do so, a problem which may result in excessive fragmentation of assets and low liquidation values (so that the liquidation option may be used less frequently). In providing a set of rules in which debtor assets can be liquidated in an orderly manner, bankruptcy legislation allows the realization of the maximum value for the assets and therefore preserves the rights of creditors as a whole. Securing higher liquidation values for assets enhance their mobility by encouraging creditors to resort to bankruptcy proceedings more frequently. As well, higher liquidation values imply higher collateral values for assets, thereby facilitating firms' access to finance and hence their entry into new activities. When bankruptcy procedures, either as a matter of legislative design or because of insufficient capacity in the court system, are

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<sup>36/</sup> For India, see M. Dutz, "Industrial Restructuring and Exit Policies in India," mimeo, IENIN, Washington, D.C.: World Bank, 1992; for Tanzania, see M. Dutz and C. Frischtak, "Industrial Adjustment and Restructuring: Reflections from Tanzania," mimeo, IENIN, Washington, D.C.: World Bank, 1992.

inadequate in providing for relatively fast liquidation of assets, asset disposition becomes a high-cost low-return activity.

5.19 Besides liquidation, most modern bankruptcy laws also have provisions for bankruptcy reorganization of the debtor. Reorganization procedures are important because they may encourage restructuring of the assets and liabilities of financially distressed enterprises through a formal judicial process.<sup>37/</sup> The relevant issue in designing bankruptcy reorganization legislation is how to distribute bargaining power and control rights over assets between creditors, debtors and the court so as to exploit fully the economic potential for the rehabilitation of the bankrupt enterprise, without allowing debtors to abuse the process at the expense of creditors. Even though countries differ in the way that they have solved this issue,<sup>38/</sup> the emerging consensus seems to be that efficiency in restructuring decisions is maximized by allowing creditors to retain substantial authority in deciding whether and how to reorganize the bankrupt enterprise.<sup>39/</sup> This approach may be suited especially to industrializing countries where contract enforcement and processing capacity of the legal system is limited, and where there may be constraints in the availability of expert bankruptcy practitioners such as trustees or administrators.<sup>40/</sup>

5.20 Coordination problems and capacity reduction schemes. Whether or not physical assets are sunk, strategic considerations in markets where firms' decisions are interdependent can delay or prevent exit or downsizing even though it may be socially desirable for one or another enterprise to do so. Established enterprises may not have sufficient incentives (absent outside intervention) to withdraw physical assets in sectors affected by worldwide excess capacity, shrinking demand and aging technologies. In such imperfectly competitive markets (where firms' decisions are interdependent), each enterprise may wait for others to bear the burden of reducing capacity with the expectation that returns to remaining firms will be increased.<sup>41/</sup> Absent outside intervention to ensure exit, individual market incentives may not be sufficient to stimulate

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<sup>37/</sup> Existence of bankruptcy reorganization rules also is justified by problems of coordination between creditors. For example, even though efficiency gains may make debt reduction desirable for creditors as a whole, individual creditors would not have incentives to reduce debt unilaterally. Achieving debt reduction therefore would require coordination between creditors.

<sup>38/</sup> For example, under Chapter 11 of the US Bankruptcy Code, debtors retain control of assets unless the court appoints a trustee. In the administration procedure in the U.K., management of assets is automatically transferred to a court-appointed administrator. By contrast, in France much of the decision making authority ultimately lies with the court.

<sup>39/</sup> For an international comparison of bankruptcy laws, see "Bankruptcy Law: A Sticky End", The Economist, February 24, 1990.

<sup>40/</sup> Depending on the availability of government administrative resources, capacity constraints in the legal system may be relaxed by establishing specialized commercial or even bankruptcy courts.

<sup>41/</sup> Geroski and Jacquemin provide a few illustrations of how such strategic exit barriers can prevent welfare-superior outcomes in "Industrial change, barriers to mobility, and European industrial policy", Economic Policy, November 1985, 170-218.

efficient restructuring decisions and to enforce the industry rationalization which may be required. In these circumstances, governments can play a critical role in enforcing such rationalization.

5.21 The Japanese Government (through the Ministry of International Trade and Industry) has played an explicit coordination role to reduce production capacity in structurally depressed, capital-intensive industries. Following designation as a "depressed industry" (for which a majority of firms within the industry had to apply), the responsible ministry would try to forge a consensus on capacity reduction goals and plans for their attainment. In general, downsizing in designated industries was achieved through planned allocation of capacity reductions in concentrated industries and through the exit of small firms in unconcentrated industries.<sup>42/</sup> To facilitate implementation of significant capacity scrapping and to help individual firms finance adjustment costs, production cartels or tie-ups were permitted as short-term measures to raise or at least stabilize prices. Firms in designated industries were exempt from provisions of the Antimonopoly Law following approval by Japan's Fair Trade Commission, which had the right to reject or modify ministry plans if considered anticompetitive.<sup>43/</sup> Although there were no legal requirements to compel firms to carry out these capacity reductions, the consensus strategy and process of government "administrative guidance" (including specific explicit as well as implicit enforcement mechanisms) ensured that targets were usually met, since they reflected what firms were willing to do.<sup>44/</sup>

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42/ While MITI officials discussed volumes to be scrapped directly with individual firms in concentrated industries, their influence was smaller in unconcentrated industries where trade associations served as intermediaries. In concentrated industries, firms typically volunteered larger capacity reductions in response to rivals increasing their commitments; the stability of market shares suggests that firms may have reached agreement on pro-rated capacity reduction. On the other hand, with individual-firm commitments less common in unconcentrated industries, exit seems to have been concentrated among firms with the highest costs. See M.J. Peck, R.C. Levin and A. Goto, "Picking Losers: Public Policy Toward Declining Industries in Japan", in J.B. Shoven (ed.), Government Policy Towards Industry in the United States and Japan, Cambridge: CUP, 1988. For a fuller discussion, see Annex 1.

43/ In contrast to many other countries where government agencies finance most adjustment costs, larger Japanese firms themselves carry a substantial portion of such costs, including schemes to relocate or retire workers. While production cartels, tie-ups and other contractual arrangements among firms in the same industry yielded the revenues to finance adjustment-related expenditures, the costs were thereby imposed on consumers in the form of higher prices. The Fair Trade Commission did, however, monitor the competitive impact of cartels, and would refuse to grant cartels an extension if prices recovered. See *ibid.*

44/ In addition to sanctioned cartels, various carrots and sticks provided incentives for compliance. Firms that scrapped capacity in line with goals qualified for loan guarantees. While smaller firms received more generous subsidies, the major government contribution to large firms was exemption from the Antimonopoly Law. On the other hand, firms that did not meet obligations (as monitored by industry association inspectors) were required to pay fines. MITI could also withhold access to investment funds, hold up building permits, regulate raw material imports and provide financial incentives to competitors.

5.22 The Lazard Scheme to rationalize capacity in the U.K. steel castings industry illustrates the drawbacks of an incentive system that fails to encourage compliance by all firms.<sup>45/</sup> At the request of several larger enterprises within the industry, a rationalization scheme was sponsored in 1982 by the government and the merchant bank Lazard Brothers to coordinate and speed up capacity reductions. Under the scheme, cash payments to firms which closed plants were to be financed by a voluntary levy on firms that did not wish to close (based on recent sales of foundry products). While the original scheme did not include government contributions, intense lobbying by Lazard and a few larger firms resulted in public assistance. The voluntary nature of the scheme led many firms not to contribute to the closure fund, nor to close.<sup>46/</sup> There was no attempt to forge an industry-wide consensus; apparently, some of the reluctance of many firms to participate stemmed from their animosity to a scheme designed by the industry leaders. In addition, due to the non-selective nature of the scheme, a significant proportion of plants that closed were not amongst the least profitable. Importantly, the differing capabilities of firms at executing closure decisions were not taken into account. Undiversified firms with limited financial resources were reluctant to close their plants since the high costs involved made bankruptcy and the loss of jobs for both executives and workers more likely; such firms also had, in general, less advantageous opportunities to redeploy assets and less experienced managers at executing closure decisions. Another lesson from this experience is the need for rapid and decisive action by outside intervening agents. The delay of two years in negotiating the Lazard Scheme halted a process of market-driven adjustment that had already been underway prior to this period; firms delayed or postponed closure decisions during the prolonged and uncertain negotiating period. Intervention, while potentially beneficial, can be worse than no intervention when improperly structured.

5.23 Most industrialized countries have not attempted to pursue the same type of consensus strategy for rationalization as used in Japan. However, rather than helping to overcome the coordination problem, many governments have in fact complicated the exit process through trade protection and financial support schemes.<sup>47/</sup> These schemes have allowed existing domestic capacities to be (artificially) sustained and have impeded desirable industrial restructuring. For instance, government aid enabled the European market share of the four main Italian synthetic fibers companies to improve despite their relative inefficiency and continuing state of near financial collapse, complicating the European-wide rationalization process. In the West German steel industry, selective government subsidies led at times to the preservation of firms that would

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45/ For an overview, see C.W.F. Baden-Fuller, 1989, "Exit from declining industries and the case of steel castings", The Economic Journal, 99: 949-61. A comprehensive discussion is provided in Annex 2.

46/ While it was intended that all firms within the industry participate either as contributors or closers, a large number of firms did not participate, with only 52 percent by tonnage signing the agreement. Most of the financial contributions came from four of the largest firms, in the form of five annual payments of 2.5 percent of average 1980-82 turnover; the government contributed almost as much as industry members combined. See C.W.F. Baden Fuller, "The Wisdom of Collective Action: The Lazard Scheme for Rationalizing the UK Steel Castings Industry", Strategic Management Research, 1986, pp. 93-107.

47/ At times, the waiting game between firms at the national level merely has been shifted to the international level, as governments delayed adjustment in the hopes that the capacity of other countries would be reduced.

not have survived without them, at the expense of more efficient firms. While Arbed Saarlouis, a relatively inefficient German steel producer, would not have continued to exist had it not been subsidized more than other producers, Korff, allegedly the most efficient and internationally competitive German steel producer but recipient of no subsidies, had to close all plants in the 1980s; during the recent favorable business upswing, Arbed nonetheless still remained in need of assistance.<sup>48/</sup>

5.24 Experience with government policies towards declining industries suggests that policies aimed at encouraging or coordinating capacity reductions are probably more effective in promoting restructuring than those that provide subsidies or protection to distressed industries. While the latter tend to sustain inefficiencies, the former are more likely to stimulate a timely elimination of capacity in depressed industries. However, coordination mechanisms are most effective when they are structured so that it is in the self-interest of firms to participate, that is, when they are in line with what firms would be willing to do if they were confident that all firms would cooperate with the scheme. In addition, a successful scheme must take into account the particular resource constraints (for example, restructuring skills, information or finance) that firms may be facing. Finally, experience suggests that schemes based on pure voluntary compliance are likely to be much less successful than those that include carefully selected enforcement mechanisms.

5.25 Coordinated capacity reduction schemes should be designed only after governments are convinced that market-driven solutions without any intervention would yield inferior outcomes. One important criterion influencing the decision to intervene is the extent of productivity differentials among firms. With a small number of dominant firms participating in the scheme, such mechanisms are likely to result in agreements that envisage pro-rated capacity reductions. However, such market-sharing, pro-rated reductions are not desirable when there are large efficiency differentials between firms. In these circumstances, and absent appropriate market-based incentives, government mechanisms should create the incentives for less efficient firms to undertake larger capacity reductions. Another criterion is the structure of the financial system. If the structure of the financial system allows firms to sustain losses over a long period of time and to delay capacity reduction decisions, some form of coordination is likely to dominate market-driven outcomes. Available enforcement mechanisms also are very important. A poorly enforced capacity reduction agreement is almost certain to be inferior to the free market outcome.

5.26 Whereas coordination of actions may enhance mobility in oligopolistic market structures with a small number of large enterprises, mobility among medium and small firms can be enhanced by mechanisms that facilitate firms' exit from unprofitable lines of business and their entry into new activities. The Japanese

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48/ R.W. Shaw and S.A. Shaw ("Excess capacity and rationalization in the West European synthetic fibers industry", *The Journal of Industrial Economics*, 32:2, pp. 149-66, 1983) examine the West European synthetic fibers industry as a good example of how government policy complicated the exit process. H. Dicke and H.H. Glismann ("The rise and decline of West German steel industry: the role of national and supranational agencies", *Aussenwirtschaft*, 42:4, pp. 421-44, 1987) discuss the experiences of European policy co-ordination in steel markets, emphasizing how misguided policies provided incentives for capacity widening regardless of actual sales performance. For other examples of government intervention in the capacity adjustment process, including more detailed information and references to the discussion in the previous paragraphs, see Annexes.

experience provides examples of such mechanisms. In addition to the consensus-based approach adopted for the more capital-intensive industries, the Japanese Government has extended a different type of assistance to troubled industries composed primarily of small and medium-size firms. Rather than coordinating industry-wide capacity reductions, the Government has provided an array of incentives to assist such firms in switching to different activities. Following filing and approval of plans to move to a different line of business, firms in designated industries become entitled to low-interest loans, special tax credits on new investment, tax credits for merger with a firm in another industry, grants for retraining workers and payments to workers to facilitate moving to other jobs, as well as consulting services.<sup>49/</sup> The advantage of this approach is that while providing *exit subsidies*, it makes these subsidies conditional on entry into a new line of business. Therefore, the approach enhances mobility while minimizing the danger of discouraging entrepreneurship.

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<sup>49/</sup> For additional information on the Smaller Enterprise Business Switchover Act, covering the period 1976-1986, see M. J. Peck, R.C. Levin and A. Goto, *op. cit.*, and especially Y. Yonezawa, "The System of Industrial Adjustment Policies for Trade in Japan", Japan Economic Research Center Discussion Paper, 1979.



## **VI. BARRIERS TO IMPROVED RESTRUCTURING DECISIONS AND THE ROLE OF THE GOVERNMENT: RESOURCES**

**6.01** Ability to carry out desired restructuring actions is predicated on availability of resources. Specialized skills, knowledge and finance are the most critical resources for restructuring.<sup>50/</sup>

### **Skills**

**6.02** Restructuring is a complex task, particularly when falling short of complete exit. Above all, it is extremely management-intensive. A broad range of *management capabilities*, including strategic planning, marketing, and control of financial and other input flows are required. In particular, restructuring usually requires drastic decisions both to change the asset and liability structure of the enterprise as well as to re-define basic corporate functions. It calls for the ability to identify in what areas the firm has strategic competence and on the basis of what products/services it can take advantage of such competence; it requires a redesign of organizational structures and hiving off or contracting out intermediate activities, a typical need of excessively vertically integrated producers; it demands production, marketing and other agreements with other firms, to fill up critical needs in terms of product scope, buyer proximity, and market knowledge. Such agreements, often with foreign partners, are not easy to negotiate; often it is even difficult to identify potential partners.

**6.03** Probably the region with the greatest disparity between the potential benefits of restructuring and available managerial skills is Eastern Europe and the former Soviet Union. In the CSFR, as in other former COMECON countries, marketing of products had been almost assured through bilateral trade agreements entered into at government levels. In addition, the major customer, the former Soviet Union generally had been unwilling to pay any increases in prices, even those which could be justified on account of product improvements. Thus, enterprises had no incentive to develop new products and to keep up with modern business practices of capitalist countries. Management capabilities--to choose the most promising product areas, to aggressively market existing and new products, to control financial, labor and material input quality and flows, as well as to design realistic strategic plans--have therefore dropped badly behind levels now required to maintain international competitiveness. Lack of management expertise in these areas continues to be a critical bottleneck impeding enterprises from restructuring to reposition themselves in the more open and increasingly competitive markets.

**6.04** The capabilities of some managers accustomed to a less competitive economic environment can be strengthened and redirected in line with changed, more free-market environments. However, radical

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**50/** Experience with capacity reduction efforts in the U.K. steel castings industry, for example, suggests that efficiency of plant exit decisions were severely affected by lack of skills in closure, information regarding alternative technologies and markets, and financial resources. See C. W. F. Baden-Fuller, "The Wisdom of Collective Action: The Lazard Scheme for Rationalizing the UK Steel Castings Industry", Strategic Management Research, 1986, pp. 93-107.

shifts in corporate culture also often require radical shifts in management practices. While different modalities of management assistance and training are needed and undoubtedly will be effective in strengthening management capabilities, a number of managers will remain wedded to outmoded business practices. In such instances, a change in management leadership may be required to infuse enterprises with individuals skilled in new modes of business. The recent U.S. experience with deregulation illustrates the difficult and problematic challenges posed by changing the prevailing business culture. As sectors of the regulated telecommunications industry were opened up to competition in the 1980s, new executives and managers with experience in marketing and in non-regulated sectors rapidly displaced entrenched managers who had been successful in the old regime. Managers accustomed to operate in the regulated U.S. railroad industry were apparently also not able to adjust to the new, deregulated environment of the 1980s; a change of management occurred before enterprises began to take actions more in line with the new, more competitive conditions.<sup>51/</sup>

6.05 Two main types of mechanisms, formal training and learning-by-doing, are generally available to overcome management deficiencies and attain levels required for efficient restructuring. There is a strong rationale for at least some government involvement in formal management training programs. In several industrialized countries, the existence of a proliferation of private formal facilities (side-by-side with government-funded schools) providing management training, consulting and information services is evidence that supplying such education may be profitable for the private sector. In many instances, managers attending training programs, either at home or abroad, should be and are willing to finance at least part of the costs, given that they expect to recoup expenses in the future through the application of learned skills. Government-sponsored subsidy and loan programs should nonetheless assist in financing management education, in view of the large spillover effects, particularly at early stages of market development.<sup>52/</sup>

6.06 The government may promote or provide *management training programs*, when countries are faced with massive restructuring needs; the emerging market economies certainly qualify for such consideration. Coordination between public and private parties to provide training, and cost-sharing on the part of the productive sector in training endeavors, would provide appropriate incentives to ensure that funds are efficiently spent.

6.07 In addition to formal training, a number of indirect local and international business cooperation mechanisms that rely on learning-by-doing can be very useful in transferring the types of

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51/ These examples are cited in Robert Willig, "Anti-Monopoly Policies and Institutions," paper presented at the conference on *The Dynamics of Policy and Institutional Reform in Emerging Democracies*, Prague, 1991.

52/ Experience with formal management training and development programs suggests that formal training for top-level management is the most cost effective. Skilled managers at the top will be most visible to serve as role models for more junior staff. See U. Yavas and T. Cavusgil, 1989, "Management Know-How Transfer to Developing Countries: Efficacy of Specialized Training Courses", *Management International Review*, pp. 72-80, and the references cited therein.

management skills required for efficient restructuring.<sup>53/</sup> Such mechanisms range from in-house training and executive exchange programs to management contracts, leasing of enterprises, franchising and joint ventures. In addition to the transfer of skills, whenever these mechanisms include the entry of outside specialists into the decision making process of the enterprise, they often create an environment more conducive for difficult and painful restructuring decisions to be taken. The appropriate scope for government intervention is much more limited in this area, though policies may be desirable to ensure that the legal and tax climates are supportive of international business cooperation. Especially in countries where the public sector is dominant, the government may play a more direct role in *tapping foreign expertise* by establishing agencies that assist enterprises to locate and attract foreign managerial skills on a temporary basis.

6.08 Governments also will have a limited role to play in the upgrading of *worker skills*, to ensure that the decision of enterprises to move into new areas is not impeded by the unfamiliarity of existing workers with available new technologies. When such upgrading does occur, it often is undertaken within the enterprise, as a form of on-the-job training. However, firms tend to underinvest in training because they find it difficult to retain workers once trained, or because they lack financing. Hence, provision of government subsidies to on-the-job training activities may be necessary, especially in periods when firms face extensive restructuring needs.

6.09 Another type of expertise that is highly scarce in most developing countries is that found in *turnaround entities*. These are institutions that specialize in restructuring overindebted and financially distressed firms, often without major financial commitments from their own resources. Their expertise mostly lie in two areas. First, they have deal-making expertise, that is, the ability to draw agreements between creditors and debtors which, while restructuring claims on the enterprise, also safeguard the interests of participants against possible reciprocal opportunistic behavior. More importantly, turnaround entities are able to identify measures which are mutually beneficial but which otherwise are not obvious to the debtors and creditors. Second, turnaround entities have access to managerial expertise that can identify restructuring measures that would increase earnings. Often such expertise includes detailed information about the subsector, appropriate technology, product mix, and global market developments. Measures that boost earnings themselves increase the potential for financial deals that redistribute claims on assets, by increasing the value of the underlying assets. Absence of such "turnaround expertise" limits the efficiency of restructuring decisions by reducing the number of available restructuring options to decision makers.

6.10 Can governments play a useful role in developing *restructuring and turnaround skills*? It could be argued that if restructuring and turnaround activities were profitable, then private sector agents would perceive this opportunity and enter such activities; hence government action in this area is inappropriate. This view finds support in the fact that rehabilitation-oriented activities of government agencies in most industrializing countries have ended up with bailing out unprofitable enterprises rather than imposing efficient

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<sup>53/</sup> For a useful survey of these types of management skills transfer mechanisms and the benefits and possible problems associated with each, see Ali Carkoglu, "Reforming the Management System in Eastern Europe: What are the Available International Business Cooperation Mechanisms?", Mimeo, IENIN, 1990.

restructuring decisions. On the other hand, developing restructuring and turnaround skills entails large risks and learning costs. Agents need to incur learning costs not only to resolve uncertainties (regarding, for example, the profitability of such activities, or legal and institutional barriers), but also to develop deal-making expertise, and find out about appropriate incentive and control structures. Once initial learning costs are incurred, further entrants can easily appropriate the information produced by the initial experience. As a result, expected learning costs may be higher than returns that an initial entrant can appropriate, even though the activity may prove to be socially profitable net of learning costs. This externality justifies governments to subsidize or internalize some of the costs. In order to prevent the crowding-out of subsequent private entry, government-sponsored activities in this area should start on a relatively small scale and be time-bound. Moreover, to make it less likely that these activities result in bailing-out operations, government-sponsored agencies may rely predominantly on external (private) financial resources and combine these with management/financial and engineering skills. Alternatively, establishment of such a company exclusively with private resources also may be promoted. In any case, the enterprise should have a narrow scope in the beginning, focusing on subsectors where restructuring needs and potentially viable but distressed firms are concentrated.

### Information

6.11 Production and dissemination of information is characterized by externalities and economies of scale. Hence there is a relatively active role for governments to play in the *promotion of information flows*. Regarding technological information, it can be supplied in principle through private sector industry associations, though there may be a role for public-private cooperation in setting up and running information dissemination services or *technology support institutions*.

6.12 In addition, restructuring enterprises will need access to *market information*, to assist in the search for lowest cost sources of inputs and most profitable sales outlets. In particular, firms that are attempting to penetrate export markets as part of their restructuring strategy require information on markets, potential buyers, and product specification and design.<sup>54/</sup> Generating such information entails fixed costs, making it an uneconomic activity for individual producers.

6.13 There are two ways in which the government can enhance the flow of such information. The first option is to establish a trade development organization. Experience shows that in order to be effective and commercially relevant, such an organization needs to be closely linked to the private sector, and to producers in general. One way of securing such close links is to establish advisory boards that oversee the activities of the organization and have representatives of industry to take an active part in them.

6.14 Another option is to promote suppliers of information services in the private sector. Given that exporting itself generates externalities and use of information greatly facilitates export orientation, supply

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<sup>54/</sup> For a detailed analysis of support services needed for development of exports and the role of the government in promoting their supply, see P. Hogan, D. B. Keesing and A. Singer, "The Role of Support Services in Expanding Manufactured Exports in Developing Countries," Economic Development Institute of the World Bank, EDI Seminar Series, 1991.

of such information services deserves subsidies.<sup>55/</sup> Subsidies can be provided to users of the services, who *ex ante* often are not knowledgeable about their value. Subsidies of a temporary nature can also be provided to firms which are willing to act as leaders in the business of provision of export services.

## Finance

6.15           Restructuring operations often require fresh *financial resources* for short term liquidity or for restructuring investments. When the decision to restructure leads to partial exit, actions such as laying off workers and closing (or mothballing) facilities involve real resource outlays. Expenditures are particularly steep when it comes to paying workers what has been contractually agreed (or what is constitutionally assured). Thin credit markets may block the restructuring option.

6.16           Absence of credit encourages managers to strip assets from the facility, sell forward at poor terms, delay payments to creditors and employees, and engage in other predatory activities. Often such activities entail taking excessive risk at the expense of creditors. Such behavior fails to maximize the value and accelerates the unwarranted demise of the firm. It becomes a strong disincentive to workers, whose effort diminishes; to suppliers who further curb credit; to financial institutions which become less willing to lend; to customers, who retract orders or attempt to compensate increased risk with lower prices; and to competitors or potential buyers, who might under other circumstances be willing to bid up the price of the firm if offered for sale. The absence of credit tends to generate a self-perpetuating vicious cycle in which insiders are encouraged to deviate from value-maximizing behavior and engage in unproductive activities that aim at survival of the firm in the short run. Such behavior further discourages lenders from extending loans.

6.17           The Argentine experience in the steel sector illustrates some of the problems that may arise in the absence of finance. After many years of producing in sheltered environments and facing soft budget constraints, Argentine firms are being deprived of protective barriers, fiscal incentives, and preference in government procurement. Discipline has been reinstated. Regulatory constraints on labor mobility do not appear to be binding (although intrafirm mobility seems to be limited due to excessively rigid contractual rules). There are some barriers to the disposition of assets (steel-producing equipment is not easily saleable), though most can be traded. Loss-making but still viable firms in the private sector do not appear to lack managerial resources, and for finance, they are turning to their shareholders, while taking bold restructuring decisions.

6.18           This picture stands in contrast with the resource constraints and adverse incentive effects facing public sector steel producers. Discipline is also being imposed on public sector steel producers. However, if the current fiscal crisis has had a positive effect in ensuring a tight budget constraint to public sector firms, it also may be precluding the government from extending credit or injecting equity even when such actions might lead to economically superior restructuring decisions. These decisions may involve, inter alia, massive layoffs, which cannot be undertaken because firms lack the resources to award severance payments (which range from an average of \$10,000 to \$20,000 per employee). Management weaknesses and lack of

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<sup>55/</sup> See *ibid.* for a discussion of externalities in export activities and possible subsidy schemes.

autonomy (for firms which have been only partially corporatized) help explain the long-term slide of public steel producers. But the inability of these producers to restructure decisively, by selling assets, downsizing, narrowing product scope and deverticalizing, in face of poor market conditions and major structural obstacles to competitiveness, appears closely linked to the financial difficulties in laying off workers, the result of being credit and equity starved.

6.19 These difficulties also have generated adverse incentive effects on management, workers, suppliers, and buyers. Financial starvation has aggravated agency problems commonly found when the principal's identity is constantly changing (as is the case with Argentine public steel producers). Management's concerns shifted from maximizing the enterprises' value to maximizing own pecuniary or other rewards, in view of the imminent demise of the firm. Such circumstances also accentuate risky behavior: for example, it has brought excess reduction of inventory levels, led to high-interest short-term borrowing to make up long-term financial needs, and entailed selling forward at discounted prices in both domestic and international markets.

6.20 However, it should be stressed that such agency problems in and of themselves do not constitute sufficient reason to provide firms with financial resources to facilitate restructuring. All that is being suggested is that in the absence of such resources, managers and workers (as well as suppliers and competitors) may precipitate exit or force shareholders to undertake (possibly through new management) restructuring decisions, while incurring larger closing costs than otherwise. Whether or not to provide the firm with new resources depends on a complex calculation of costs and benefits. Such a calculation should precede any major resource commitment.

6.21 What can governments do in general to increase the availability of external finance? The nature of appropriate government action depends on the root causes of lack of external financing. One possibility is financial repression, which calls for interest rate liberalization. Another recurrent cause is distress in the financial system itself, which may lead to highly distorted lending decisions, such as refinancing of non-performing assets or excessive risk taking. Financial distress may also result in sharp reductions in lending activities. In both cases, economically desirable restructuring projects may not get financed. *With systemic financial distress, government action towards industrial restructuring becomes closely linked with its strategy towards the financial sector.* Thus, for example, if bad loans in the banking system are transferred to an asset recovery agency, then that agency would replace the financial institution as the creditor and undertake requisite activities to maximize the value of the loans, including extending new credits if circumstances warrant. If, on the other hand, bad loans are left in banks' books and government intervention mainly takes the form of recapitalization, then banks retain the main responsibility for dealing with financially distressed borrowers. The choice between the two approaches depends very much on country circumstances. If, for example, banks have sufficient workout specialists, corruption is minimal, and transfer of bad loans to a recovery agency is legally complicated, then it is more efficient to leave management of bad assets to banks. Otherwise, it may be more effective to centralize the management of these assets and the skills required to manage them.

6.22 Of course, if financial distress is widespread so that the financial system is *de-facto* "nationalized" (that is, the management of most banks are taken over by the government or its regulatory agencies), then the government or its agencies have no option other than to exert a major influence on

decisions regarding bad loans, and therefore on the allocation of financing for restructuring purposes. In such cases, the government's role in firms' restructuring is similar in scope to that of a vigilant creditor seeking to maximize the value of its claims. This should be seen as an interim role. In the meantime, the government should actively pursue the rehabilitation of the financial system, especially by altering the system of incentives that helped bring about its initial collapse. As rehabilitation of the financial system proceeds, the government should seek ways of reducing its direct involvement in restructuring and relegate this role back to the financial system as soon as possible.

**6.23** When systemic distress in the financial system is not a major problem, lack of financing for restructuring projects may be due to two other reasons. Financial institutions may lack expertise in financing workout projects, or they may perceive it as an excessively risky activity, primarily because relatively cost-effective mechanisms to monitor and control the activities of the borrower are not available. Under these circumstances, the government should mainly focus on encouraging the development of profit-oriented turnaround entities (paras. 6.09-6.10). Note, in addition, that in order to encourage banks and other financial institutions to undertake workouts, an environment within which contractual relations between debtors and creditors are conducive to restructuring is necessary. In countries where established patterns of business relations allow for and encourage informal reorganizations, the legal framework may not require immediate attention. In most other cases, however, reforms in bankruptcy and related legislation may be needed. The perceived risk of these operations could be reduced by bankruptcy laws which permit fast recovery of assets or which are conducive to reorganizations (para 5.19).

**6.24** The textile subsector in Turkey illustrates the critical role that turnaround entities can play. To compete internationally, Turkish textiles have primarily relied on low domestic wages. The subsector was hit by two shocks in 1990. On the one hand, nominal wages increased by almost 300 percent due to an industry-wide wage agreement. At the same time, the Turkish Lira appreciated by almost 60 percent in real terms. As a result, the industry became uncompetitive in international markets. The industry responded by massive layoffs, reaching almost 30 percent of employment in some cases. Furthermore, firms accelerated their plans to invest in new, more capital intensive technologies to regain international competitiveness.

**6.25** These restructuring measures were relatively easily financed by firms with high liquidity and substantial internally generated funds. However, significantly indebted firms which had to use an important part of their cash flow to finance interest obligations could not rely on internal funds; financing from the banking system was not an attractive option either, because of both high costs and unavailability of investment credit. An alternative solution for these firms is to reorganize their liabilities and assets informally through agreements with their creditors. Implementation of this alternative requires overcoming significant barriers (see Box 6.1) and has been rare in Turkey.

### **Box 6.1: RESTRUCTURING DECISIONS FOR AN OVER-INDEBTED FIRM**

Over-indebtedness and the consequent burden of high interest payments is a frequently encountered cause of financial distress. Typically, over-indebtedness arises due to two reasons. First, firms may have accumulated too much debt because of past distortionary government policies, such as credit subsidies, negative real interest rates or an overvalued currency that artificially reduce the cost of debt. Under these conditions, unanticipated increases in the cost of debt impose a severe burden on the cash flow of enterprises. Second, overindebtedness also may arise because of persistent losses that are ultimately financed by firms' capital reserves or by new borrowing. The losses themselves may arise from the main operations of the enterprise or from non-operating expenses, such as maintenance of unproductive assets which do not generate income.

What kind of special considerations does overindebtedness introduce in restructuring decisions? In particular, how does overindebtedness affect the shut-down versus reorganization decision? The answer to this question depends both on the relation between gross earnings, debt obligations and the cost of capital, as well as on available opportunities for debt reduction.

A reorganization can improve gross (operating) earnings for several reasons. A better organizational structure, improved technology and more efficient input choices may improve earnings. Gross earnings also may improve if debt is somehow reduced to "normal" levels. With potentially more income available for appropriation by managers and owners, improvements in performance are expected. This may be called the indirect incentive effect of debt reduction. Finally, debt reduction itself is likely to reduce interest payments and therefore improve net (after interest) earnings; this may be called the direct effect of debt reduction. When calculating the net benefit of reorganization, therefore, one needs to make a forward-looking comparison of any direct and indirect improvements in earnings (net of the cost of reorganization) with the expected capital cost of a "normally" leveraged firm; comparison of current earnings potential with the existing level of debt would result in inefficient restructuring decisions. (The term "normally" leveraged firm is used rather loosely here. In real world contexts, financial and real decisions are not independent from each other and the optimal level of indebtedness is determined jointly with production and investment. For our purposes, a normal level of indebtedness may be taken as the average leverage of financially healthy firms in the same industrial subsector).

However, this discussion presumes that debt can indeed be reduced to "normal" levels. There are two issues here. First, would creditors as a group be willing to reduce the face value of their claims? And second, are there mechanisms which can facilitate such operations? With respect to the first issue, creditors generally have three options when faced with an overindebted borrower. They can refinance the borrower in a passive manner, they can seek ways for renegotiating their claims, or they can push for liquidation. With a severely over-indebted firm, refinancing often may amount to throwing good money after bad; creditors would not resort to that option unless the other options are not feasible or unless there are severe loopholes in the supervision of the financial sector. Generally, creditors as a group would be willing to renegotiate (and reduce the face value of) their claims if the value of their restructured claims is higher than the liquidation value of the debtor's assets. If the present discounted value of gross earnings of the enterprise, including those allowed by the direct and indirect improvements, is higher than the present value of the cost of the capital of a "normally" leveraged firm, then generally creditors would be willing to go through a renegotiated settlement. Under these circumstances, the post-settlement value of their claims would often be higher than the liquidation value of the assets. The question is, are there mechanisms for such deals?

There are several important barriers that prevent the emergence of such deals which in principle can be restructuring-efficient. The first is a problem of coordination. Unless there is a platform in which creditors can act in a cooperative manner, it may be optimal for each one of them to rush and exercise their claims for fear that otherwise another creditor may do so. Second, creditors will require mechanisms to closely monitor the debtor. Granting creditors or their agents significant control rights, either through shares or perhaps on a temporary basis, can in principle help solve that problem. Third, there are resource related barriers. Such financial deals require significant expertise. Creditors need to assess the earnings potential of the enterprise, and be well informed both about the particular sector and about complex financial contracts that protect each side from the opportunism of the other side. Moreover, creditors must have access to management expertise. In most cases, main creditors are commercial banks which have little experience in these areas; developing expertise may be costly if there are no significant economies of scope between such activities and their main lines of business. Therefore, existence of specialized institutions may be required (para. 6.04).



6.26 There have been a few cases where informal reorganizations have been carried out through the activities of a turnaround entity specifically set up to reorganize distressed firms in the textile sector. This entity, established with equity capital from a government-owned development finance institution, has taken over the equity capital and management of ailing textile companies and rehabilitated them by improving technology, product choice, marketing, and management. It was able both to reorganize their balance sheets--mainly through informal reorganization agreements--and to secure new financing. Profits by this turnaround entity were made either on a fee basis or by capital gains on shares acquired in the beginning of the rehabilitation operation.

6.27 When the financial system is relatively sound, should the government be directly involved in providing liquidity or other financing to firms in need of restructuring, especially to those that are in financial distress? In particular, should the government intervene when very large firms experience severe financial difficulty, and if so, in what capacity? In most cases, government agencies can play a more efficient role by acting as mediators between the firm and its creditors. The government can foster a process of negotiations which mimics bankruptcy reorganization procedures but would take place in an informal setting. In particular, removal of the management of the enterprise or a change in its ownership would be an explicit subject of negotiation. Unless other creditors are willing to bear the main financial burden of restructuring, the government should not be involved in direct financing. Generally, the administrative capabilities of governments to monitor and control enterprises in need of restructuring are worse than those of financial institutions. Therefore, it is more efficient for the government to leave the main task of financing to financial institutions, restricting its own activities to reducing frictions that discourage financial institutions from financing restructuring projects.

6.28 Some countries (Turkey, for instance) have experimented with special legislation designed to resolve the financial distress of very large firms. Essentially, such laws encourage creditors and debtors to reach reorganization agreements without resorting to bankruptcy courts. They are often designed to protect an enterprise from failing without necessarily protecting its management or owners. To be efficient, such legislation should envisage initiation of bankruptcy proceedings if the process of negotiation is not successful.

6.29 Can development finance institutions (DFIs) play a useful role in industrial restructuring? Experience with investment financing by DFIs has been favorable only in very few countries; that should cast doubts on how well they would perform in financing restructuring projects. Nevertheless, a well-managed DFI is likely to be much more successful in screening and monitoring creditworthy restructuring programs than a government agency providing finance to financially distressed companies on an *ad-hoc* basis. All restructuring projects should be judged in the same manner as any other investment project, with the proviso that additional specialized skills and more stringent conditionality will be required. However, this principle is not so easy to implement. Experience has shown that even some better run DFIs have been obliged or forced by

governments to bail out companies. Hence, whether DFIs can or should play an active role in restructuring depends very much on how independent they are from government pressures.<sup>56/</sup>

6.30 Another recurrent cause of lack of financing occurs when a whole manufacturing subsector falls into a situation of financial distress, often due to fragmented or excess capacity. In these cases, financial institutions may withhold their financing because they cannot distinguish enterprises that are potentially viable from those that should exit, due to problems of asymmetric information. In these cases as well, it is quite doubtful that the government can solve the problems by getting involved in direct financing. However, the government does have a larger instrument set than financial institutions, which can be utilized to help resolve the information problem. In particular, if the government can design a mechanism that induces positive selection--a mechanism that induces relatively less efficient enterprises to exit and viable enterprises to stay--then financial institutions will find it more attractive to provide financing to those enterprises that stay. Exit subsidies may potentially prove useful in these circumstances. In fact, the subsidy may be partially or in whole financed by a tax on those enterprises that stay in business. Experience, such as in the U.K. steel castings industry, has shown that making participation into such schemes voluntary may result in underfinancing (para. 5.22). The government's authority to impose taxes and subsidies would help overcome this free-rider problem.

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<sup>56/</sup> For example in Brazil, the National Bank of Economic and Social Development (BNDES) has often been involved in the past in bailing out operations due to government pressure, even though it is generally known to be a well run DFI. See The World Bank, Industrial Regulatory Policy and Investment Incentives in Brazil, Report No. 7843-BR, March 15, 1990. Governments often are able to put pressure on even private banks to provide financial help to companies in difficulty. In Turkey, for example, the largest private bank has been forced to get involved in several restructuring/bailing out operations by successive governments.

## **VII. CONCLUDING REMARKS: COMPLEMENTARITY OF GOVERNMENT ACTIONS, AND THE DESIGN OF COUNTRY RESTRUCTURING PROGRAMS**

### **Complementarity of Government actions.**

**7.01** The different government actions described for improving the environment for restructuring decisions are complementary and need to be coordinated. Otherwise, they might be ineffective, or at worst, counterproductive. Take the case of measures to remove discipline-related barriers that are not accompanied by complementary efforts to overcome mobility obstacles and resource constraints. As discipline is tightened, firms initially react by attempting to lay off redundant labor or redeploy them internally to reduce variable costs; disposition of certain physical assets or least profitable units normally follows. In the absence of mobility, these restructuring actions would be constrained and firms' financial difficulties increased.

**7.02** Yet factor mobility itself is predicated upon the availability of financial resources (for severance payments, disposition of physical assets, and adoption of new technology) and turnaround skills (which usually are unavailable from within the firm). When such resources are not available, increased discipline may aggravate financial distress. Widespread financial distress, in turn, may encourage the government to relax discipline once again. Hence, when the economic environment is not conducive to restructuring, government's intentions to strengthen discipline may in fact not be credible. Depending on the circumstances, these tendencies may result in too many or too few liquidations, as well as economic losses due to excessive risk taking and asset stripping by managers.<sup>57/</sup> Problems also arise in the converse situation, when measures to augment resources are not complemented with those that strengthen discipline. In particular, increased availability of financial resources in an environment with soft budget constraints would most likely end up in the misuse of these resources.

**7.03** Finally, proper behavior of financial institutions also requires coordination of government actions. Strict regulation and supervision of the banking system would be relatively ineffective in encouraging banks to undertake workouts, unless these measures are complemented by bankruptcy laws which permit fast recovery of assets or which are conducive to reorganizing debtors. Similarly, a bankruptcy law, however

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**57/** The recent poor performance of the state owned sector in Poland, for example, is partly attributable to the government's reform strategy that has emphasized removal of policy distortions to enhance discipline (for example, trade reform, elimination of subsidies, and imposition of a dividend tax) to the relative neglect of ownership reform, and credible mechanisms of exit and liquidation. Even in cases where managers and workers' councils are willing to undertake restructuring measures--despite the persistent ambiguities in ownership and control rights--this has been impossible due to lack of managerial skills and information. Despite substantial losses and reductions in output, Polish enterprises are in a wait-and-see mood, hoping that budget constraints may be relaxed again. See Ira W. Lieberman, "Poland: Enterprise Governance, Commercialization, Restructuring and Privatization," Mimeo, 1991.

modern, would be ineffective or insufficient in encouraging improved restructuring decisions unless financial institutions are required to keep sufficient levels of capital as well as provision for doubtful and bad assets.

### **Coordination of Policies**

7.04 In view of the large number of complementary government actions required to create an environment conducive to restructuring, it may be necessary to establish a *government coordinating unit*. The importance of coordination increases with the size of the restructuring task. When this task is substantial, a coordinating unit should be established to take a comprehensive policy approach to the restructuring problem.

7.05 Various government actions to improve the restructuring environment, such as providing unemployment compensation, directing exit subsidies by monitoring eligibility, mediating between creditors and large borrowers, and providing information on markets, technology, and potential buyers are functions that normally would be carried out in different branches of the government. Unemployment compensation schemes often would be designed and implemented by the ministry of labor, while incentives and subsidies for industry generally would be in the domain of the ministry of industry, a planning agency or subsectoral ministries. Even though detailed implementation of policies generally will be carried out by distinct branches within the government, it may be important for one unit to ensure that necessary elements are in place and are mutually consistent. This is especially relevant for countries facing massive restructuring needs where establishing policies, rules, and institutions necessary for socially desirable restructuring actions is a complex and multi-layered task. The important point is not to create an additional layer of bureaucracy, but rather to ensure that some administrative unit exists to coordinate inter-related tasks.

7.06 Additional functions of such a unit might be to supply advice, exchange information with business groups, help coordinate concerted business actions when necessary, and collaborate with industry associations both on policy discussion and formulation, and on support services that are provided with private/public participation. In particular, this unit would ensure that support services provided by other government agencies, such as market and technology information, worker retraining, and standards, all conform to the restructuring needs of industry. Finally, the unit would work as a clearing house for foreign restructuring assistance. The staffing, size, and location of the unit would depend on country-specific features, such as the availability and location of competent staff.

7.07 Restructuring-oriented administrative units exist in various forms and capacities in many countries. In Japan, sectoral restructuring programs were carried out by units within MITI, especially the Industrial Structure Commission. Adjustment assistance programs for labor were implemented by the Ministry of Labor, which worked in close coordination with MITI and other ministries in charge of other industries, to ensure that employment adjustment took place simultaneously with the rest of the components of industrial restructuring. Restructuring in the shipbuilding industry was overseen by the Ministry of Transportation. In Spain, the Ministry of Industry and Energy approves and monitors industrial restructuring plans through its offices of "Planes de Reconversion". The National Institute of Employment is in charge of implementing plans for training and other measures to assist displaced workers.

## Issues in the Design of Country Programs

7.08 Complementarity between the various proposed government actions does not imply that they should receive equal emphasis in country-specific restructuring programs. On the contrary, the framework developed in the previous chapters is helpful to customize restructuring programs according to specific country characteristics. In most countries, the government's capability to design, implement, and enforce policies is limited; like any other scarce resource, it has to be allocated to those areas that will have the highest effect in terms of improving the economic environment for industrial restructuring. Moreover, the level of development of restructuring-related elements of the economic environment vary substantially across countries.<sup>58/</sup> Hence, the most urgent task of country restructuring programs is to identify the critical constraints (or barriers) in the economic environment and design a restructuring program accordingly.<sup>59/</sup>

7.09 Before embarking on the removal of critical constraints, it is necessary to assess whether the requisite government capabilities are present, and if not, whether it is feasible to develop them. Government actions to remove such constraints require substantial administrative and technical expertise as well as enforcement capabilities. This is most apparent in areas such as developing an anti-trust administration, instituting and running an efficient system of unemployment compensation, job placement and retraining, exercising the state's ownership function over public enterprises (including formulating objectives, monitoring and ensuring compliance by management), privatization, and enhancing information flows on foreign markets. Wherever deemed feasible, enhancing government capabilities in the relevant areas, possibly by tapping assistance from international organizations or other foreign public or private sector expertise, is likely to be an important component of restructuring programs. Whenever the necessary capabilities are seen as unlikely to be adequately built over the relevant time frame, it is often preferable for the country programs to refrain from attempting to carry out the associated policies and to rely on, albeit imperfect, market solutions.

7.10 A critical element that the design of country restructuring programs must take into account is the existence of some primary restructuring agents in the economy. Often, enterprises themselves are able to design and implement restructuring programs, perhaps by making use of outside expertise and available government services. In the case of financially distressed enterprises that lack access to necessary (especially financial) resources, *commercial and investment banks* are among the primary candidates for acting as

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<sup>58/</sup> Hence in Korea, the weakness of the banking system was a major cause for the government's direct involvement in several workouts in the 1980s; adjustment of labor did not pose a critical constraint and consequently received less attention. In Japan, on the other hand, labor adjustment was the main focus of the Government; especially in the case of large enterprises, the Government played little or no role in enhancing the flow of finance.

<sup>59/</sup> At the risk of oversimplification, it can be said that in most middle income countries where the private sector plays a dominant role, the critical gaps lie in policies and institutions that address labor mobility, the availability of turnaround entities, and the flow of information. In emerging market economies with extensive state ownership, agency problems and ambiguities in ownership rights and managerial skills appear as additional binding barriers.

restructuring agents in most countries. If such banks are financially sound, all that would be necessary is to strengthen their ability to undertake restructuring activities.

7.11 Frequently, however, these financial institutions, just like their industrial counterparts, can function effectively only after being restructured. In fact, whether restructuring in the financial sector should be undertaken in parallel with industrial restructuring is an issue that often arises in the design of restructuring projects. In cases where the industrial sector as a whole requires restructuring, it is highly likely that financial intermediaries' portfolios are heavily contaminated with non-performing loans. Non-performing loans distort intermediaries' lending decisions; creditworthy industrial enterprises may face an unwarranted credit squeeze whereas inefficient enterprises may be over-financed. Such intermediaries are not likely to play a useful role in industrial restructuring. In these instances of "double contamination", a simultaneous approach to financial and real sector restructuring is required.

7.12 Often credit institutions, especially commercial banks, are unwilling to play a major role in industrial restructuring because they lack the necessary managerial skills or the capability to exercise control. In such cases, turnaround entities are a potential--sometimes complementary--institutional model (paras. 6.10). With limited precedent, and no single institutional model that can be applied to all country circumstances, there is room for experimentation and multi-track approaches.

7.13 In countries where the private sector is dominant and such entities have not arisen on their own, the government may promote their establishment by subsidizing initial entry of private agents or even by providing equity financing. The predominant reliance on private agents to carry out turnaround activities may be appropriate also in countries dominated by state-owned enterprises. On the other hand, such countries may prefer establishing a public agency to provide turnaround services.<sup>60</sup> One important consideration in the establishment of a public entity is whether such an agency will provide exclusively technical expertise or if financial resources also are to be provided. The former option is the preferred one, with financing to be provided through the banking system or other financial institutions, and perhaps also through foreign capital. If the banking system is not able to meet this challenge, then the feasibility of building up commercial banking capabilities should be considered first. If it is decided that financial institutions can play no useful role in financing enterprise restructuring, then there may be a role for the provision of financing through the public restructuring agency.

7.14 A variety of approaches have been tried within Eastern European countries. In the eastern part of Germany, most of restructuring prior to privatization has been carried out by the government's agency of privatization, the Treuhandanstalt.<sup>61</sup> The Treuhand took over the ownership of about 8,000 enterprises. Under the Treuhand ownership, enterprises underwent significant restructuring, including debt write-offs, and

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<sup>60/</sup> Whether relying primarily on private or public implementation, the strategy for restructuring state-owned enterprises should be coordinated with privatization efforts (Box 4.1).

<sup>61/</sup> For a detailed account, see for example, Wendy Carlin and Colin Mayer, "Restructuring Enterprises in Eastern Europe," *Economic Policy*, October 1992, forthcoming.

reduction in employment; Treuhand also provided guarantees for liquidity credits. Enterprises were then sold, with the sale price negotiated against commitments for investment and maintenance of employment. This centralized scheme for restructuring and privatization was made possible by availability of a large pool of management skills (Treuhand employed 3,000 people) and financial resources, features that limit the applicability of this approach in other countries.

7.15 Poland first established an Industrial Restructuring Fund (IRF) under the Ministry of Industry, which not only was active in the preparation of enterprise restructuring plans, but also provided financial support. In 1991, IRF was transformed into an Industrial Development Agency whose major function was only one of advisory services and supporting analyses. In Yugoslavia, each republic established a restructuring agency that carried out both restructuring and privatization. The government of Hungary decided not to establish a centralized agency, but instead is promoting the establishment of non-government turnaround entities operating on a commercial basis.<sup>62/</sup>

7.16 It is unlikely that a single agency, restructuring unit or model will prove adequate for most countries with massive restructuring needs. Thus, replicable models that are consistent with decentralized actions (and which minimize monitoring costs) customized to specific circumstances are preferred. Ultimately, the most effective government policy is one that aims at attracting to the market a diverse array of restructuring agents. The key challenge that countries with massive restructuring needs will be facing in the next decade is the creation of an environment where such agents can thrive.

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<sup>62/</sup> A detailed account of restructuring agencies in Central and Eastern Europe is contained in Kochav and Sood, *op. cit.*

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**ANNEXES:**

**POLICIES FOR DECLINING INDUSTRIES**

## **JAPAN**

### **A. Overview**

The worldwide recession following the 1973-74 oil crisis and increasing competition from newly industrialized countries led to a significant increase in the number of declining industries in Japan. Japan's problem between the mid-1970's and early 1980's was that due to the slower growth of the economy, adjustment to decline--especially the absorption of displaced workers by other industries--became more difficult than it was during the period of rapid expansion before 1973. This created severe economic and political pressures that had to be addressed by the government. The government's response to problems of adjustment to decline were contained in numerous pieces of legislation designed to ease the burden capacity reductions in the depressed industries: i) The 1978 Law for Stabilization of Specific Depressed Industries; ii) The 1978 Law for Stabilization of Specific Depressed Regions; and iii) The 1983 Law for Structural Adjustment of Specific Industries. A piece of legislation less directly related to the above was the Smaller Enterprise Business Switchover Act of 1976 that assisted small and medium-size enterprises in depressed labor-intensive industries to move to other industrial activities. Three additional laws related to the 1978 and 1983 Laws were passed for protecting workers and assisting firms with employment adjustment: i) The 1978 Law for Employment Adjustment in Specific Depressed Industries; ii) The 1978 Law for Employment Adjustment in Specific Depressed Regions; and iii) The 1983 Law for Employment Assistance in Specific Industries.

As a result of the above legislation, several declining industries were designated as "structurally depressed" by the government and underwent industrial restructuring, including shipbuilding, textiles (wool and cotton spinning), synthetic fiber industries, electric-furnace steel industry, aluminum refining, ferrosilicon industry, chemical fertilizers, petroleum refining, petrochemicals, pulp and paper, sugar refining, and cement.

In general, the Japanese response to declining industries was a coordinated approach involving implicit agreements between government, industry, and labor concerning shifts of industrial resources and tying industrial adjustment to worker and community adjustment. Although the government provided direct assistance to depressed industries and regions, large Japanese firms themselves carried a substantial portion of the adjustment costs by eliminating excess capacity and scrapping of equipment, by repaying their creditors and by administering schemes for the relocation or retirement of workers.

The next section outlines the provisions of the 1978 and 1983 laws for depressed industries and regions and highlights the process by which industries were designated as structurally depressed. Section C describes the extent of government leverage in assuring compliance with the adjustment programs and the difficulties that arose in striking agreements with the industries. Section D reviews government and industry programs for employment adjustment. Sections E and F cover other measures taken by both the government and the industry respectively. The final section provides a brief evaluation of the adjustment process in terms of capacity reduction targets achieved and the rate of re-employment of discharged workers.

## **B. Government Assistance Programs**

The numerous legislation pertaining to declining industries set out general criteria under which industries could apply for designation as structurally depressed and outlined the concept of a basic stabilization plan to reduce industry capacity by disposing of equipment. Also, several related laws were enacted that provided measures for employment adjustment in the declining industries (see section D). Basically, these laws provided the government with a general framework, legal base, and guidelines for assisting the adjustment of declining industries.

**I. The 1978 Law for Specific Depressed Industries** empowered the Ministry of International Trade and Industry (MITI) to coordinate an industry-wide process of capacity reduction and elimination of excess equipment for structurally depressed industries. A separate statute for employment adjustment also was passed in 1978 which will be discussed later in section D.

MITI used two basic criteria stated by the law to identify an industry as a candidate for designation as structurally depressed: i) firms representing more than 50% of the industry in terms of number and share of sales must be experiencing severe financial difficulties and subnormal earnings, and ii) the industry must be characterized by unusually excessive production capacity that would require reduction but likely to take a long time (3 to 5 years) without assistance.<sup>1</sup>

In 1978, the output of the manufacturing industries classified as structurally depressed was about what it was in 1970, after having declined steadily since 1973. By contrast, the rest of Japan's manufacturing industries were producing at an average of 43% more than their 1970 levels. Similarly, the average rate of capacity utilization of the structurally depressed industries had remained unchanged since 1974 at about 70%, while the rate of capacity utilization for all other manufacturing had reached 94%. Consequently, the earnings of the structurally depressed industries were very poor. For example, in 1976 the electric furnace steel industry had a ratio of profits to sales of -8.1%, the aluminum refinery industry had a ratio of -4.7%, and the textile industry had a ratio of -1.4%. For structurally depressed industries as a whole profits as a percentage of total sales were -1.6% in 1975 and 0.5% in 1976, while for all manufacturing industries profits were 1.7% of total sales in 1975 and 3.5% of total sales in 1976.<sup>2</sup>

Before an industry could be designated, MITI conducted discussions with firms and industry associations to determine whether or not the firms favored designation, and unless 2/3 of the firms (measured both by the number of firms and by the share of sales) representing the industry sought designation as structurally depressed, MITI would not initiate the process of adjustment.<sup>3</sup> Once the firms applied formally and the industry was designated as structurally depressed, then MITI or the responsible ministry (e.g. Ministry of Transport in the case of shipbuilding) would formulate a capacity reduction plan for the industry. The ministry would forecast supply and demand (including imports and exports) in order to measure excess productive capacity, establish the extent to which such capacity were to be shut down, and decide how the shutdowns were to be handled, i.e., scrapping or mothballing.<sup>4</sup> A special advisory subcommittee was set up within the Industrial Structure Commission of MITI as a forum for dialogue between MITI and the industry associations and representatives from individual firms. In concentrated industries, MITI officials discussed the

volume to be scrapped directly with individual firms, while in unconcentrated industries, MITI officials dealt largely with trade association executives who then carried on discussions with individual firms.<sup>5</sup> Labor unions were granted specific rights to contribute to these deliberations by law. In the course of these consultations, MITI tried to forge an industry-wide consensus on a capacity reduction goal and a schedule for its attainment. Once consensus was reached, it was formalized as the industry's "basic stabilization plan" and officially approved by MITI.<sup>6</sup> The law also gave Japan's Fair Trade Commission (FTC) the right to reject or modify ministry plans if these plans were considered anticompetitive. The Commission's approval of these plans exempted industries from provisions of the Antimonopoly Law.<sup>7</sup> In principle, FTC disagreed with the law and would have liked to do away with it on the grounds that it would add to Japan's reputation as protectionist and further exacerbate her relations with her trading partners.<sup>8</sup>

Once a basic stabilization plan was approved, there were no legal requirements to compel firms to carry out the capacity reductions. However, since stabilization plans were formalized through a process of government guidance and industry-wide consensus, once consensus was reached it was difficult for the parties involved not to cooperate. Section C discusses the extent of government leverage in the implementation of the stabilization plans in more detail.

If an industry's capacity-reduction goal, as established by the basic stabilization plan, was higher than what could be achieved by individual firms, MITI or the responsible ministry recommended to the industry the formation of a cartel to facilitate capacity reduction. Such cartels were not designed to cope with long term restructuring, but rather with short term price and production problems. To accomplish this, supply was artificially restricted to force up the price. This prevented individual firms from cutting prices to gain market shares and helped the industry to undertake the adjustment costs, normally undertaken by creditors or government agencies in other countries. The Japanese shipbuilding industry, for example, faced with a dramatic decline in world demand for ships following the 1973-74 oil crisis and projections that future demand would not approach pre-oil crisis levels, was designated structurally depressed under the law. As required by the law, a stabilization plan was drawn up in consultation between the government and industry calling for roughly a 35% cutback in production capacity. Individual firm scrapping volumes were developed in consultation between the industry, its associations and the government and were determined on the basis of firm production capacity. However, this scrapping effort proved insufficient to restore balance in supply and demand; the Ministry of Transport thus recommended that operating levels be adjusted to achieve production cutbacks. Consequently, participating companies formed an antirecession cartel in 1979 to facilitate the implementation of the scrapping program.<sup>9</sup>

However, cartels had to be approved by FTC in order to obtain exemption from the Antimonopoly Law. FTC would monitor the progress of a cartel and if prices recovered, it would refuse to grant the cartel an extension. The spinning industry, for example, formed a series of recession cartels to cut production and increase prices, but the one formed in 1981 lasted only 4 months because FTC determined that the position of the industry was improving.<sup>10</sup> Similarly, the shipbuilding cartel was scheduled to terminate in March 1982, but the Ministry of Transport did not expect FTC to approve an extension because the industry had succeeded in regaining 46.5% share of the world market, albeit at reduced absolute levels, by 1980.<sup>11</sup>

Once approved, cartel agreements were, in principle, enforceable as private contracts under Japanese law, but cartels also relied largely on voluntary cooperation of firms. Some cartel agreements provided for inspectors from industry associations to monitor compliance, and members who did not meet their obligations were required to pay a fine.<sup>12</sup>

In addition, in order to facilitate plans calling for scrapping of plant or equipment, the 1978 law authorized the establishment of a Guarantee Fund for depressed industries. The Japan Development Bank provided 80% of this fund, and the private banks provided the remaining 20%. Firms that scrapped their capacity in accordance with the stabilization program became qualified to borrow from commercial banks with a loan guarantee provided by the fund. These guarantees were considered necessary because long term loans normally required plant and equipment as collateral, which would hinder the companies' scrapping efforts. The guarantees substituted as collateral so that companies that wanted to destroy some plant and equipment could do so without jeopardizing their bank loans.<sup>13</sup> Of the 23 billion Yen in guarantees made by the end of 1981, almost 62% had been used by the shipbuilding industry alone.<sup>14</sup>

Finally, small- and medium-sized companies were allowed to form industry associations that purchased and then scrapped equipment and facilities. For example, in the synthetic fiber industry the joint scrapping effort was coordinated within the Japan Chemical Fibers Association. The Association had committees broken down by type of fiber, and each committee decided how much its member companies could scrap. These company-specific decisions were based on two major factors--the company's existing production capacity and its existing share in the domestic and international markets.<sup>15</sup>

**II. The 1978 Law for Specific Depressed Regions** was aimed at assisting the adjustment of small firms (mainly subcontractors or suppliers of parts and components to large firms) which were concentrated in specific regions badly affected by capacity and production reductions of large firms. The provisions of the law included emergency loans by government financial institutions to small firms in trouble. The law also provided incentives in the form of credits and subsidies to firms in the growth sectors to relocate or to build new plants in these depressed regions.<sup>16</sup>

In addition, a law for employment adjustment in the depressed regions was enacted in 1978. The provisions of this law will be discussed later in section D.

**III. The Smaller Enterprise Business Switchover Act** covering the period between 1976 and 1986 was quite different from the production capacity reduction approach of the 1978 laws described above. Its purpose was to aid troubled industries composed of small- and medium-sized enterprises by encouraging firms to move to a different industry in order to be able to provide continued employment for their workers. The difference between this law and the 1978 laws stemmed from the fact that the latter covered capital-intensive industries and thus focused on scrapping excess equipment while the Smaller Enterprise Business Switchover Act covered firms that produced a wide-variety of labor-intensive products subject to import competition from lower-wage Asian countries. Some of these industries included manufacturing of canned food products and saccharin, leather goods, footwear, fireworks, metal dinnerware, porcelain tiles and ornaments, rattan blinds, silk-yarn spinning and weaving, linen weaving, circular knitted fabrics and goods, embroidery lace, and agalomite mining.

Once a firm's plan for changing over to a new activity was approved by the local government, the firm would become entitled to: i) low interest loans from the central government's Small and Medium Enterprise Agency and from the local government, ii) special tax credits on new investments, iii) consulting services from the Small and Medium Enterprise Agency and the local government, iv) tax credits for merger with a firm in another line of activity, and v) grants for retraining workers to facilitate the move to another activity.<sup>16</sup>

**IV. The 1983 Law for Structural Adjustment of Specific Industries** replaced the 1978 legislation which expired in April 1983. On average, 95% of the scrapping targets had been achieved by then. However, the second oil shock and the weak Yen (which increased input costs) created additional problems for the depressed industries.

The new legislation consisted of the same criteria and procedures for designation of structurally depressed industries as in the 1978 Law for Stabilization of Specific Depressed Industries, but it differed from the 1978 law in several other respects. It was designed not only to eliminate excess capacity, but also to assist the development and application of new technology and investment. The coverage of the law was broadened to include both depressed and rising industries.

A major change from previous legislation was the provision for business tie-ups and contractual arrangements among firms in the same industry. These covered production, transportation, marketing agreements and mergers. MITI came up with the idea of business tie-ups with mainly the petrochemical industry in mind. Some of the producers in this industry were so small that reducing capacity would have meant closing them down altogether. MITI believed business tie-ups would result in more concentration in the industry and facilitate the required capacity reductions.<sup>18</sup>

Production tie-ups were intended to facilitate the exit of underutilized, high cost capacity by allowing a dozen or so producers to divide into three or four groups and concentrate production in the most efficient plants. Transportation tie-ups were intended to reduce cross-hauling by allowing the company nearest the customer to make delivery for sales made by other companies. The third type of tie-up involved the formation of a common selling agent for several companies to market their most competitive products. Business tie-ups were based on approval by FTC only if the combined market share of the companies was 25% or less. The objective of business tie-ups was to raise or at least stabilize prices by facilitating oligopolistic coordination. Higher prices, in turn, yielded the revenue to finance the costs of adjustment.<sup>19</sup> Many economists disagreed with business tie-ups, arguing that these arrangements could increase costs to the Japanese consumers in the long run by restraining competition. Nevertheless, the law was passed by the diet at MITI's insistence.<sup>20</sup>

The 1983 Law also provided for a broader range of financial assistance measures to encourage shift of resources from declining industries into more competitive activities. These measures included: i) low-interest loans from the Japan Development Bank for equipment investment, modernization and improvement; ii) extension of the Guarantee Fund for Depressed Industries to cover a wider range of industries and the easing of the conditions of the guarantee; iii) grants for construction of coal-fired thermal power plants to replace oil-fired plants; iv) grants for R&D to develop energy-conservation technologies; v) grants for R&D to develop new products and lower production costs; vi) accelerated depreciation for



modernization and capacity-reduction investment; and vii) reduction of fees for registration of mergers, investment in kind, and transfer of business, as well as for license tax and real estate acquisition tax.<sup>21</sup>

As with the 1978 laws, employment adjustment measures were provided for under a separate statute called the 1983 Law for Employment Assistance in Specific Industries. This law will be discussed in section D.

### **C. Government Leverage in the Implementation of Stabilization Plans**

As mentioned above, the 1978 and 1983 laws required that an industry voluntarily submit for designation as structurally depressed if it was characterized by excessive productive capacity and over half of the firms in the industry were experiencing financial difficulties. Although there were no legal requirements that forced firms to cooperate, once designated as structurally depressed they were implicitly obligated to work with the government to achieve a restructuring program. Similarly, there was an implicit understanding on the part of government to provide guidance and assistance to the industry in the adjustment process.

Specific industry plans developed under the 1978 and 1983 Laws were the result of extensive discussions and interactions between the industry concerned and the government. Consultative councils and the responsible ministry set the ground work for these interactions. Such councils typically consisted of representatives from the troubled industries, government, and other related industrial sectors. The councils recommended steps the industry needed to take in order to improve its position. On the basis of these recommendations, the responsible ministry would develop a basic stabilization plan for the industry. These stabilization plans provided for permanent production capacity cutbacks, or temporary adjustments in operating levels.

Much of the leverage that MITI and other agencies exerted over industry in the process of designation and during development of capacity-reduction plans stemmed from the pervasive practice of "administrative guidance". The government also used administrative guidance to encourage firms to comply with stabilization plans or to shift into different product lines. Administrative guidance occurred when government officials guided industries and firms in desired directions by informal means and without statutory authority. Ministries justified the practice by invoking the broad statutory mandate of the laws under which they were established, which called on the ministries to promote, regulate, and guide those industries under their jurisdiction. Ministerial officials would summon representatives of a firm, an industry, or the industry association to their offices and express their wishes or expectations. These may have been expressed in the form of a request, a recommendation, or advice.<sup>22</sup> Some of the power of this guidance came from close personal ties among government officials and the parties affected. Administrative guidance was therefore flexible and often involved negotiations to reach agreement on desirable actions.<sup>23</sup> Compliance was technically voluntary, but the officials would not hesitate to use the various carrots and sticks available to them. For example, MITI could place restrictions on new plant and equipment investment in the designated industries by withholding access to investment funds, it could hold up building permits, regulate raw material imports, and provide financial incentives to competitors.<sup>23</sup> In recent years, however, the effectiveness of both administrative guidance and the explicit instruments has declined as individual firms have established more solid financial positions.<sup>25</sup>

The other agents involved in the adjustment process were the powerful industry associations which embraced the major firms in each industry. They were far more than data-collecting and lobbying groups. They maintained a working relationship with MITI's industry bureaus and divisions. Officers of the associations sat on formal MITI advisory councils attached to the industry bureaus and put forward policy proposals for MITI policy toward an industry. Associations were, therefore, ideal intermediaries for MITI's attempts to impose direction on particular industries. They were authoritative representatives of the industry on whom the acceptability of the proposed stabilization measures were tested, and they acted as the channels for administrative guidance and for the organization of recession cartels.<sup>26</sup>

Despite a generally constructive working relationship, industry and the government sometimes failed to agree on certain issues. Proposed stabilization plans were occasionally a source of conflict between the government and industry.

One major issue that resulted in conflicts was that Japan's larger firms were expected to carry out production capacity cutbacks without government assistance. This practice was based on the government perception that since major industrial companies were highly diversified and engaged in a number of economic activities, they were financially capable of handling the adjustment process on their own and could shift resources into other industrial activities within their own companies. The only government contribution was essentially to exempt these large companies from the Antimonopoly Law while they were carrying out joint scrapping activities (see Box 1 for the shipbuilding industry example).

In addition to difficulties in agreements on who should cut back and where, in some instances the government found it politically difficult to declare that an industry, or segments of an industry, should be phased out and had to settle for less than what it would consider optimal restructuring. One example in the shipbuilding industry was when the government had essentially determined that Sasebo Heavy Industries should be allowed to go bankrupt and close its doors. Although the government regarded this an economically rational decision, the intervention of the Prime Minister forced the government to reassess its position and bail the firm out of its economic troubles. It was noted that since Sasebo was a major employer in the region, its bankruptcy would have caused severe social, political, and economic problems in the area and employees would find it difficult to move into other activities in that region.<sup>27</sup>

#### **D. Employment Adjustment Programs**

Both the government and the private sector took action to facilitate the labor adjustment process. The government passed several laws that provided subsidies to assist the firms with the costs of employment adjustment. Firms--particularly large firms--in the declining industries carried most of the burdens of financing and administering the employment adjustment process. Assisted in part by government subsidies, firms made substantial efforts to retrain and relocate their workers or to provide inducements for early retirement.

**Box 1: The Stabilization Plan for the Shipbuilding Industry**

In the shipbuilding industry, disagreements occurred regarding how the industry stabilization plan should be carried out and who should bear the burden of capacity reductions. The government wanted to see the large companies cut capacity and many of the small companies close down. The small companies wanted the large ones to take all the cuts because they claimed the larger firms could afford to bear a greater portion of the burden, while the larger firms felt all should suffer equally. Companies that had recently invested in up-to-date berths from which they expected to gain comparative advantage wanted special exemptions (berth is the area where a ship rests when at anchor or at a wharf). All companies wanted government assistance in the form of subsidies to pay for early retirement of workers, government procurement programs, schemes to supply ships as foreign aid, as well as restoration of the earlier investment rate subsidies for purchase of ships by domestic and foreign shipping companies.

Even among the larger shipbuilders themselves, disagreements existed as to the appropriate mix of capacity reductions. In particular, it was difficult to reach a consensus because the plan called for the seven major companies (Mitsubishi, IHI, Kawasaki, Hitachi, Mitsui, Sumimoto, and Nippon Kokan) to become guarantors of government loans to small- and medium-sized firms in the industry and to help in the loan repayments, even though these seven would receive no government assistance other than exemption from the Antimonopoly Law for the formation of recession cartels. The major shipbuilding companies therefore raised objections to helping repay or guarantee loans which they were not entitled to receive (USGAO, 1982b, p. 62).

However, agreements were finally reached because shipbuilding had always been a closely regulated industry and the Ministry of Transport used its legal authority as leverage. Under the Shipbuilding Act of 1950, the Ministry had been authorized to issue permits to shipbuilding companies for the expansion of production facilities, and these companies were required to report to the Ministry the manufacture of all vessels above 2,500 tons. Although these measures were originally introduced to enable the Ministry of Transport to regulate new entries into the shipbuilding industry, they now appeared to give the Ministry the power to enforce the rationalization plan (USGAO, 1982a, p. 73).

The Ministry of Transport laid down the goal of a 35% cut in total capacity after lengthy consultations with individual firms, the Shipbuilder's Association of Japan, the Cooperative Association of Japan Shipbuilders, and the Shipping and Shipbuilding Industries Rationalization Council, the Ministry's advisory body. The capacity cutbacks were determined based on the size of shipbuilders. All the 61 surviving firms participated. The cut backs in terms of percentage of total cutbacks were as follows: the 7 major firms cut 40%, 17 semi-major firms cut 30%, 16 medium-sized firms cut 27%, and 21 small firms cut 15% (USGAO, 1982b, pp. 62-63).

The government assisted the smaller firms but not the seven major shipbuilders. The government felt that the large companies were diversified and would be financially capable of handling the cutbacks themselves and of shifting resources into other industrial activities within their own companies. For smaller firms that were to cut back, the Ministry of Transport set up the Designated Shipbuilding Enterprises Association responsible for purchasing facilities and equipment from shipbuilders and also for selling these items. The money received through the resale of land and equipment was used to help repay the bank loans. The remainder of the loan was provided by all of the companies involved in the cut backs, including the seven major companies. To ensure repayment, all shipbuilders were required to place 1.3% of the contract price of each new vessel into a fund administered by the Shipbuilding Enterprises Association (USGAO, 1982b, pp. 62-63). By and large, the newest shipyards kept going while the older ones were scrapped or idled. Many were converted to other uses. For example, one of Mitsubishi Heavy Industries' five shipyards started making offshore rigs, while another was made into a repair yard (Boyer, p. 60).

## **I. Ministry of Labor Employment Adjustment Programs**

To provide employment adjustment to workers in industries for which the government recommended production capacity cutbacks, the Law for Employment Adjustment in Specific Depressed Industries was enacted in 1978. A second law, the Law for Employment Adjustment in Specific Depressed Regions also was passed to ease the impact in areas where depressed industries such as shipbuilding were important regional employers. The 1978 laws expired in 1983, but were replaced by the Law for Employment Assistance in Specific Industries which covered the period 1983 to 1988. These laws provided the framework for government assistance to displaced workers in depressed industries and were administered by the Ministry of Labor. The Ministry of Labor worked with the ministry responsible for the industry or region designated as structurally depressed to ensure that employment adjustment was available to complement industrial and regional adjustment. In general unemployed workers received unemployment insurance, retraining and job-hunting allowances. Unemployed workers from structurally depressed districts or industries were entitled to extended unemployment benefits, higher retraining allowances and priority treatment in job-hunting under the 1978 and 1983 laws.<sup>28</sup>

a. **The 1978 Law for Employment Adjustment in Specific Depressed Industries** provided for significant subsidies to assist all firms in relocating, retraining, or retiring workers made redundant by capacity reductions. These payments were made directly to firms and not to workers.

One provision of the law was that the Ministry of Labor reimbursed firms for relocating and retraining permanent employees of firms in designated depressed industries. The subsidy amounted to as much as full salary for six months if the government determined that a worker's new employment could be regarded as training.

Another category of subsidy covered special allowances related to early retirement. Employees retired between the ages of 55 and 60 usually received lump-sum bonuses of three or four times their annual wages, rather than a continuing pension. Permanent discharges in depressed industries tended to be concentrated among older employees, and they received both a regular retirement bonus and an extra bonus for early discharge. The Ministry of Labor financed a fraction of the cost of the early retirement bonus (but not the regular retirement bonus).

A third category of subsidy was for temporary layoffs, provided by the Employment Insurance Act of 1975. Under the system of permanent employment, large firms typically paid as much as 85% of a worker's salary during layoffs. The 1978 law enabled the Ministry of Labor to cover half of these payments for large firms in trouble, and two thirds for small- and medium-sized firms.<sup>29</sup>

In order to enforce the law, enterprises which reduced employment more than a certain amount in the specified industries were required by the Ministry of Labor to declare their plans, including the proposed assistance for the displaced workers in finding new jobs. Once the Employment Security Agency accepted the plan as reasonable, it issued a special identity card. A job seeker who held this card was entitled to receive extended payments of unemployment insurance, vocational training, and services necessary for reemployment.<sup>30</sup>

**b. The 1978 Law for Employment Adjustment in Specific Depressed Regions** was the regional version of the aforementioned legislation. Under this law, the Ministry of Labor designated 44 regions where both employers and employees were qualified to receive employment adjustment assistance.<sup>31</sup>

In addition to subsidies given to firms for retraining and relocating displaced workers, the above legislation provided direct protection for workers with at least one year of employment in a depressed industry. Such workers were eligible for 12 months of unemployment compensation, paid directly to them by the Ministry of Labor. This law was different from the 1978 Law for Employment Adjustment in Specific Depressed Industries in that the latter provided subsidies only to the firms. The 1978 Law for Employment Adjustment in Specific Depressed Regions was very important to workers in small firms because such firms were not only not unionized but lacked the established systems of permanent employment of large firms.<sup>32</sup>

Also, under this law, additional public works projects were undertaken in the depressed regions and it was stipulated that at least 40% of the workers on these projects should be displaced workers from the designated region.<sup>33</sup>

**c. The 1983 Law for Employment Assistance in Specific Industries** was formed by merging the two 1978 laws for Employment Adjustment. The new law put a stronger emphasis on preventing unemployment. The law stated that firms that planned to displace workers were to be subsidized at two thirds of the wage bill for six months (three quarters in the case of small and medium sized firms) on the condition that the firm extended six month's retraining for those they planned to displace. In addition, firms that employed displaced workers were qualified to receive an employment subsidy of one quarter (one third for small firms) of the wage bill for a year.<sup>34</sup>

## **II. Private Sector Employment Adjustment Efforts**

Finding other employment for workers and retraining them have been crucial to the entire process of industrial adjustment in Japan. Depressed industries demonstrated that private industry had the initiative, ability, and flexibility to make large-scale employment adjustments.

Despite the subsidies provided by the Ministry of Labor, large firms in declining industries paid substantial amounts for layoffs, relocation, and early retirement.<sup>35</sup> Government programs were therefore augmented by those of large firms, in contrast to the practice in Western Europe and the United States where governments have tended to take exclusive responsibility for unemployment compensation programs and retraining and relocation schemes. In the context of the "Japanese lifetime employment system" and implicit contracts with labor unions within the companies, large firms had a continuing obligation to support or compensate laid-off or discharged workers.<sup>36</sup> Consequently firms were highly motivated to make the necessary adjustment without laying off regular employees (see Box 2).

**Box 2: The Japanese Life-time Employment System**

The life-time employment of large Japanese companies has traditionally meant employment until retirement. Under the life-time employment system, a large part of regular employees in large and medium size enterprises work there for almost their entire working life. Regular workers constitute 80-90% of total employees in these firms, but this percentage declines as the size of the firms diminishes. Regular workers normally retire at the age of 55 or 60 with a retirement bonus, but re-enter the labor market after retirement and stay in the labor force until they are eligible for social security at 65.

However, life-time employment with the same firm is not automatically guaranteed. For example, if an employee does not exhibit continual progress, he or she may be separated in mid- to late-career, although an honorable exit is usually arranged by the employing firm by posting the employee in a less promising job at a subsidiary or other related firm. But actual dismissal as a disciplinary measure seldom needs to be observed insofar as a credible threat of discharge for unsatisfactory performance exists. Also, the potential loss of seniority and of retirement compensation discourages the mid-career exit of trained employees. As a result, the duration of employment tends to be relatively long for Japanese workers (Aoki, p. 12). Also, most large Japanese companies hire numerous classes of workers in addition to regular workers, including part-time, temporary workers, and subcontractors. Although the regular workers constitute up to 90% of the work force of large Japanese companies, the non-regular workers provide a sizeable number of workers that can be laid off in the event of a substantial decline in production (Saxonhouse, p. 409).

In general, the maintenance of an employment relationship has been of great value to the Japanese. For this reason, if a reduction of labor is unavoidable as in the case of declining industries, it must be done as much as possible without disrupting the employment relationship. Thus measures which by definition involve the termination of an employment relationship like voluntary resignations solicited by the employer must be compensated for by generous financial settlements. When the employer solicits a resignation, he is seen to be transgressing the implicit right of a regular worker to work until retirement implied in the notion of "lifetime employment". Thus, the lump-sum severance payment for such resignations carries the price for the breach of trust in addition to the pro-rated retirement lump-sum to take account of the shortened length of service. In principle, when the implicit rights and obligations are not honored, the adversely affected worker may sue his employer in court and the employer could be penalized if he fails to establish that he had exhausted all painless means of employment adjustment before he resorted to request for resignations (Dore and Taira, p. 71). The managing director of Mitsui Petrochemical Industries, for example, was quoted in 1983 as saying "the reason we are making great efforts to restructure is to preserve the permanent employment system that has fueled Japan's success" (Boyer, p. 60).

The life-time employment system also has supported extensive investment in training and education by Japanese firms, thus increasing the flexibility of employment within a company (Nagaoka, p. 11). Training programs are structured such that they not only develop the level of a worker's skills but also increase the worker's knowledge and awareness of the company. The initial training period for the regular workers includes an intensive introduction to the company's organization, product lines, production technology, and nature of the competition. The purpose of such an extensive orientation is to make workers fully aware of their role in the company and the mutual responsibilities of employers and employees. On the shop floor, this emphasis is supported by the systematic rotation of workers among a variety of jobs within the company. Promotions are based on improvements in skill levels and on experience and ability in performing a variety of jobs at each level. The amount and type of training given to workers depends upon the expected tenure of the workers with the company. Regular workers, for example, are trained and exposed to all phases of the company's operations throughout their careers, while the part-time workers, temporary workers, and workers who have been trained at other companies are placed in far less intensive training programs. These training programs increase the flexibility and reduce the cost of transferring regular workers among jobs should adjustment be required (Orr, pp. 409-410).

Before firing workers, one of the measures taken was a reorganization of the managerial structure, consolidating units or sections, knocking out some steps from the ladder of promotions, or eliminating the luxury of nonfunctional status rewards like associates, deputies and senior members. The next measure was a cut in salaries and bonuses, including a reduction in executives' and managerial salaries.<sup>37</sup> Management pay cuts came in handy tactically when management negotiated wage reductions with unions. Managers also reduced overtime, stopped hiring new workers, and laid off part-time workers. If they felt that was not enough, managers would urge early retirement with additional retirement pay. Finally, if worse came to worse, managers encouraged voluntary retirement whereby younger workers who had expressed a willingness to leave were offered substantial severance pay and placement assistance.<sup>38</sup>

Japanese firms also took primary responsibility for retraining and shifting their workers into other industrial activities when necessary. Workers retrained for new jobs either at the company's own facility (if the firm was large enough) or at one of the hundreds of government centers around the country (if the firm was smaller). Large firms in depressed industries were successful in transferring workers internally to healthier divisions within the firm and loaned or placed their excess workers externally with a subsidiary company, an affiliate within the industrial group, to the firm of a supplier or customer, or to a firm involved in an entirely different industrial activity. However, the mechanism of relocation was less successful in industries with small firms or in ones where group membership was less prevalent.<sup>39</sup>

The following are examples of several firms that were successful in relocating their displaced workers. In the mid-1970's, Japan Steel lent some of its surplus workers on rotation to Isuzu Motors--several thousands for a year at a time. The workers kept their Japan Steel wage and status, and Isuzu paid Japan Steel a lump sum for their services. In aluminum refining, all six primary producers were members of a large group. Aluminum refining had 15,000 workers in 1975 and about 4,000 in 1983. About half of the workers who left the industry were reemployed by affiliated companies. Between March and September 1979, Mitsui, one of the major shipbuilders at the time, laid off 2400 employees. Of those, 300 were lent to nearby Toyota plants which were thriving at the time.<sup>40</sup> Because workers were forced to take pay cuts in the transfer, Mitsui made up the difference. Another 400 workers were shipped off to other Mitsui subsidiaries, while the rest took early or voluntary retirement.<sup>41</sup>

The experience of IHI, one of the other major shipbuilding companies, is another illustration of how one such company dealt with its excess workers. When the shipbuilding industry went into recession, about 4,600 workers left IHI voluntarily. In addition, a mandatory early retirement program was established for workers 55 to 59 years of age. Once these workers left, the company was able to draw up a plan to determine how many workers should be shifted into other production groups within the company. IHI retrained some workers to build jet engines while other workers were shifted into the company's nuclear power division. The company also arranged the transfer of 500 workers to an auto plant north of Tokyo during the height of the recession between 1977 and 1979. In general, growth industries were able to absorb excess workers from depressed industries. For example, the arrangement between IHI and the auto plant was possible because at the time the Japanese auto industry was growing rapidly and the auto company welcomed the additional workers. According to IHI, all of the workers loaned to the auto company returned to IHI eventually, but not to its shipbuilding division.<sup>42</sup>

Excess textile workers also were absorbed by growth industries. A typical example is the case of the cotton spinning segment of the industry. In the mid-1970's, spinning workers in Nagoya, the city most affected by the industry's decline, were able to find jobs at a nearby auto plant.<sup>43</sup>

In Japan, the practice of contracting out part of the production work to smaller firms and the existence of a large percentage of women employees who were not regular or permanent employees in the work force were the two major characteristics of the shipbuilding and textile industries, respectively. These characteristics allowed firms greater flexibility in reducing employment than a labor force composed entirely of regular employees would have permitted.<sup>44</sup>

There were several advantages to the Japanese system of employment adjustment. One advantage was that the firms had a strong incentive to retrain or relocate a worker because as mentioned before firms had to pay a large portion of the laid off workers' discharge payments even after government subsidies. If there was a small chance that the worker would be needed in the future, the firm had a strong incentive to retrain or relocate the worker. Also, firms would have more information about a specific worker's potential and prospects for reemployment than public employment agencies. Due to higher wages, greater employment security, and more extensive fringe benefits, competition for jobs in the large firms was keen and most of the hiring was limited to young workers who were paid entry level wages. While large firms had the contacts and the influence to place their discharged workers with other large firms such as directly affiliated firms or other firms in their business group, public employment agencies had a hard time placing discharged workers, especially older workers, in large firms. Large Japanese firms also had some incentive to find good jobs for redundant employees because the labor unions monitored these placements. A poor record could result in demands for higher discharge payments in the next round of labor negotiations. Finally, because firms in a business group had similar wage scales, finding jobs for discharged workers at comparable wages spared some of Japan's declining industries of the social problems experienced by the unemployed workers in the U.S. automobile and steel industries who normally have not been able to find jobs with comparable wages and benefits to the ones they have lost.<sup>45</sup>

#### **E. Other Types of Government Assistance**

**I. Efforts to Increase Demand.** The government also took measures to increase demand for products in declining industries. For example, the restructuring plan for the shipbuilding industry called for increasing demand for Japanese vessels as well as reducing existing production capacity. It included the following actions by the government: i) construction of 3 million gross tons of new commercial shipping under a 3 year shipbuilding program; ii) provision of funds for a portion of the construction cost of each new vessel through long term loans at low interest rates and the payment of a portion of the interest payment on loans; iii) acceleration of the replacement schedule for government owned vessels; iv) extension of Japan's territorial limits to 200 nautical miles which increased the government demand for patrol vessels; and v) introduction of a program funded by the government and the private sector to encourage the scrapping of existing ships through the Ship Disposal and Scrapping Promotion Association, providing subsidies for the disposal of ships at 2,500 gross tons or above.<sup>46</sup>



**II. Protection from Import Competition.<sup>47</sup>** There is no adequate evidence to support the notion that trade barriers have been a major form of government assistance in the designated depressed industries. The 1978 laws made no formal provisions for protection from import competition and there were no increases in tariffs. Also, Japan did not introduce trade barriers such as voluntary export restraints. One of the objectives of formation of cartels under the 1973 law was to achieve a degree of price stability that may not have been possible under unrestrained competition in the presence of substantial excess capacity. Many observers, especially in the United States, argued that the objective of price stability was not compatible with import liberalization, and therefore suspected that the Japanese structural adjustment policies were accompanied by disguised protectionist measures.

Data on imports as a share of Japanese consumption for some of the depressed industries show that trade barriers could not have been very important in the ferrosilicon and aluminum industries because import penetration actually increased dramatically between 1978 and 1983 in these industries. In the phosphoric acid industry, high transportation costs were the main reason for low import penetration and not informal trade barriers. Also, trade barriers were not a major source of protection for the electric-furnace steel industry because most of the competition came from domestic steel produced by conventional blast furnaces. Imports remained a small share of Japanese consumption throughout the period covered by the 1978 law in the synthetic fiber industries, but the industry remained competitive in international markets and exports continued to account for a large share of the Japanese production. Domestic prices actually fell slightly relative to world prices.

However, import protection measures may have been a feature of the chemical-fertilizer industries, characterized by very low import penetration. The urea industry, for example, experienced no import penetration, despite a substantial increase in domestic prices since the mid-1970's. In 1983, the average domestic price of urea at the factory was \$228 per metric ton. To maintain some level of exports, the Japanese export price averaged \$195 per metric ton. At the same time, landed U.S. producers' prices in Japan were \$145 per metric ton, but they could not gain a substantial share of the Japanese market. As a result urea became the focus of the U.S. criticism of the Japanese trade policy. U.S. officials argued that price discrepancies in urea were too large to support any conclusion other than that the imports had been restricted.

Although the 1978 legislation did not directly promote or condone the adoption of trade barriers, it is possible that in the process of coordinating capacity reductions, both industry and MITI officials may have inclined to the view that sharp increases in imports would be disruptive to the stabilization programs and therefore indirectly reinforced tendencies favoring the imposition of informal trade barriers.

#### **F. Other Adjustment Measures Taken by the Industry**

In general, there was a willingness on the part of companies to undertake large-scale rationalization investments in order to lower costs. For example, the iron and steel industry reacted to the slow growth of demand and high energy costs by switching to continuous casting methods. In addition, they shifted to higher value specialty steels.<sup>48</sup>

Also, willingness was shown by many large and small enterprises to diversify their activities. In response to the changing demand structure and technological progress, many businesses diversified downstream and into other related areas. The main examples were firms producing nonferrous metals and cement who switched to production of new materials such as fine ceramics, and the iron and steel industries who started producing robots.<sup>49</sup>

IHI and Kawasaki Heavy Industries were among some of the shipbuilding companies that branched out into new fields of business. IHI, for example, set up two departments in July 1986 to study possible new operations, including some in the service industry. The company included various new lines of business in its articles of incorporation, such as real estate, the management of sports, leisure facilities and hotels, the marketing of apparel, furniture, pharmaceuticals, cosmetics and cars, and a temporary manpower service. Kawasaki Heavy Industries established a factory automation center to integrate its high-tech operations, including industrial robots and electrical systems and also got involved in domestic infrastructure development projects and the leisure industry.<sup>50</sup>

#### **G. The Impact of Industrial Policy in Declining Sectors**

What makes Japan different from other industrial countries is that its comprehensive policy for helping the declining industries allowed these industries to settle into gentle rather than convulsive decline. Government, business and labor worked together to shift resources out of the ailing sectors of the economy into the healthy ones with relatively little pain. Although the adjustment was carried out mainly by the private sector, industrial policy ensured the restructuring and elimination of capacity in an orderly manner by encouraging cooperation between firms in depressed industries.

In the 1970's government assistance was oriented towards promoting the reallocation of resources and much larger assistance was extended to employment adjustment and aid to small firms. Employment adjustment assistance worked to the extent that those who received subsidies were often re-employed in similar activities. After 1983, adjustment assistance policy moved towards more active intervention to promote innovation, not only in new areas but also in industries in which firms were already engaged.

#### **I. Success Rate in Achieving Capacity Reduction Targets**

Overall, the capacity-reduction process worked well, and most of the industries designated under the 1978 law met the targets for capacity reduction specified in their basic stabilization plans. Several industries shed substantially more capacity than planned in anticipation that their industry's international competitiveness would continue to decline. The synthetic-fiber industries scrapped less than planned because of an increase in the worldwide demand for synthetic fiber. One exception was the electric-furnace steel industry. Fearful of losing their market shares, some of the more aggressive producers consistently avoided capacity reduction. If they owned two or more furnaces, they either shut down one while expanding capacity in the others, or they replaced old furnaces with new ones. The most unyielding company of all was the leading producer Tokyo Steel Manufacturing which accounted for 10% of industry sales. The company disagreed with the view of the industry association and MITI that the industry had lost its competitiveness. Although the industry's

stabilization plan called for reduction in capacity, it permitted investment to upgrade the production process. Consequently, Tokyo Steel and a few other firms undertook an aggressive modernization program that ultimately led to an increase in capacity.<sup>51</sup>

In general, capacity reductions appear to have been accomplished largely by means of planned allocation of capacity reductions in the concentrated industries and the exit of small firms in the unconcentrated industries. For example, more than 20% of all firms exited from ammonia, ferrosilicon, shipbuilding, phosphoric acid, wool, and cotton industries, with exit concentrated among the smallest firms.<sup>52</sup>

## **II. Success Rate in Reallocation of Discharged Labor**

According to the FTC, 39,000 jobs were lost in the designated industries, excluding shipbuilding, in 1978. A study by the United States General Accounting Office reports that in 1978 there were about 21,000 workers on the unemployment-compensation roll who had been continually employed in a designated industry (other than shipbuilding) for at least a year prior to being discharged.<sup>53</sup> This suggests that perhaps half of the workers found other employment without showing up on the unemployment-compensation rolls.

In the shipbuilding industry, 27,000 jobs were lost in 1978, of which 25,000 were on the unemployment rolls, indicating that most did not move directly to new jobs. The reemployment of shipyard employees was difficult because of the large numbers involved and the geographic distance of some shipbuilding locations from major metropolitan areas. In addition, shipbuilding was a large local employer in several areas. Thus, unemployment in shipbuilding led to additional unemployment in local supply and service industries, aggravating the problems of shipyard workers in finding other employment.<sup>54</sup>

On the whole, the magnitude of unemployment problem associated with depressed industries was not severe. Unemployment peaked in 1978, with 47,000 workers on the unemployment-compensation roll, representing only 5% of the total number of workers who received unemployment compensation in 1978. By 1979, that figure declined to 19,000.<sup>55</sup>

It is not certain whether the moderation of the unemployment problems in the depressed industries can be entirely attributed to the 1978 legislation. First, it is possible that some workers withdrew from the labor force. For example, in two industries (wool and cotton spinning), 71% of the workers were women who often left the labor force once they were discharged. Also, the low economy-wide rate of unemployment made reemployment more likely.<sup>56</sup>

**ENDNOTES TO ANNEX 1**

1. Peck, Levin, and Goto, p. 199.
2. Saxonhouse, pp. 299-302.
3. Peck, Levin, and Goto, p. 199.
4. Mothballing refers to the process of dismantling equipment for possible future use.
5. Peck, Levin, and Goto, p. 210.
6. Ibid., p. 199.
7. USGAO, 1982a, p. 68.
8. Boyer, p. 58.
9. USGAO, 1982a, pp. 70-71.
10. USGAO, 1982b, p. 51.
11. USGAO, 1982a, p. 71.
12. Peck, Levin, and Goto, p. 200.
13. Boyer, p. 60.
14. USGAO, 1982b, p. 64.
15. Ibid., p. 53.
16. Sekiguchi and Horiuchi, p. 384.
17. Peck, Levin, and Goto, pp. 206-207.
18. Boyer, p. 63.
19. Peck, Levin, and Goto, p. 234.
20. Sekiguchi and Horiuchi, p. 386.

21. Peck, Levin, and Goto, p. 233.
22. Magaziner and Hout, p. 41.
23. Pugel, p. 423.
24. Magaziner and Hout, p. 41.
25. Pugel, p. 424.
26. Dore, p. 99.
27. USGAO, 1982a, p. 71.
28. Ibid., p. 69.
29. Peck, Levin, and Goto, p. 204.
30. Sekiguchi and Horiuchi, p. 384.
31. Ibid., p. 385.
32. Peck, Levin, and Goto, p. 206.
33. Sekiguchi and Horiuchi, p. 385.
34. Ibid., p. 386.
35. One of the rationales for cartelization is to provide the revenue for these payments.
36. Peck, Levin, and Goto, p. 235.
37. The high degree of flexibility in employment shown by Japanese companies is facilitated by flexibility in wages. Wages are revised annually and reflect current business conditions. Declines in demand can be accommodated relatively quickly by lowering labor costs rather than by reducing employment. The semiannual bonus system whereby workers are rewarded on the basis of the profitability of the company is an additional source of flexibility in relating labor costs to changes in the market conditions. Furthermore, wage rates and wage structures are specific to each company and reflect the economic situation of that company, not conditions throughout the industry. Workers are organized into company unions, and wage bargaining occurs between the company and the union (Orr, p. 411).
38. Boyer, p. 60.

39. Ibid.
40. Toyota and Mitsui had swapped favors over the years going as far back as the 19th century when Toyota started out as a textile-machinery company and Mitsui backed the new enterprise with some money.
41. Boyer, p. 60.
42. USGAO, 1982a, p. 75.
43. USGAO, 1982b, p. 55.
44. Ibid, pp. 75-76.
45. Peck, Levin, and Goto, pp. 205-206.
46. USGAO, 1982b, p. 64.
47. This section is mainly drawn from Peck, Levin, and Goto, pp. 226-230.
48. OECD, 1985, p. 70.
49. Ibid.
50. Imanishi, p. 16.
51. Peck, Levin, and Goto, pp. 212-213.
52. Ibid., pp. 213-215.
53. USGAO, 1982a, p. 67.
54. Peck, Levin, and Goto, pp. 215-217.
55. Ibid.
56. Ibid.

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## **THE UNITED KINGDOM**

### **A. Overview**

Several initiatives have been taken at the industry level over the last two decades to assist the process of industrial restructuring. These attempts have usually been directed both at initiating or accelerating the process of restructuring, and at influencing the form or direction of such adjustment--i.e., they have been concerned with both the speed and the quality of restructuring. All of these attempts have involved some role for the government which may be grouped as follows:

- (i) The work of the Industrial Reorganization Corporation (IRC) over 1966-71. IRC was a government-funded institution that was set up with the specific task of promoting industrial reorganization through mergers.
- (ii) The sectoral rationalization schemes promulgated under the 1972 Industry Act.
- (iii) Schemes, such as the Lazards Scheme to rationalize the steel castings sector and other selective assistance to declining industries.

In addition to the above, the government also has pursued regional policies that have been mainly concentrated in areas with declining industries and housing policies that have been aimed at increasing the mobility of labor.

The restructuring of declining industries has basically involved capacity reduction and labor shedding by firms. The process of employment adjustment has been one of collective bargaining among employers and trade unions on a firm by firm basis.

The next section reviews the role of the government in industrial restructuring, and section C discusses the Redundancy Payment Act of 1965 and provides examples of employment adjustment at the firm level.

### **B. Government Assistance Programs**

Since the 1960's, the government has assisted with the industrial restructuring of declining sectors through several means including the Industrial Reconstruction Corporation founded in 1966, the Industry Act of 1972, a series of ad hoc measures to help various industries in trouble, and regional and housing policies focused in areas affected by declining industries.

#### **I. The Industrial Reorganization Corporation**

The IRC was set up in 1966 as a publicly funded organization but with a high degree of independence from government, with the object of promoting mergers where there was a scope for exploiting economies of

scale and achieving a more rational use of resources. It was not intended to be a state holding company. In practice, it achieved most of its results through advice and persuasion, using the offer of financial assistance as an incentive. The IRC was closed down in 1970 but proved to be quite active in its short life, being involved in over 70 mergers or reorganizations. Its principal contribution was as a catalyst to reorganization and in securing the services of appropriate top managers for the reorganized businesses. Provision of finance was of secondary importance--partly because the backing of the IRC would tend to improve the company's access to the market anyway--but was useful as a means of securing the cooperation of target companies. The IRC is generally credited with having rescued the UK ball-bearing industry and having successfully reorganized the mining machinery sector and parts of the electrical and electronics sectors. Among its other most famous interventions were the creation of British Leyland and the backing of the General Electric Company (GEC) takeover of associated Electrical Industries (AEI), to form, in GEC, the largest and strongest group of electrical engineering and electronics. It also showed some preference for nationalist solutions, backing British companies in the face of possible foreign takeovers. For example, in ball-bearings it created Ransom Hoffman Pollard as a means of preventing the Swedish firm SKF from taking over Ransom.<sup>1</sup> Although IRC is seen as having executed its objectives with great efficiency, doubts have been raised as to whether the emphasis on mergers as the sole solution to industrial restructuring needs was justified.<sup>2</sup>

## **II. 1972 Industry Act Schemes**

The principal schemes of industrial restructuring were: (i) the Cotton Industry Scheme (1959-64), (ii) the Wool Textile Scheme (1973-79), and (iii) the Clothing Industry Scheme (1975-79).

The objective of the schemes was to modernize and restructure these traditional industries in order to meet the growing challenge of international competition. These schemes were aimed at the scrapping of obsolete plant and machinery and their replacement by more up-to-date equipment. A net reduction in overall capacity and the rationalization of production in fewer larger units frequently featured as additional objectives. The schemes involved a set of incentives in the form of interest relief grants and low interest loans under different headings, such as equipment scrapping, plant closure, compensation for redundancies and reinvestment. Participation in schemes was voluntary, but assistance was usually automatic if the criteria were met. In most cases, firms could qualify for assistance under one heading independently of whether they took action under another.

Assessments of the results of these schemes suggest that they were all successful in meeting some of their objectives. The scrapping and redundancy incentives under the Cotton Industry Scheme led to a reduction in the number of firms in the industry; however, there was little participation in the re-equipment measures. The main result was therefore an acceleration of the rate of contraction rather than the achievement of restructuring as a basis for survival. The Wool Textile Scheme also is judged to have accelerated the rate of capacity reduction, both through firm withdrawals and through plant closures of continuing firms (some 10% of establishments were closed between 1973-75). But the greater emphasis on re-equipment assistance brought about a sharp increase in modern plant and buildings which allowed the sector to widen its markets and compete in higher quality markets particularly in the export field. Under the

clothing Industry Scheme, the results were less dramatic; but the scheme brought about some rationalization of production and of warehousing within companies.

However, an important objective of all these schemes had been to alter the fragmented structure of these industries by eliminating the weaker, smaller firms, and promoting mergers. This was motivated by the concern that financial weakness would restrict the ability of firms to undertake the necessary strategic investments to meet the pressures of international competition, as well as by a presumption that substantial unexploited economies of scales existed in the production and marketing spheres. In practice, the schemes were unsuccessful in these respects. In many cases, the principal form of rationalization occurred within firms through plant closures. Among firms that did withdraw, there was no clear predominance of small, less efficient firms. In addition, there was an almost total absence of mergers resulting from these schemes. Several reasons have been given for the failure of these schemes to encourage restructuring around a smaller number of larger, more efficient and financially more stable firms:

- Unwillingness of smaller firms to exit may have been related to a lack of employment opportunities for owners, managers and workers in the remote locations in which these firms were situated.
- The scope for economies of scale in production were overestimated.
- There was an insufficient number of larger firms with the necessary management expertise and financial strength to initiate mergers.
- The incentives for profitable firms to rationalize were reduced since grants were netted out from capital allowances for corporation tax purposes.<sup>3</sup>

### **III. Selective Assistance to Declining Industries**

Besides rationalization sponsored by the IRC and the Industrial Act Schemes, a number of industries posed sufficiently intractable problems during the 1960's-80's to be seen as meriting special treatment.

#### **a. The Shipbuilding Industry**

One such industry was shipbuilding which had become a declining industry with substantial regional concentration. Even by 1960, the United Kingdom's share of what was then a growing market was declining. The shipbuilding Industry Board was established in 1966 to bring about reorganization, and special credit terms were made available to ailing firms; but by the end of the decade a number of the reorganized yards were still in trouble. Most of the aid injected into the industry between 1965-66 and 1973-74 went to Upper Clyde Shipbuilders, Harland and Wolff (in Northern Ireland) and Cammell Laird (on Merseyside). The main motivation for the provision of aid was undoubtedly the avoidance of unemployment. In spite of the call for increased productivity in successive reports on the industry, both productivity and employment remained stable after 1970 when the relatively substantial injection of government funds had begun.<sup>4</sup> British Shipbuilders (BS)

was formed after the nationalization of the industry by the labor government in 1977. At that time, BS was made up of 32 subsidiaries covering 70 manufacturing sites, including merchant and warship building and a range of related activities, and employing 87,000 people. Only the specialist warship building yards were profitable. Subsequently world demand for new merchant ships remained low, and shipbuilders in many countries made substantial financial losses. By March 1987, following several rationalization programs, closures and the 1986 privatization of warship yards, employment at BS had fallen to 6500. Between 1977 and 1987, over 47,000 employees were declared redundant, and many yards and related facilities were closed or sold out. Against this background BS negotiated a number of major national agreements with the trade unions aimed at improving labor productivity, covering such issues as mobility of employees, flexibility within and between occupational groups, and the greater use of both fixed-term contract labor and subcontracting.<sup>5</sup> Section C reviews the process of employment adjustment by BS in more detail.

#### **b. The Steel Castings Industry**

Another industry that received government assistance was the steel castings industry. In 1975, there were about 60 firms in the UK steel castings industry, operating about 90 plants. The largest four firms (each with multiple plants) accounted for almost half of total industry output.<sup>6</sup> Over the period 1975-81, demand for steel castings fell rapidly and 10% of the industry's capacity was closed. Much of the labor force in the industry was skilled and long serving, and therefore qualified for substantial redundancy payments, estimated at up to six months salary after allowing for government subsidies. Nevertheless, the labor force was reduced quickly in line with the fall in output over this period. There were, however, significant lags of up to two years in the adjustment of capital through the closure of foundries. Most of these closures occurred in the period 1979-80, mainly plants of above average size. Around 60% of the capacity closed was owned by the two largest groups in the sector, Weir Group and F. H. Lloyd, both of which owned several steel foundries and had extensive activities in other areas of engineering. A further 30% of capacity closed was in five foundries shut by diversified firms that quit the industry altogether by closing all their plants. The remaining 10% of closed capacity was in four foundries owned by undiversified independent firms who went out of business altogether. Independents accounted for 35% of total industry capacity but only 10% of capacity closed. Many of them were owner-controlled, and for them plant closure would have meant bankruptcy. Delaying closure was attractive because it allowed the owner managers to continue to draw a salary and offered a chance of redeeming their capital if trading conditions improved.<sup>7</sup>

This adjustment process, however, was both too slow--in that excess capacity persisted despite closures--and inappropriately structured--in that the plants which closed were not always the least efficient. In 1982, at the request of members of the industry, a rationalization scheme was sponsored by the government and the merchant bank Lazard Brothers in order to speed up capacity reductions. The scheme, which took nearly two years to complete, involved cash payments to firms which closed plants, financed by a voluntary levy on the industry and a substantial contribution from government. Under the scheme, 12 firms closing some 14 plants, received a total of 15.4 million Pounds Sterling in compensation, of which the government contributed nearly half. This amounted to roughly 30% of annual sales and was sufficient to generate a small positive return from closing. A substantial number of firms in the industry took advantage of the voluntary nature of the scheme and did not contribute. The need for a government contribution arose primarily from the failure of

these members to participate.<sup>8</sup> The largest foundry to close during 1982-83, accounting for nearly one third of scrapped capacity, was owned by Investors in Industry, a large government-sponsored bank. Fully independent firms closed only two foundries, accounting for only 2% of plants dismantled. Firms with limited financial resources were reluctant to close their plants, noting the high costs involved and the probability that this would precipitate bankruptcy and the loss of jobs for both workers and executives. In the steel foundry industry, plants could not be abandoned without extensive site clean-ups. The largest cost was relocation of employees and severance payments to redundant employees. The diversified firms anticipated lower cost under all headings since they could avoid or lower some closure costs by moving assets and people to other divisions.<sup>9</sup> Although a substantial amount of capacity was closed under the scheme, there have been reservations as to its overall success. First, the delay of two years in negotiating the agreement in the general sector stopped the process of market driven adjustment during this period. There is therefore some doubt as to whether the scheme in practice achieved a faster rate of adjustment than would have occurred any way. Moreover, as demand continued to fall, excess capacity persisted, with the result that contributing firms were unlikely to have repaid a return on their investment. Second, the pattern of closure suggests that the scheme had little impact on the quality of adjustment, i.e., as in the earlier phase of adjustment (1975-81), a significant proportion of closing plants were not necessarily the least profitable.<sup>10</sup>

### **c. The Crude Steel Industry**

Industrial restructuring also took place in the crude steel industry. The principal characteristic of the steel industry in the UK in the post war period was its low performance by international standards due to enterprise units being too numerous and too small in capacity. In 1967, the 14 largest enterprises were amalgamated by the Labor Government into the state owned British Steel Corporation (BSC). A lack of modernization and concentration had resulted in major slumps in profits and had further increased the industry's lag behind its foreign competitors. In 1973, the Conservative Government adopted an ambitious 10 year program of expansion. The program envisaged large-scale closure of obsolete plants and a loss of 30,000 jobs out of 210,000, concentration of production at six modern giant plants, and an increase of production capacity. Implementation of this program, however, was embarked on at a time when the world-wide steel slump was beginning and the volume of the British market was declining steadily. The situation was exacerbated by the fact that modernization was started too late and that even during the crisis the bulk of the steel was being produced by outdated production methods. Between 1974 and 1977, in spite of massive decline in demand, the Labor Government continued with the investment policy and the intended closures were not implemented due to opposition from politicians and unions. By 1977, financial pressures had grown to such an extent that the original expansion program was cut down to half, and in cooperation with the unions the closure of unprofitable plants and a reduction in the number of jobs by 40,000 was initiated. While this policy of shrinkage envisaged a gradual job reduction over a prolonged period, the Conservative Government that came to power in 1979 decided to find a solution to the BSC problem quickly, without much consideration for steel workers or steel regions. Nevertheless, the objectives of regaining profitability by 1980/81, of having radically liquidated so-called over-employment and of producing at the same standards as European competitors was not achieved. In 1981, the Government came up with an even more massive survival plan involving partial privatization of the industry which meant further reductions in employment and production capacity. Once union resistance to this reorganization was broken, the role of the unions became confined to negotiating

redundancy payments (see Section C, Box 1 for more details on collective bargaining agreements between BSC and the unions).<sup>11</sup>

#### **IV. Regional Policies**

Regional policies have been aimed at helping those parts of the country where unemployment has been persistently above average, usually because they have contained a disproportionate share of older industries subject to long term decline. These regions also have tended to be areas where incomes are below average. These areas have been called "development areas" or "development districts," and their boundaries have varied from time to time. The provisions of regional policy have changed frequently, but the essence has remained the same--to provide incentives for investment in new plants in development areas and to discourage expansion in prosperous and congested areas. The main incentives have taken the form of especially favorable investment allowances (higher rates of initial allowance being available in these areas), but also of the provision of cheap loans and outright grants, of factory premises at low rents, and of new roads and other industrial infrastructure. Industrial Development Certificates--planning permissions necessary for industrial expansion--have been granted more readily in development areas than elsewhere.<sup>12</sup>

New measures, announced shortly after the Conservatives came to power in May 1979, severely curtailed the geographical area of the country eligible for special assistance, limited the rates of grants available, and imposed a four-month moratorium on payments. Levels of expenditure (in real terms) eventually stabilized at approximately 30% below the level of the mid-1970's--the very high levels of unemployment providing some impetus to their continuation.<sup>13</sup> However, between 1979 and 1983, the government established 11 "enterprise zones" mainly in the more depressed areas, including places like Corby (hit by steel closures) and the Isle of Dogs in London's dockland. Their success led to the establishment of 14 more zones which proved very effective in attracting new development. These zones ranging from about 60 to 400 hectares were to receive the following incentives for ten years:

- Exemption from rates and development land tax.
- Easing of the corporation tax burden on industrial companies through 100% capital allowances for industrial and commercial buildings.
- Removal of tax disincentives to mergers.
- Exemptions from planning controls and Industrial Development Certificates.
- Streamlining of customs and warehousing procedures.<sup>14</sup>

A major criticism of the regional development grant system, which had become the mainstay of policy in the post-war years, was the disproportionate degree to which it favored expensive, capital-intensive projects which often created very few jobs. As a result, a major switch in policy occurred in 1983 which effectively

limited grants to 3000 Pounds Sterling per job created and gave greater impetus to service sector developments. But the overall effect of the changes was to limit expenditures even further.<sup>15</sup>

In 1987/88, there was a further decline in funds allocated for regional policy objectives as well as a shrinkage of the area in which businesses were eligible for regional assistance. Up to 1987, firms in these assisted areas could obtain subsidies principally for capital expansion in manufacturing industry and certain service industries. These grants were either provided on an automatic basis, Regional Development Grants, or on a selective basis, Regional Selective Assistance. In early 1988, the government announced the phasing out of regional development grants and automatic forms of assistance. In its place a general business development initiative with strong regional elements was established. Its aim was to improve the managerial skills and strategies of small and medium-sized businesses in the assisted regions by subsidizing their use of private sector consultancy in specific functions, such as design, marketing and quality management. Thus, subsidization of capital, which had proved unable to arrest regional decline in the past, had been partly replaced by subsidizing managerial skills, which have been in short supply. Businesses located in designated urban areas, facing exceptional problems due to structural changes, also have been eligible for subsidized consultancy services under the new business development initiative.<sup>16</sup>

#### **V. Housing Policies and their Impact on Labor Mobility**

The geographical concentration of declining industries has coincided with widening disparities in regional unemployment. This would seem to suggest the existence of serious inhibitions to inter-regional labor mobility, since unemployed workers would otherwise tend to migrate to regions where the prospects for finding a job are better. Housing policies and regional differences in the housing market are widely seen as having impeded the movement of labor in general, and in particular from unemployment areas. Rent control on large proportions of the private sector has resulted in sharp contraction of the private rental market. This contraction has seriously undermined the private rented sector's function of supplying short-term housing for migrants into an area. An important feature of the housing market is that more than a quarter of all households are living in publicly-owned accommodation (council houses), which are predominantly located in high unemployment areas. Studies have shown council tenancy to be a strong deterrent to inter-regional mobility. A council tenant wishing to move from a high unemployment region to a more prosperous one must find vacant council housing in his destination area. With many more council tenants wishing to leave high unemployment regions than prosperous areas, migration of council tenants has become difficult. Regional differences of house prices also can act as a barrier to migration of owner-occupiers from depressed areas. As wages are relatively uniform across regions, the real wage of the migrant will improve to the extent that prices are lower in the destination area. Taking account of the housing costs, the real wage of the migrant would actually fall, thus weakening the economic incentives to move.<sup>17</sup>

Although the housing market distortions act as a brake on labor moving to areas of relatively high demand for its services, they should facilitate the relocation of businesses from prosperous to depressed regions. Yet there seems to be strong reluctance on the part of both businesses and managers to move into more depressed areas. Senior managers may be reluctant to move to depressed areas because of perceptions of the lack of social infrastructure and dereliction of the environment. Employers may be hesitant to move

due to actual or perceived skill deficiency and motivational problems with the workforce in the depressed region. High local tax rates on businesses often found in depressed areas, as local councils try to make up for contraction of their tax base by heavy taxation on businesses, also may act as a deterrent to incoming businesses.<sup>18</sup>

The policy response to regional disparity in the 1980's has had two distinct aspects. First, measures have been taken in the field of housing policy and pension transferability in order to increase the mobility of labor. Second, financial assistance to businesses has been used to attract them to deprived areas. The major aims for housing policy in the past decade have been to spread home ownership, enabling private landlords to make reasonable returns so as to provide accommodation for those wishing to rent, and to encourage the private sector to take a greater responsibility in running public housing. In accordance with these aims, the Government initiated legislation in 1979 enabling council tenants to buy their home at a discount. During the same period, rent controls were relaxed somewhat. The housing Bill presented to Parliament in 1987 called for further developments along previous lines. Investment in private rented housing was encouraged by the extension of the Business Expansion Scheme in the 1988 Budget to give relief on investment in companies providing rented housing under the new assured tenancy scheme. Although the increase in owner occupation which has taken place is likely to enhance labor mobility, the effects may prove to be small. Buyers of council flats in high unemployment areas are unlikely to move to more prosperous regions, since that might entail a cut in real wages as discussed before. Mobility across regions should be increased, however, by some measures taken by the government to even out the disparity of house prices. For example, reclamation of derelict land and redevelopment in high pressure areas may have moderated the rise in housing prices. However, restrictions on land development in many prosperous regions remains in force.<sup>19</sup>

### C. Employment Adjustment

In 1965, the government created the Redundancy Payment Act in order to increase the flexibility of the nation's industrial base and its ability to modernize. Unemployment was low at the time and the primary concern was shifting to newer modes of production and expanding Britain's economic base to compete in future markets. The Act established the idea that an employee gains the equivalent of property rights to his or her job by virtue of years of service with the company. Those rights include the privileges and security associated with seniority, as well as rights to the job itself. The Act called for advanced notification of impending cutbacks and lump-sum payments to workers who were laid off.<sup>20</sup> Employers were required to give 30 days' advance notification to the Department of Employment before a redundancy involving 10 employees or more were to occur. Ninety days were required when the redundancies involved more than 100 employees.<sup>21</sup> The amount of the lump-sum payment was expressed in terms of number of weeks of pay for years of service at different ages. Years worked when the worker was 18 to 21 resulted in a half week's pay per year. Each year worked when age 22 to 40 yielded 1 week's pay. The worker was credited with 1.5 weeks' pay for each year worked from age 41 to the normal retirement age. A worker had to have at least 2 years of service beyond the age of 18 to be eligible for the statutory payment. Payment levels were linked to age based on the assumption that older workers had more to lose in the event of displacement. The Act also established a Redundancy Fund, financed by a surcharge on the National Insurance tax. The fund had two purposes: first, it made payments to redundant employees whose employers were unable to fulfill that obligation, and second,



the fund reimbursed employers for 60% of the costs of redundancy payments. In 1986, however, reimbursements to firms with 11 employees or more were phased out. The reimbursement structure initially reduced the costs for companies experiencing redundancies, undercutting some political opposition. Also, the governmental share of redundancy expenses was decreased over the years by lowering the proportion of employer expenses reimbursed.<sup>22</sup>

Most larger companies provide extra payments to supplement their statutory obligation. The amount of the payments varies with the wage level, seniority, and age of the work force affected, and this is usually not made public by the companies. It is estimated that the extra payments tend to result in two to three times the level of payments mandated by law. These payments are found in nationalized industries, particularly those tied to the European coal and steel community. These redundancy payment levels reflect the effect of standards established by the European Coal and Steel Community and, to some extent, funds from the Community. As part of attempts to nationalize coal and steel production in Europe, Community funds have been used to ease the costs involved in closing less productive facilities. The contributions have been applied to early retirement packages, training, and redeployment as well as to redundancy pay.<sup>23</sup>

Early critics of the Act feared that the costs would discourage employers from imposing necessary redundancies. But, in practice, the payments have facilitated dismissals. The Act created an orderly process so that a manager could reduce a work force with an easier conscience and reduced costs and arguments. The statutory program not only created a universal payment which was considerably beyond the general standards of the time, but it also stimulated the growth of private-sector schemes which built upon this base. Extra payments, a rarity before 1965, became a normal part of the redundancy plans of medium-sized and larger firms. The Redundancy payments Act also changed the role of unions. Prior to the Act, unions typically resisted the imposition of redundancies. With the growth of redundancy payments, however, many workers found the payment attractive enough to justify volunteering for redundancy. There has often been little support for opposing redundancies. The union role has shifted from fighting redundancies to bargaining for larger payments (see Box 1).

Statutory redundancy payments arose as an attempt to encourage labor mobility, and they were a consolation prize designed to reduce employee resistance to industrial innovations. In a growing economy with low levels of unemployment, the payments were appropriate for such a role. As unemployment increased, however, redundant workers found that the loss of a job was not followed by re-employment and payments were quickly exhausted. Redundancy payments were created within the context of labor policy, but as long-term unemployment has become more common among the workers affected, they have become closely associated with welfare policy. They have become, in effect, an element of the British income maintenance structure.<sup>24</sup>

### Box 1: The Process of Collective Bargaining in the UK

Employment adjustment in the declining sectors in the UK has generally taken place through a process of collective bargaining between the employers and the trade unions. The following are two examples of employment adjustment by two public firms in the shipbuilding and the steel industries respectively.

Given the steadily worsening conditions in the merchant shipping market in the 1970's and the financial losses being incurred, it was apparent that if the British Shipbuilders (BS) was to survive, major improvements in competitiveness and some capacity reductions would have to be made. The trade unions were at first opposed to contraction and run-downs, and they agreed to initial moves in this direction only on the condition that capacity was retained on a care and maintenance basis. The Confederation of Shipbuilding and Engineering unions (CSEU) was strongly opposed in principle to compulsory redundancies, and adopted a policy of supporting local action wherever a majority at the yard contested them. The early reductions in manpower were achieved fairly easily, since many workers accepted the benefits offered by the special improved redundancy compensation scheme; the effectiveness of this scheme, which was funded by successive governments and applied until the end of 1986, was furthered by union agreements covering transfers between sites and recruitment freezes. With the exception of some total site closures, the rundown of the workforce was achieved largely by a combination of voluntary redundancy under the special statutory scheme, transfers between sites, and retraining. When the needed labor force reduction was not forthcoming by voluntary means, BS offered career counselling and, where possible, transfers to other company locations. Initially, given the geographical concentration of work sites, transfers could be offered within reasonable daily travelling distances. However, as the number of yards decreased such moves began to involve greater distances and to become less attractive. In general, the warship building yards often offered transfer opportunities for employees from the rapidly contracting merchant shipping yards, but the privatization of the warship yards in 1986 closed this option. Widespread knowledge of the industry's difficulties and the extent of overcapacity limited the likelihood of effective industrial action being taken against closures. Under British labor law, an employer can dismiss striking workers without compensation if that action breaches their employment contracts. Hence, taking industrial action against closures in circumstances of demonstrable overcapacity was likely to entail the risk of dismissal and loss of some or all potential redundancy benefits. In general, the contraction took place without major industrial action, though there were some resistance, including a prolonged strike at Cammell Laird and an occupation at the Robb Caledon yard when closures without compulsory redundancy seemed impossible. Given BS's status as a deficit nationalized industry dependent on government subsidies, protracted union-led industrial action against capacity reductions carried the risk of provoking cutbacks in government financial support (Goodman, pp. 604-605).

The case of the British Steel industry is another example of employment adjustment in a depressed industry. In 1967, when the government merged and nationalized 14 major steel companies to form the British Steel Corporation (BSC), the company found itself bargaining with 23 unions. The leading union was the Iron and Steel Trades Confederation (ISTC), which represented close to 50% of BSC employees. Other unions which were more craft oriented worked together through the National Craftsmen's Coordinating Committee (NCCC). A special steel committee of the Trades Union Congress (TUC) helped coordinate union activities vis-a-vis BSC. In 1979, the BSC decided to move forward with a policy of drastic closures of what it judged to be obsolete works, or parts of works. In the face of strong opposition to such closures by the ISTC, the corporation proceeded to negotiate special termination agreements on a plant-by-plant basis. While some efforts were made to transfer displaced employees to continuing operations, several factors led to few of such transfers. In the first place, the shutdowns were far-reaching, and few opportunities were available. Second, union and management both stressed the traditional resistance of British workers to moving even short distances. There were, however, a number of cases in which young and old workers changed places, permitting the former to retain their employment in the steel industry while the later chose layoff (with benefits) or early retirement.

**Box 1: The Process of Collective Bargaining in the UK (cont.)**

The agreements negotiated with the various unions (jointly, but plant by plant) provided significant severance benefits, beyond those provided under national legislation and by the European Economic Community. Under national legislation (Redundancy Payments Act of 1965, amended in 1979), terminated workers' benefits were scaled to their previous service and age. Thus, for each year of service a worker had completed between the ages of 18 and 21, he would be entitled to half a week's pay; for service between ages 22-41, 1 week per year; and for each service year between 42-64, 1.5 week's pay. Under the Act, for example, a worker who started his employment with the BSC at age 36, and was terminated at 51, would be entitled to 19.5 weeks' pay (13.5 weeks' pay for service years from 42 to 51, and 6 weeks' pay for his service between the ages of 36 and 41). As part of the various plant-level collective agreements on termination, the BSC agreed to increase the redundancy payments by an additional 50%. Also, a combination of regular unemployment benefits and special benefits for steel workers under the EEC regulations were available for a displaced worker who took a new job that paid less than his old BSC job. He would be eligible for an additional benefit to bring his total compensation up to 90% of his previous earnings. This would be available for a maximum period ranging from 104 to 130 weeks, depending on the worker's age at termination. Those enrolled in retraining courses were eligible for benefits up to a maximum of 52 weeks. Workers transferred to other steel plant jobs were guaranteed pay equal to that of their last jobs, for a period ranging from 20 to 26 weeks (depending on their age) and thereafter from 70 to 122 weeks at 90% of their previous pay (again depending on their age). In addition to the foregoing, there was another tier of large severance payments for terminated workers, which was negotiated in the 1979 closure agreements. These payments varied from plant to plant, as the company sought to gear them to local labor market conditions in its negotiations with the unions. Under these provisions employees generally received payments varying from 16 to 26 weeks, but in individual cases payments could range as high as 48 to 50 weeks. Sometimes there were severance payments carried over from earlier agreements in the industry. The collective agreements also provided accumulated vacation pay benefits for terminated employees (Kassalow, 1985, p. 355-358).

BSC also created its own job creation agency, BSC Limited, a wholly owned subsidiary whose purpose was not simply to bring new job opportunities to closure areas, but to help create a climate conducive to job creation. The Board of Directors of this new company included six trade unionists as well as the BSC chairman. BSC reported that although aid from several sources (the EEC as well as the British government) was already available for such stricken steel areas, the new company helped give considerably more power and access to substantial resources to business men and depressed communities. These efforts had some useful results, but they were made in a difficult economic environment. By 1982, the BSC was indicating that it was planning to phase out this program as it could no longer afford its cost. However, in 1984 the BSC Limited announced that it had become self-supporting and would no longer need funding from the BSC. It reported having assisted 1400 companies and forecasted the creation of 30,000 new jobs by March 1986 (Kassalow, 1985, p. 355-358).

**ENDNOTES TO ANNEX 2**

1. Sharp, Shepherd, and Marsden, p. 114.
2. NEDC, pp. 20-21.
3. NEDC, pp. 21-25.
4. Sharp, Shepherd, and Marsden, p. 115.
5. Goodman, pp. 602-603.
6. Baden-Fuller, p. 953.
7. NEDC, p.
8. Ibid., p. 26.
9. Baden-Fuller, pp. 953-955.
10. NEDC, p. 26.
11. Esser, et. al., pp. 281-283.
12. Sharp, Shepherd, and Marsden, p. 119.
13. Ibid., p. 123.
14. OECD, 1983, p.
15. Sharp, Shepherd, and Marsden, p. 123.
16. OECD, 1988, p. 78.
17. Ibid., p. 76.
18. Ibid., pp. 76-77.
19. Ibid., p. 77.
20. Root, p. 18.

21. Ibid., p. 19.
22. Ibid.
23. Ibid. p. 21.
24. Ibid. p. 22.

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## **THE UNITED STATES**

### **A. Overview**

The U.S. Government has provided relief to industries affected adversely by import competition through a number of statutes in the U.S. trade law. Employment adjustment has taken place through federal and state programs as well as corporate personal policies and union contracts. Dislocated workers in declining sectors have benefitted from extended unemployment insurance coverage, obtained supplementary income maintenance through trade adjustment assistance (available only to workers adversely affected by imports), and received retraining, job search, relocation, placement, job development and other support services under the Job Training Partnership Act and later through the Economic Dislocation and Worker Adjustment Act. In addition, there has been an attempt to protect workers through regulation of plant closings.

The next section reviews the U.S. policy of granting import protection to declining sectors. Section C discusses the role of the government and the private sector in employment adjustment. Section D provides an overview of the industrial restructuring process in the case of the steel sector.

### **B. Trade Protection in Declining Industries**

The U.S. government has relied heavily on special protection for individual industries facing severe import competition (see Box 1 for details on trade protection in the steel industry). The most important types of import relief have been the escape-clause provisions contained in Section 201 of the 1974 Trade Act, and the antidumping and countervailing-duty statutes of the Fair Trade Laws. The U.S. industries have come to rely more on the antidumping petitions than the escape clause because of the more stringent eligibility conditions and the longer processing time required for escape clause petitions.<sup>1</sup>

#### **I. The Escape Clause**

Under Section 201 of the Trade Act of 1974, also known as the **Escape Clause Provision**, industries can receive protection from imports if the imports are a "substantial cause" of injury to the industry. Substantial cause is defined as one that is at least as important as any other cause of injury. If the U.S. International Trade Commission (USITC) is persuaded by the industry of actual or potential injury, the President must decide within 60 days on a remedy that could include tariffs, quotas, orderly market arrangements, voluntary export restraints, or trade adjustment assistance (see Section C). The initial remedy awarded to the industry can last for no more than five years with a three year extension.<sup>2</sup> From 1975 to 1984, some 53 import-relief petitions were brought to the USITC under sections 202 and 203 (section 203 enables an extension of prior relief). Significant cases involving over \$100 million in trade coverage included ball bearings, specialty steel, nonrubber footwear, color TVs, motorcycles, and ceramic articles.<sup>3</sup>

### Box 1: Trade Protection in the U.S. Steel Industry

As the share of steel imports surged during the 1960's, concerns mounted in the U.S. regarding the impact of these imports on the domestic industry. In response to these concerns, an accord was reached in 1968 with the Federal Republic of Germany and Japan on three year voluntary restraint agreements, which were later extended for another three years. The restraints lowered average annual imports of steel by somewhere between 3 and 9 million net tons relative to the level of imports that otherwise would have prevailed. Following the end of the voluntary restraints in 1974 and a drop in world demand during the recession of the mid-1970's, the share of steel imports began to rise again. In response, import controls on specialty steel were imposed in 1976, followed in 1977 by the Carter Administration's "trigger price" mechanism designed to keep imported steel from being dumped on the U.S. market, while avoiding lengthy legal proceedings. The mechanism set a price floor determined by Japanese costs (assumed to be the lowest in the world) plus an 8% profit margin. Steel entering the U.S. market at prices below this trigger point was, in principle, subject to an immediate antidumping investigation (Kenward, p. 30). But European producers continued dumping steel in the U.S., the oversupply crisis worsened, and the U.S. steel producers suddenly faced staggering losses. They closed down plants, idled workers, and extracted pay cuts, reducing their production from a peak of 137 million tons in 1973 to just 77 million a decade later (Kuttner, p. 24). By the late 1970's, U.S. steel makers had become disillusioned with the trigger price mechanism and in 1981 began filing wide ranging complaints against dumping and subsidies, alleging that producers in several countries would not be competitive in the U.S. market without significant government transfers. Several of these complaints were settled in early 1980's through bilateral negotiations with the EC, Mexico, and South Africa. Also, in July 1983 the President invoked the "Escape Clause" Provision to extend new protection to specialty steel producers, increasing duties and implementing global quotas on certain products for four years. In January 1984, carbon steel producers filed a new request for escape clause relief. Following an investigation, the USITC recommended that tariffs be increased on a number of products and that imports of other products be limited to their average market shares in the 1979-81 period. The President rejected the commission's recommendations and announced an alternative program that sought to limit steel imports to 18.5% of U.S. consumption. Voluntary restraints were to be negotiated with all major steel exporters except the EC (which was already subject to a voluntary restraint) and Canada. The President's plan also provided for continued rigorous enforcement of the U.S. laws on unfair trade, discussions with trading partners to liberalize steel trade, and monitoring of the domestic industry's efforts to adjust (see Section D for details of industrial restructuring in the steel sector). The U.S. companies were required to reinvest substantially all of their net cash flow from steel operations in the modernization of their industry and to commit at least 1% of their net cash flow to retraining displaced workers. By December 1984, five-year restraints had been negotiated with Australia, Brazil, Japan, the Republic of South Africa, and Spain; subsequently additional agreements were concluded with Czechoslovakia, Finland, Poland, and Romania. During 1985, the U.S. and the EC extended an earlier arrangement on finished steel and brought it into conformity with the other agreements. However, an understanding on EC exports of semi-finished steel was not reached, and the U.S. unilaterally limited such imports in January 1986. The EC retaliated, imposing quotas on the U.S. exports of certain non-steel products. During the summer of 1986 this dispute was resolved, with EC producers of semifinished steel permitted to export under quotas to the U.S. and with the EC eliminating its retaliatory quotas on U.S. exports (Kenward, pp. 30-31). The steel industry after losing \$11.6 billion from 1982 to 1986, turned profitable again in 1987, earning about \$1 billion. It earned about \$2 billion in 1988 and anticipated the same in 1989 (Kuttner, p. 24).



In general, the escape clause has been successful in providing temporary relief for industries seriously hurt by import competition. The USITC has resisted political pressure and has recommended relief only when the industry has demonstrated serious injury from imports. About 50% of petitions have been consistently rejected. Furthermore protection provided, other than to the steel and roofing materials industries, has been temporary. Since 1975, few industries receiving protection have obtained extensions. Finally, one of the merits of the system is that the process of granting concessions to troubled industries is slow and allows a great deal of adjustment to take place. For example, several cases were eventually terminated because of a cyclical revival in demand and an upsurge in product prices. Other cases of special protection were eventually terminated following adjustment--involving some combination of downsizing, product shifts, and modernization.<sup>4</sup> The number of production jobs have almost always dropped during the episodes of special protection. Employment in the CB radios industry went down by 15.2% per year between 1980 and 1986, carbon steel employment declined by more than 10% per year, and the rubber footwear, glassware, maritime, orange juice, industrial fasteners, and automobile industries shed labor at rates in excess of 4% annually. Textile and apparel employment dropped by 1.6% annually between 1980 and 1986.<sup>5</sup>

Escape-clause protection, however, has proved to be very costly to consumers. A 1986 study of seven escape-clause cases calculated the costs to consumers to be \$340,000 on average per job saved. Both domestic and foreign producers, however, have gained through higher prices because relief has often been provided in the form of quotas rather than tariffs.<sup>6</sup>

## **II. Fair Trade Statutes**

Industries injured or threatened with injury by imports may also seek protection under antidumping and countervailing-duty statutes in the Tariff act of 1930. Complaints of dumping or government subsidization of exports are investigated by the Department of Commerce, while the USITC determines whether imports resulted in injury. If it is determined that the domestic industry is subjected to unfair-trade practices and injury from imports, then the U.S. Customs is instructed to impose a tariff or countervailing duty on the imports. Unlike escape-clause cases, where the "substantial cause" test of injury is required, the USITC needs only to determine that the imports in question contributed, however minimally, to the difficulties of the domestic industry. Between 1980 and 1988, there were 48 antidumping and 49 countervailing-duty petitions per year. For cases reaching a final determination, the Fair Trade Laws appear to ensure that only petitions that satisfy both unfair trade and injury criteria receive relief. Between 1980 and 1988, only 50% of antidumping cases and 40% of the countervailing duty cases were approved.<sup>7</sup>

## **C. Employment Adjustment Assistance in Declining Sectors**

Dislocated workers are likely to benefit from unemployment-insurance coverage, as well as from other federal and state programs, corporate personal policies, and union contracts. See Table 1 for a list of both government and private sector programs for employment adjustment.

Table 1: Existing Protection for Dislocated Workers

Protection	Coverage
<b>Federal &amp; State</b>	
Unemployment compensation	Income maintenance for the unemployed
Comprehensive Employment and Training Act	Employment, training, and counselling for structurally unemployed adults
Trade Adjustment Assistance	Income maintenance and CETA-like services for workers adversely affected by imports
U.S. Employment Service	Job referral, counseling, and other supportive services
Employee stock ownership Plans (ESOPs)	Internal Revenue Code and Treasury regulations offer very favorable tax treatment to ESOPs
Prior notice of separation	National Labor Relations Board (NLRB) decisions require that unions have sufficient time to bargain over the rights of workers affected by closings, out-sourcing, and subcontracting
Effects bargaining	NLRB decisions require that unions be allowed to discuss effects of closing; usually upheld by courts
Decision bargaining	NLRB decisions require that unions be given the opportunity to bargain over decision to close, out-source, or subcontract; usually overturned in courts
Health insurance	Conversion to individual policy without waiting period or physical examination upon layoff (40 states); Employer required to continue health insurance coverage for 3-12 months after layoff (22 states)
<b>Corporate Personnel Policies</b>	
Severance Pay	Separation for economic cause, 2-week lump sum payment to 2-week pay times years of service in lump sum
Supplemental unemploy. benefits	Supplements to income after layoff
Relocation assistance and/or retraining	Reimbursement of relocation expenses; company paid retraining
Outplacement counseling	Counseling, job referral, supportive services
Continuation of life and/or medical insurance	Company continues to pay insurance premiums for period of 1 month to 3 years
Advance notice of separation	1-6 months advance notice
<b>Collective Bargaining Agreements</b>	
Prior notice of closing	2 weeks to 1 year prior notice
Decision bargaining	Negotiations with union over decision to close
Effects bargaining	Negotiations with union over effects of closing
Supplemental unemploy. benefits	Income supplements to laid-off workers
Severance pay	Lump sum payment upon termination
Relocation assistance	Reimbursement for relocation expenses
Transfer rights	Preferential transfer rights with retention of seniority

Source: Littman and Lee, pp. 8-9.

## **I. Government Employment Adjustment Assistance**

In response to pressure for adjustment, the U.S. Government has devised a two-tiered approach to the problem of displaced workers. The first tier consists of the traditional unemployment insurance programs. A second tier of programs attempts to address the problems of specific displaced workers. These include Trade Adjustment Assistance, the Job Training and Partnership Act (JTPA) which became the Economic Dislocation and Worker Adjustment Assistance Act in 1988, and several demonstration programs. In addition to the above, certain states have plant-closing laws that are intended for the protection of workers.

### **a. Unemployment insurance**

The unemployment insurance programs are operated by individual states and financed by tax contributions from employers. These programs are aimed at dealing with the immediate consequences of layoffs by providing all eligible unemployed workers with weekly benefits to replace lost earnings and an array of services to assist the unemployed in getting new jobs. About 97% of all wage and salary workers are covered by the unemployment insurance system. Most states pay benefits for 26 weeks. Extended benefits up to an additional 13 weeks are triggered in states that experience very high unemployment, with the cost shared 50-50 between the states and the federal government. In periods of recession, the federal government has extended benefits for longer durations.<sup>8</sup>

### **b. Trade adjustment assistance**

Trade adjustment assistance (TAA) first became a component of American trade policy through its incorporation in the Trade Expansion Act of 1962. The purpose was to offer a constructive alternative to trade protection, by aiding industry and worker efforts to cope with import competition through retraining, re-equipment, and development of new products.<sup>9</sup> Under section 302 of the Trade Expansion Act of 1962, firms and workers have to demonstrate serious injury (significant unemployment) caused by imports, resulting from specific U.S. concessions granted under trade agreements in order to be eligible for TAA.<sup>10</sup>

Trade readjustment allowances were available after unemployment insurance benefits were exhausted. For workers meeting eligibility criteria, TAA provided supplemental unemployment insurance payments, up to 65% of previous wages or up to 65% of average weekly wages in manufacturing (whichever was lower). Together with unemployment insurance, income maintenance with TAA could not exceed 75% of earnings in the previous job. This coverage could be received for up to 52 weeks, with an extension of 26 weeks if the worker was enrolled in a certified training program. Firms affected adversely by trade were eligible to receive financial and technical assistance after being certified by the Department of Commerce. These included technical assistance for market research and engineering to help firms develop adjustment plans, loan guarantees, direct loans, and tax relief. There also was a provision for technical assistance to communities in developing adjustment plans if the community could demonstrate to the Department of Commerce that imports contributed to a significant portion of layoffs in the local community.<sup>11</sup>

Due to the stringent eligibility criteria and the lag in filing and processing of worker petitions, the timely provision of training, relocation and placement assistance has not been addressed effectively and benefits have often been provided long after injury or job displacement occurred.<sup>12</sup> Furthermore, empirical evidence does not support the notion that TAA encouraged much labor market adjustment. Extended income maintenance under TAA may have actually increased the duration of unemployment by providing insufficient incentives for workers to find new jobs.<sup>13</sup>

In general, there has been a reduction in trade adjustment assistance payments, and it has become standard government policy not to create any new entitlement to trade-impacted workers.<sup>14</sup> In addition the programs is scheduled to terminate in 1993.<sup>15</sup>

**c. Other programs for displaced workers**

The main vehicle for federal participation in training and retraining efforts of older and displaced workers is the Economic Dislocation and Worker Adjustment Assistance Act of 1988 which replaces and expands the Title III program of the Job Training Partnership Act of 1983. In addition, there have been several demonstration programs for assisting certain regions.

The Job Training Partnership Act contained provisions for aiding displaced workers regardless of the cause of their dislocation. A worker was eligible if he was permanently displaced and had little opportunity of returning to his previous industry or occupation. Most of the projects (62%) were open to all eligible dislocated workers who applied for assistance. The remaining was targeted toward specific populations, such as groups of dislocated workers from a specific factory, or an entire industry facing large numbers of layoffs. The act shifted the emphasis from income maintenance of trade adjustment assistance to training and retraining, job search, relocation, placement, job development and other support services. Between 1982 and 1986, \$650 million in federal funds were made available through this program. These funds were allocated to the states in two ways:

- (i) Three-quarters of the funds were allocated in proportion to the state's share of unemployed in the country.
- (ii) The rest of the funds were distributed at the discretion of the Secretary of labor.

These federal funds were matched by states, with reductions for states with higher unemployment rates than the national average.<sup>16</sup>

The Title III program passed on to the states many of the earlier federal responsibilities for designing and implementing dislocated worker programs such as decisions on which population to target, how to distribute resources, and what services to provide. As a result, there has been considerable variation among programs in different states. Title III projects are operated through a network of so called Service Delivery Area - Private Industry Councils, educational institutions (primarily vocational and technical schools and community colleges), public organizations (including state and local employment service agencies), and private sector organizations, including unions and employers. Some community colleges, for example, opened

Dislocated Worker Assistance Centers which gave training and retraining, often with industry input. A Job Training Partnership Act survey conducted in late July 1983 revealed that 83% of the responding community colleges had Private Industry Councils formed in their areas with retraining geared toward the skills needed by area businesses.<sup>17</sup>

Despite the emphasis of the program on training, relatively few participants received training assistance in the form of classroom training, on the job training, or remedial training. However, most participants received job placement assistance, 80% received job counseling, and 60% received job search assistance. A study done in 1986 found an average placement rate of 69%.<sup>18</sup>

The Economic Dislocation and Worker Adjustment Assistance Act resulted from the amendment of the Title III of the Job Training Partnership Act through the 1988 Omnibus Trade and Competitiveness Act of 1988. The Economic Dislocation and Worker Adjustment Act with a \$980 million budget is currently the major U.S. Federal employment adjustment program. It still provides 80% of the funds directly to the states and 20% for use at the discretion of the secretary of labor for employment and training assistance of displaced workers. However, workers are responded to more quickly once they are laid off, funds are targeted to areas of greatest need, and training and reemployment rather than income support are strongly emphasized.<sup>19</sup>

Under the above act, a federal Dislocated Worker Unit (DWU) is established, with local counterparts in each state, to respond rapidly to the adjustment needs of displaced workers. The responsibilities of the DWU are as follows:

- Establish contact with employers and workers after notification of plant closings or massive layoffs.
- Provide information on job availability in the local labor market.
- Promote the creation of labor-management committees.
- Collect information on worker dislocation.
- Provide entrepreneurial training to help set up new businesses.

In order to encourage greater use of training assistance, the new act established time limits for enrollment in training (no later than the 13th week of receipt of unemployment insurance or the 8th week after receiving notice of layoffs) to qualify for supplemental income support after the unemployment insurance support runs out.<sup>20</sup>

**Demonstration projects.** Six sites that experienced dislocation were selected by the Department of Labor in 1982 and asked to design and operate adjustment programs during fiscal year 1983. The programs were supposed to offer a full range of employment services, including on-the-job and classroom training, and relocation assistance. The highest placement rates were found among workers taking on-the-job training, while lower rates were found among those taking classroom training. Regardless of the type of assistance provided, reemployed workers experienced a wage loss that was greater the longer the worker had remained unemployed.<sup>21</sup>

The government also has given money to a special project in the Detroit area known as the Downriver Community Conference, a public, community based, nonprofit organization that enrolls workers laid off because of plant closures in the car, steel, rubber and related industries. In addition to job search assistance and other services such as classroom and on-the-job training is provided. The Downriver Community Conference Economic Readjustment Activity Program refers to a program of assistance to workers displaced from five automobile and automobile-related plants in Southwestern Wayne County, Michigan. All of the plants closed permanently during the summer of 1980 and all workers were eligible to participate in an assistance program. Based on a sample of 1000 workers, half of whom participated in the program and half of whom were similarly unemployed but ineligible for participation, the program increased the probability of reemployment from under 60% to over 72%. Displaced workers received lower wages on their post-layoff job. Weekly earnings of program participants in the Downriver project, however, were 25% above what they would have been in the absence of the program.<sup>22</sup>

#### **d. Plant-closing legislation**

Since late-1970's numerous legislation has been passed in order to restrict plant closings and make advance notification of closings mandatory. Existing plant-closing laws are rather diverse with respect to comprehensiveness, coverage, and statutory obligations placed on public authorities and affected firms. In Wisconsin, for example, firms that wish to close facilities employing more than a specified minimum number of workers must give employees and public officials a 60-days prior notice of such action. Maine's plant-closing law requires a 60-days prior notice of closing and severance pay to laid-off workers equivalent to their average weekly pay multiplied by their years of service. In marked contrast, the proposed plant closing law in Hawaii would require a three-year prior notice of closing. Ohio's proposed law would require a one-year prior notice and severance pay. Michigan's Public Act 44 required employer notification so that the Michigan Department of Labor could offer state assistance to facilitate employee wherever it was possible.<sup>23</sup>

The features of plant-closing laws that specifically address the problems of displaced workers include cash severance benefits, extra paid-leave time, continuation of health insurance benefits after closing, occupational training, job counselling and placement, and income support. Advocates of plant-closing laws justify such labor-market intervention on the grounds of reducing hardship for dislocated workers, reducing flows into national and local unemployment, and insulating local governments from the fiscal distress that a plant-closing could cause. The provisions of plant closing laws include discouraging closings through the threat of financial penalties for firms contemplating such action, providing incentives for employee ownership, and requiring firms that intend to close plants to offer preferential transfer rights and relocation assistance to affected workers.<sup>24</sup>

The laws are intended to inhibit closings and reduce the number of unemployed workers (especially high-seniority workers). However, these laws could increase the incentive to use less labor per unit of output.<sup>25</sup> One effect of advance notification has been early job separation prior to plant closing, resulting in higher costs to employers due to loss of qualified manpower during notification. Also, the provision of mandatory severance pay and extended health benefits create additional costs for employers. Furthermore, state efforts to retard plant closings and relocation may inhibit future plant openings and job creation in the state, and by

making it more expensive to do business or stay in business, lead existing and potential employers to locate in other, lower-cost regions.<sup>26</sup>

Plant-closing laws have been amended through the Worker Adjustment and Retraining Notification Act (part of the 1988 Omnibus Trade and Competitiveness Act). The new law mandates 60-days advance notification of plant closings and mass layoffs in firms with over 100 full-time employees. Employers are required to send written notice to worker representatives and to both the state Dislocated Worker Unit and local government officials. Notification would set into motion a coordinated, rapid delivery of adjustment assistance. The act also specifies employer liabilities to workers (backpay) and to the state (\$500 a day) for failure to provide advance notification. A number of exemptions are allowed under this act. Employers are exempt when plant closings or layoffs do not result in:

- Break in employment exceeding six months.
- Affected workers are offered an opportunity to transfer to a different plant site.

Other provisions permit employers to shut down plants prior to the end of the 60-days period if notification prevents employers from getting capital and business that would have allowed postponement of the shutdown, or if plant closings or mass layoffs were caused by business circumstances that were not reasonably foreseeable at the time notice was required. Severance pay and other benefits are no longer mandatory.<sup>27</sup>

## **II. Industry's Role in Employment Adjustment**

Many industry-led initiatives have some government financing, principally in activities like upgrading and retraining. An example is the ECIDA-General Motors program in Buffalo, New York. ECIDA, an area private industry council, received \$400,000 of federal financial support from the U.S. Economic Development Agency in 1983. Its total budget, based primarily on industrial financing, was \$120 million. It used some of this money to run two training programs at GM: one which trained 400 managers, and another which introduced 1000 assembly line workers to robotics in preparation for starting a new engine-assembly line. As a result, a permanent training center was developed at the GM plant. Another example is the Ford-United Auto Workers agreement. The Ford-UAW National Development and Training Center (NDTC) is located at a community college in Dearborn, Michigan, and was established in 1982, at a time when there were many lay-offs and firings at Ford. Both active and laid-off workers attend the retraining programs. Other specialized programs are aimed solely at permanently laid-off Ford employees, providing vocational training. Money comes from the trade union (UAW), Ford, and the State of Michigan. There are local training and development projects in the south-eastern part of the state which rely on a network of existing educational institutions and local community resources to provide counselling, education, and retraining. Other joint initiatives of industry and trade unions include the Joint Skill Development and Training Program of General Motors with the UAW, aimed at both GM workers remaining on the job and those displaced by the company. Both kinds of training are aimed at skill enhancement to meet the challenges of new technology. The retraining of displaced workers draws upon collaboration also with state and local bodies to provide training and other supportive services. There also is the UAW-Buick Employee Development Center which, like the Ford Center, is supported by a negotiated company contribution to a jointly managed fund. It was developed

by the company and the union working together and provides up to two years of retraining for Buick workers who will be displaced by the introduction of new technology. In the steel sector, Bethlehem Steel in Pennsylvania is retraining for out-placement with the aid of the federal and state governments and the private industry councils. Another example of retraining sponsored jointly by the community with state and federal government and industry aid is the retraining program in Alameda County, California. The state government used Job Training Partnership funds to set up 15 mini-projects throughout the state, modelled after the Downriver Community Conference in the Detroit area. The Alameda County retraining venture involves four partners--General Motors, United Auto Workers, State of California, and the Alameda Private Industry Council. The program itself was employee driven. The goal of the project was to enrol some 40% of the area's displaced workers.<sup>28</sup>

#### **D. Restructuring of the Steel Industry <sup>29</sup>**

The restructuring of the U.S. steel industry has been mainly market driven. It has taken place through plant closures and partial shut downs, diversification, chapter 11 filings under the U.S. bankruptcy law, transfer of ownership to workers, mergers, joint ventures, the adoption of new steel technology, product improvement and market specialization, and internal reforms such as improvements in the management of the firms.

**I. Contraction, Shut-down, Bankruptcy, Liquidation.** In view of the problems of decreased demand, world overcapacity, and the competitive disadvantage of most integrated steel mills in the U.S., market adjustment has often necessitated the contraction of the firm's production facilities. This has involved the closure of part of a plant's capacity, such as equipment involved in a discrete portion of the steel making process, the shut down of a self-contained facility within a steel plant, or the shut down of an entire steel making facility. In extreme cases, the entire firm has shut down at least temporarily or ultimately has been liquidated. From 1977 to the end of 1986, steel-making capacity in the U.S. fell from 160 million tons to 119 million tons. Most of the reduction took place through plant closures and partial shut downs of the integrated mills, and have been partially offset since then by the expansion in the mini-mill sector.

A number of large firms with access to substantial financial resources followed a strategy of diversification out of steel and into other industries. USX Corporation for example changed its name from U.S. Steel Corporation, reflecting the fact that it was no longer primarily a Steel Company. The principal component of USX diversification into nonsteel sectors was its acquisition of an oil company in 1982. This action infuriated the U.S. Workers and many politicians, whose position was that USX and other steel companies should be devoting all available capital funds to modernization and the enlargement of U.S. steel plants, thereby increasing the number of steel worker jobs. Other firms, such as Inland Steel, undertook selective capital deepening investments that proved to be profitable. These investments were aimed at modernizing and improving steel making operations that were consistent with future market opportunities.

Chapter 11 filings became a common occurrence among the U.S. steel producers. Eight firms declared bankruptcy in this manner between 1983 and 1987. In receiving protection under chapter 11, firms can prevent their creditors from seizing their assets or demanding payment on outstanding debts. Instead, debts are settled by negotiation, under the supervision of a judge. Firms must file a reorganization plan within 120 days for



paying off their debts, after which time the judge may allow creditors to submit their own plans. Normally, at least half of the creditors must approve the plan. The judge must also determine that the plan provides the creditors with more than they would receive under total liquidation of the firm's assets. After the reorganization plan is approved, firms can emerge from chapter 11 status to carry on business as normal. One significant development in bankruptcy law for steel industry was the use of chapter 11 to repudiate existing collective bargaining agreements with labor. Given the serious financial positions of many steel firms and the aggressive manner in which firms sought to reduce labor costs, this legal means of breaking labor contracts appeared to create a new incentive to file for chapter 11 protection. However, when Wheeling-Pittsburgh attempted to break its United Steel Workers contract in 1985, the courts ruled that the firm under chapter 11 could not cut wages unilaterally unless it could show that total collapse of the firm would otherwise occur. From an economic point of view, a bankruptcy filing is beneficial if it allows a firm in temporary financial trouble but capable of long run profitability in the market place to continue operations. This often permits the continued operations of the firm's productive assets, which may be otherwise threatened with seizure. In the meantime of course the firm's activities are strictly restricted by the law, and liquidation is possible. Continental Steel Corporation, for example, was liquidated in 1986 to satisfy its creditors.

In general, shut-down, bankruptcy and liquidation play an important part of the market-driven adjustment process. In shutting down a plant, redundant capacity is either removed from the industry or made available for purchase by other firms or investors. Temporary bankruptcy status provides for a reorganization of the firm to accommodate long run financial health. Liquidation typically represents a transfer of the firm's assets into productive uses in other parts of the economy. Because of its specialized nature in production, much of steel making equipment must be scrapped when it is no longer economical to keep in operation. Land, buildings and other more fungible types of capital can more easily be transferred to other industries.

**II. Worker Ownership.** Ownership transfer of an ailing firm cannot, on its own, improve efficiency and competitiveness. However, in the case of a worker buy out of Weirton Steel Corporation, the accompanying reforms provided a framework for improving the operations and cost competitiveness of the plant, especially with regard to labor-management relations, debt load, and labor cost. In 1982, National Steel Corporation announced that it would shut down its Weirton facility, laying off 7800 employees. Workers reached an agreement with National Steel Corporation that transferred ownership of the firm to them in January 1984. The agreement included the formation of an independent steel workers union and a 20% reduction in wages, to be followed by a six-year freeze on wages. The newly independent Weirton Steel Corporation began its existence with a greatly reduced debt load and the lowest labor costs among the large integrated firms. Weirton was ranked ninth in capacity and was the most profitable of large firms in 1985. Much of its success was attributed to improved morale and worker-management relations. A profit sharing arrangement tied worker incentives to the firm's performance. Also, management remained in contact with workers at the plant level, and workers' input into decision making appeared to be significant.

**III. Mergers.** In the years of depression in the U.S. steel industry, only one major merger between large integrated firms has taken place and it has proven unsuccessful. After a lengthy review by the Justice Department, Jones & Laughlin Steel was allowed to join with Republic Steel to form LTV Steel, the second largest company in the United States. Both J&L and Republic suffered individually from the typical problems

of integrated steel producers: high labor costs, overcapacity, obsolete equipment, and production imbalances. The merged firm, LTV Steel Corp., ended up with substantial overcapacity in bar-making. Many of its plants exhibited serious imbalances, especially in coking capacity and continuous casting facilities. Another major problem was its unfunded pension liability. The supposed economies of scale to be gained from the merger never materialized. After the merger, the new firm had spent months sorting out its new, expanded order-entry system. As a result, it fell behind on shipments, losing customers and market share. Skilled young workers left the company. In June 1985, banks canceled a \$100 million credit line when the firm's losses pushed its net worth below required levels. LTV's immediate survival strategy was to cut labor costs (salaried employees took a 7% pay cut in 1985) and sell assets to raise cash. This was only partially successful. Of the company's sixteen hot-rolled bar mills, only six were operating in January 1986, and of the remaining ten, half were shut down permanently. In July 1986, LTV filed for chapter 11 protection under U.S. bankruptcy law.

The LTV case provides a precautionary example for the use of mergers as a channel of adjustment. If the merger merely combines the financial burdens, excess capacity and inefficiencies of the previous firms, the new firm will hardly have a chance to survive in a depressed market. Increase in size alone is not enough to pull a firm out of its financial or competitive difficulties. Successful mergers, especially in a declining industry such as steel, are likely to be the result of well-conceived joining of two firms that complement each other through economies of scale, opportunities for specialization, production linkages, or other efficiency gains.

**IV. Direct Foreign Investment and Joint Ventures.** Foreign participation in the U.S. steel industry has made it an important channel of adjustment that has improved the prospects of several steel firms. In addition to the efficiency and management techniques that accompany foreign investment, it has provided a new source of badly needed capital.

In 1979, Wheeling-Pittsburgh and the Japanese firm Nippon Steel cooperated on the construction and operation of a rail production plant. Nippon licensed its advanced steel rail-making technology to Wheeling-Pittsburgh, provided engineering advice, and trained Wheeling-Pittsburgh engineers at its Tokyo steel mill. Another prominent example of foreign steel investment in the U.S. was the merger of Nippon and the National Steel Corporation which occurred in 1984 as a result of the purchase of 50% of National Steel stock by the Japanese firm. This partnership was expected to reduce the time needed to implement National's capital spending program from five years to two. Aside from the new source of capital, the venture brought about a transfer of advanced technologies, engineering expertise and technical training, and several Japanese style reforms in management and labor relations to the U.S. firm. More recently, Nippon agreed to a joint venture with Inland Steel Company to construct a continuous cold-rolling tandem mill. Nippon also was involved in the restructuring program at Inland, providing evaluations of operations efficiency and management and making recommendations regarding its capital investments. Nippon's relationship with Inland also was instrumental in making Inland the major supplier of steel products to Honda of America in 1987. Direct foreign investment also resurrected the defunct steel making facilities of Kaiser Steel Corporation. Kawasaki Steel Corporation of Japan and Cia Vale de Rio Doce, a Brazilian state-owned iron ore company, each became 25% equity holders in the new California Steel Corporation, purchasing Kaiser's shut-down facilities in Fontana, California. Semi-finished steel from Brazil was being imported for finishing at the Fontana plant

for coils, sheets, piping and construction steel, principally for west coast markets. Kawasaki's links with Toyota also put the Fontana plant in a good position to supply steel sheet to the General Motors-Toyota auto plant in Fremont, California. The Nisshim Steel Company of Japan agreed in 1984 to purchase a 10% interest in Wheeling-Pittsburgh Corporation. The two firms were to jointly build and run a \$50 million steel coating plant which would produce galvanized and aluminized steel sheet products, principally for automobile and appliance manufactures. The joint venture proceeded in spite of Wheeling-Pittsburgh's chapter 11 filing in 1985. Another major joint venture was announced in 1985 when US Steel Corporation (now USX Corp.) and Pohang Iron and Steel Corporation (POSCO) of the Republic of Korea agreed to become equity participants in a modernization project at USX's finishing plant in California.

In general, foreign involvement in the U.S. steel industry has played an increasingly important role in the adjustment process. Unlike the governments of many other countries, the U.S. has not restricted the participation of foreign interest in the U.S. steel firms. The government apparently regards foreign involvement in the U.S. steel industry as a positive development in balance, providing capital, technology, and expertise to firms in trouble, and perhaps saving some American jobs.

**V. Modernization of Production Capacity.** The process of modernization has proceeded rapidly in the U.S. steel industry in recent years. This has involved the closure of plants that are technologically inefficient, poorly located, or poorly positioned to compete with mini-mills. In particular, the reduction of outdated open hearth capacity has accelerated. Only extremely high closure costs can justify the continued operation of these obsolete facilities. From 1980 to 1983, open-hearth capacity in the U.S. dropped from 20.5 million tons to 11.4 million. Another major area of modernization has been the use of continuous casting facilities. The U.S. had seriously lagged behind its international rivals in the installation of continuous casting. However, by 1986 continuous casting in the U.S. had reached 54.1% of steel production, and was expected to reach 70% in 1987. This is the result of both the shut-down of older facilities and the actual installation of more continuous casters. The U.S. thus appears to be rapidly approaching the level of continuous casting in Europe and substantially narrowing the gap with Japan. In general, many American steel facilities have suffered not only from a lack of modern equipment, but also from an imbalance in the various steps of steel processing. In order for firms to survive, there will be a continual need to remain at the forefront of technological advances and engineering improvements in steel-making. In most cases, R&D is no longer focused on increasing the amount of steel produced but rather on improving the quality of the product.

**VI. Expansion of the Mini-Mill Sector.** The mini-mill technology uses electric furnaces to produce carbon steel from scrap iron, which is then continuously cast into forms suitable for final products. By contrast, the traditional firms use integrated works--which include raw-materials facilities (such as iron ore and coal yards), coke ovens, and blast furnaces--to support basic oxygen or open hearth furnaces. The cost of these facilities constitutes an important share of the total investment in an integrated steel plant. Mini-mills comprise a remarkably robust sector of the U.S. steel industry, in contrast to the shrinking integrated sector. The advantages of the electric arc furnace in terms of flexibility and cost competitiveness indicate that this sector is likely to continue to grow into the next century. The limits on the use of electric arc furnaces in steel production appear to be primarily the relatively narrow range of steel products they can produce, but even here, new technologies appear to be on the brink of major breakthroughs that would allow mini-mills to

produce sheets, plates and rails in a cost-efficient manner. It appears that U.S. mini-mills may in fact enjoy comparative advantage in certain steel products in the future and could even become significant exporters, although at the moment most of them concentrate on servicing relatively small local geographical markets.

**VII. Product Improvement and Market Specialization.** In an increasingly competitive market, one way for a firm to adjust is to capture or develop a particular market niche for itself. For example, there is an increasing demand for certain types of steel made to exacting specifications. The part of the innovation process that is most closely tied to the steel producing firms themselves is the development of new, higher quality products for the specialized needs of customers. In addition many steel companies have found that they cannot compete in the production of certain products, particularly those that can be made more cheaply by mini-mills or by foreign competitors. Finally, some firms have begun to offer downstream services in their markets, such as steel service center facilities, which link producers with customers who generally order steel in smaller quantities, such as certain steel fabricators and construction firms.

**VIII. Internal Reform.** An important channel of restructuring has been through basic changes in the way firms are managed. One integrated firm, Inland Steel, implemented internal restructuring by reducing the layers of management from ten to six. In general, Inland's adjustment strategy focused on cost reduction, market orientation, research activities, and organizational effectiveness. Japanese consultants were called in to evaluate the firm's facilities and provide engineering and technical assistance. Company assets not related to steel were sold. New customer relationships were forged (primarily with Honda of America), emphasizing cooperation in the development and production of steel according to specification. At the same time the company installed continuous casters, increased productivity by 24%, lowered its costs by 22% and was alone among the five largest integrated firms to report a profit in 1986. The adjustment process of restructuring in order to compete on world markets thus appears to require the ability to adapt and to improve management.

**IX. Employment Adjustment.** The actual process of retraining, job search, and relocation for thousands of steel workers has been slow and painful. Many of the special conditions and peculiarities of steel labor markets made the transfer of labor from steel to other sectors especially difficult. In 1984, the U.S. Bureau of Labor Statistics (BLS) conducted a survey that gathered information on displaced steel workers, covering the period 1979 to 1983. Compared with other workers affected by layoffs during this period, steel workers were, on average, older and less likely to have found alternative employment. The BLS survey also found that displaced steel workers, compared with displaced workers from all industries, were disproportionately male and married, with families. They were likely to have a high school, but no college, education. They generally had a long employment history, half of it with the same steel firm, and job skills specific to the steel industry. Because of the typically large scale plants and the lack of a highly diversified industrial base in many steel-making regions, laid-off steel workers often had few attractive alternative job opportunities in the areas where they lived. Because they were more likely to have roots in their communities, their mobility in the search for a new job was reduced. Since their skills in most cases were not directly transferable to other industries, a period of retraining was often required to qualify them for new jobs. A further obstacle to adjustment was the premium wage that laid-off steel workers used to make, typically much higher than the manufacturing average, and perhaps even higher still than wages in alternative jobs available to them.

Several sources of assistance were designed to replace a part of the steel workers' lost income and to aid in retraining, job search and relocation. Assistance came from the worker's employer and from the state and federal government agencies. The most immediate help for displaced workers came from federal-state unemployment programs (regular state benefits and federal-state extended benefits), which provided partial income replacement. Supplemental unemployment benefits also were available to unionized steel workers and were provided by the steel companies in accordance with the provisions in negotiated labor agreements (see Box 2). In addition, individual steel companies provided training and adjustment assistance to aid displaced workers. The major sources of federally sponsored adjustment assistance to displaced workers were the Trade Adjustment Assistance (TAA) program and the Job Training Partnership Act (JTPA). The TAA program was part of the Trade Act of 1974 and was designed specifically for workers displaced by import competition, providing income replacement and job training, as well as job search and relocation allowances. The Department of Labor administered this program directly. The JTPA was a more general training assistance program for dislocated workers. Title III of JTPA gave block grants to individual states under guidelines of the Department of Labor and provided for job search, development, training, support services, pre-layoff assistance, early intervention services in anticipation of plant closures, and relocation assistance.

Since the idea of the program was to focus on import-related job displacement, workers were not eligible for benefits under the program in cases where the major causes of depressed market conditions for the domestic industry may have included other factors. Labor officials in the steel industry pointed to the limited benefits of income replacement under the program and complained about the limited success of retraining efforts in finding displaced workers lucrative alternative employment. The program was criticized for its failure to provide a positive incentive structure for adjustment. It initially concentrated on income replacement, but these payments tended to lengthen the period of unemployment, without resulting in a higher wage in new jobs. In addition, only about 1% of workers receiving income replacement payments actually received adjustment-related services under the TAA program. The lack of participation appeared to have been caused by the lack of information about such benefits and by displaced worker expectations that they would be recalled to their old jobs. Based on these experiences, government officials changed the structure of worker adjustment programs in 1981. Income replacement under the TAA program became available only after unemployment compensation benefits expired. A new emphasis was placed on reemployment services and retraining. The introduction of JTPA in 1982 reinforced this new emphasis, providing retraining to a broader base of dislocated workers. Local community participation in the JTPA programs occurred through private Industry Councils composed of representatives from local business and labor, and from state and local government.

**Box 2: Collective Bargaining and Employment Adjustment in the Steel Sector**

Trade Unions have played a major role in the employment adjustment of the steel sector. In particular, the U.S. Workers bargaining with the major steel companies established a considerable range of benefits and protection for steel workers facing displacement. These benefits have varied from company to company but, as they are fairly uniform, the collective agreement between the union and the US Steel Company is cited here for illustrative purposes.

Employees (with two or more years of service) who were on layoff, and who were not eligible for pensions were to be given priority over other applicants for hiring at other steel plants of the company located within a limited agreed upon geographical region. On application, an employee and his family were eligible for relocation allowances ranging from \$600 to \$1450 (less for single employees), depending on the distance of the move. At the new plant the employee was subject to all the rules and conditions of employment, including the wage rates in effect there. Except for the computation of vacation pay his seniority record began anew in the new plant (presumably his old seniority would continue to apply to his pension status). Where a facility or department was closed down permanently, employees who were terminated (and were not entitled to other employment, by reason of their seniority) received severance benefits ranging from 4 to 8 weeks pay, depending upon the length of company service--e.g. 8 weeks for 10 years or more of service. These benefits were an alternative, not an addition, to supplementary unemployment benefits (Kassalow, p. 361). Employees who were laid off, and had met eligibility requirements, were entitled to special, supplementary compensation benefits--these were supplementary to state unemployment compensation benefits. While an employee's benefits were calculated in accordance with his previous earnings, in any week in which he received a government unemployment benefit, the supplementary unemployment weekly maximum benefit was \$185, plus \$1.50 for each dependent up to a total of four dependents. Once he was not eligible for government benefits (presumably after he had exhausted government benefits, usually after 26 to 29 weeks depending on the State), the employee could draw supplementary unemployment benefit up to a maximum of \$235, plus \$1.50 for each dependent up to a total of four dependents. Supplementary unemployment benefits were available for most employees for a period of 11; to 52 weeks. Employees who had 20 years of continuous service were eligible for an additional 52 weeks of benefits. These benefits were financed by a company contribution into a special trust fund (Kassalow pp. 361-362). Special early retirement benefits were provided for employees whose service was broken by a plant, department or subdivision shutdown. Under the basic steel collective agreements, some six different combinations of company pension, regular unemployment compensation, and supplementary unemployment benefits options were available to employees whose jobs were terminated. As a result of these options, only employees who were under the age 41 and had less than 20 years of service lacked some kind of lifetime income protection. The others, by the combination just referred to, with the addition of social security after the age of 62, were afforded some income security from the time of layoff through death (Kassalow, pp. 362-363).

**ENDNOTES TO ANNEX 3**

1. Tan, p. 3.
2. Ibid. p. 4.
3. Hufbauer and Rosen, p. 11.
4. Tan, p. 7.
5. Hufbauer and Rosen, p. 19.
6. Tan, p. 7.
7. Tan, p. 12.
8. Hufbauer and Rosen, pp. 32-33.
9. Ibid., p. 33.
10. Hufbauer and Rosen, p. 34.
11. Tan, p. 16.
12. Mutti, p. 26.
13. Tan, p. 19.
14. Mutti, p. 29.
15. Tan, p. 16.
16. Tan, p. 20-21.
17. Bednarzik and Shiells, pp. 40-41.
18. Tan, p. 22.
19. Bednarzik and Shiells, pp. 40-41.
20. Tan, p. 29-30.

21. Hufbauer and Rosen, p. 42.
22. Hufbauer and Rosen, p.
23. Littman and Lee, pp. 3-4.
24. Ibid.
25. Ibid., p. 16.
26. Tan, p. 26.
26. Tan, p. 30.
27. Hilowitz, p.
28. This section is entirely from Jones, 1987.
29. Kenward, p. 30.



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## WEST GERMANY

## A. Overview

In 1969, the government formulated its principles of structural policy, published in the so called "Blueprint for Structural Policies". The government's philosophy as stated in the blue print was that structural change should be brought about by means of competition, but that its direction must be determined by market forces; and that problems which structural change may cause have to be solved, not by the government, but by adjustment on the part of both entrepreneurs and the labor force. It was stressed, however, that the government was responsible for removing obstacles to structural adjustment and creating legislation under which structural change would be facilitated. The general components of government's structural policy as listed in the blueprint were as follows:

- provision of information and consultation by the government itself, by official statistical information services, by research institutes and by industrial information centers;
- promotion of industrial research and development, with government participation by way of tax privileges for investment in R&D;
- promotion of small and medium-sized enterprises, including action to intensify cooperation, grant of cheap credits and credit guarantees<sup>1</sup>;
- increasing the occupational mobility of labor so as to allow for fast structural change and smooth adjustment (including improved initial vocational training and development of the knowledge and skill of already trained individuals, whether in employment or not);
- promotion of competition by control of mergers and cartels and removal of tax discrimination against smaller enterprises.<sup>2</sup>

The overall purpose of the government was to avoid any bias towards the defence or promotion of specific industries or regions. Also, individual enterprises could not rely on specific public aid to adjust to structural change (see Box 1 on the case of the Volkswagen Company). However, it is mentioned in the blueprint that only in particular cases specific and precisely defined aids--going beyond those mentioned above--should be given, in order to improve sectoral or regional economic structures.<sup>3</sup>

Section B of this annex is a discussion of the adjustment programs for sectors and regions that were felt to be in need of special public support, while section C reviews the process of employment adjustment. Section D is a brief discussion of the role of banks in the adjustment process, and section E highlights the impact of industrial policies in the declining industries.

**Box 1: Government's Policy on Individual Ailing Enterprises  
The Volkswagen Case**

The Volkswagen case provides an example of the reluctance of the government to intervene when an individual enterprise experienced difficulties.

The Volkswagen Company had reported insufficient profits since the early 1970's, and in 1974-75 it suffered severe losses, accounting for roughly one-third of its equity capital. The main reason was that the company had failed to adjust prior to the recession to changes in consumer demand and relied for roughly 60% of its output on the "beetle" model which had been produced since the 1930's. The problem was that while the demand for the "beetle" had declined, due to lack of production capacity the company could not meet the demand for a new car it had been producing since the end of the 1960's. In view of insufficient profits and then losses, the company was forced to finance immense amounts of investment required to produce the new cars. The government and the trade unions refused any assistance to the company even though both were represented on the board of directors and the government had a 20% share in the company. They argued that the company's losses were due to bad management policies and that the company should find ways to adjust itself. Volkswagen was forced to fire 43,000 workers, a quarter of its total employment. The dismissals allowed the company to close down a number of plants, to adjust production to the decrease and the change in structure of demand for its cars, and to attain lower cost per unit of output. The enforced product innovation enabled the company to introduce process innovation which economized labor costs. Not only did the comprehensive investment in new plants allow available modern technologies to be employed, but also the new cars permitted a higher degree of automation. In addition to product and process innovation, Volkswagen also innovated by producing abroad. With the higher valuation of the DM after the end of the 1960's, the company suffered from a decreasing competitive position with regards to prices, particularly on the United States markets, which accounted for about 25% of its worldwide car sales in 1970. It was therefore decided to build Volkswagen plants in the United States, making use of the lower wage costs in that country. As a result of the above measures, the company successfully recovered from the 1974-75 crisis and was able to employ significantly more than before the worker lay offs (Schatz and Wolter, pp. 49-51).

## **B. Government Assistance Programs**

In principle, the government did not make use of its own industrial property for specific sectoral aims in structural or technological policy. The companies whose ownerships were inherited from the former German Reich had to compete in the market and adjust to structural change, like any other company with private ownership. To a significant extent, however, government-owned enterprises were engaged in industries which suffered from severe foreign competition, such as iron and coal mining, shipbuilding, and iron and steel production. Also, very often they were concentrated in regions with a high rate of unemployment, below average per capita income or income growth, and a lack of rapidly developing modern industries. As a result, public enterprises in declining sectors and depressed regions received substantial subsidies in the 1970's.<sup>4</sup>

### **I. Sectoral Aids**

Coal mining, shipbuilding, and the iron and steel industry were among the industries that received substantial government assistance.

**a. The Coal Mining Industry**

The coal mining industry is almost entirely concentrated in two states--Westphalia and the Saar North. Westphalia, for example, has the largest number of voters, so successive governments have felt obliged to pay special attention to the coal problems of that region. The support granted has been based not only on the specific problems of the industry and region and on social policy arguments, but also on conservation of energy supplies. In 1968, the Ruhrkohle AG company was established through the merger of about 26 companies. The government exerted strong pressure for the merger by granting financial incentives to the previous owners of the mines who became shareholders in Ruhrkohle AG. By 1987, the company owned about 50 mines. Additional measures taken by the government to assist the coal mining sector included: i) tariff and quantity restrictions imposed on the import of coal, ii) promotion of the use of coal in the iron and steel industry, heating plants and electricity generation, iii) introduction of taxes on mineral oil in order to promote the sale of domestic coal, and iv) action taken to reduce coal production capacity, including granting premiums for closing down mines. Also, workers discharged in the coal mining sector were aided by a variety of financial measures, including direct transfers of income and subsidies for retraining.<sup>5</sup>

**b. The Shipbuilding Industry**

Shipbuilding was considered to be a problem industry because of subsidies that were paid in all other important shipbuilding countries. As a result the government felt obliged to take countervailing action. However, it should be noted that here again a strong regional element was involved, as the industry was concentrated in places where it had long been of extreme importance in terms of employment.<sup>6</sup> In 1970, the government commissioned a study on the status of the shipbuilding industry. The study concluded that big yards had lost competitiveness in the world market, while small- and medium-sized ones were judged as fairly competitive. In response, the government created a program to support investments for building large ships, new types of ships, and for new production techniques. Under this program, yards received subsidized credits. Also, regional subsidies, which were basically meant to promote a wide range of activities in specific regions, were used intensively to promote the shipbuilding industry. Furthermore, the federal states of Schleswig-Holstein and Bremen became joint proprietors of big yards in Kiel, Hamburg and Bremen. This was justified on the grounds that these yards would otherwise not have been able to undertake investments considered necessary by the respective state governments. In addition efforts were made to stimulate demand for new vessels built in West Germany. Financial support was extended to exports to both EC and non-EC countries as well as to orders from German shipping companies for ships built on yards in Germany. Also, in order to utilize the yards' new capacities for building large ships, an additional facility was established to support the demand for oil tankers. However, despite the far reaching government assistance, the German shipbuilding industry continued to lose market shares due to a decline in demand on world markets. To compensate for the decline in production, the Shipbuilding Assistance Program was now used to finance ships declared as developing projects since vessels exported to developing countries were entitled to a higher subsidy rate. Furthermore, the Ministry of Research and Technology set up several R&D programs in favor of the yards. Also, the Ministry of defence ordered new ships earlier than originally planned. Again, despite all these efforts, the decline in production and of orders could not be stopped and the yards had to reduce their workforce. In order to avoid high regional unemployment, the government established a direct shipbuilding subsidy

program which ran between 1979 and 1981. Only the construction of special vessels was subsidized, while oil tankers and bulk carriers were excluded. The support from this program enabled the large yards to continue their efforts in gaining back markets lost to small- and medium-sized yards. The government did not participate in financing a second direct building subsidy program in 1982, but the coastal states decided to run one on their own.<sup>7</sup> However, none of these government interventions in favor of the shipbuilding industry could prevent large yards from escaping severe difficulties. One of the largest yards in Bremen closed and the remaining yards were merged with substantial financial support from the state of Bremen. The federal state of Schleswig-Holstein covered losses of the largest German shipyard located in Kiel and Hamburg. Capacities for the building of new ships were closed at Hamburg and reduced at Kiel.<sup>8</sup> In 1986, another study was carried out by the government of the four coastal states to study the situation and prospects of the industry and on what the governments should do. The study recommended a 30% reduction of merchant shipbuilding capacities. In order to manage the process of capacity reduction and to solve the liquidity problems, the study supported additional financial assistance on a large scale. In particular, it was recommended that the Shipowner Aid Program and the Shipbuilding Assistance Program should be endowed with more favorable conditions and a new direct shipbuilding program be introduced to ensure the utilization of the remaining 70% of merchant shipbuilding capacities. The government agreed to follow these recommendations, and thus the story of the shipbuilding subsidization has continued.<sup>9</sup>

### **c. The Iron and Steel Industry**

The iron and steel industry received substantial assistance from the Federal Government starting in 1977. In the early part of the 1970s, the Government reiterated its policy of no subsidies to industry and constantly criticized its European neighbors for subsidizing their steel industries. However, under pressure from combined regional and trade union forces in 1977, the Government began to pour in subsidies to help rehabilitate the steel industry in the Saar region which was suffering from the worldwide increase in production capacity and the decrease in demand and competition from newly industrialized economies. ARBED a Luxembourg concern made plans to rationalize the Saarland's steel industry and agreed to contribute DM 120 million in new capital. ARBED's plans for modernization were carefully scrutinized for soundness and feasibility by a government consulting agency. The Government issued DM 900 million in bank guarantees; DM 244 million for new investments; and DM 480 million in cash for immediate social measures. The state government paid DM 120 million for construction of a new foundry, and the banks were pressured to write off DM 60 million of outstanding interest and principal. The unions accepted responsibility for identifying employment slots to be eliminated. Their task was made easier because the negotiated settlement relied on early retirement rather than forced terminations.<sup>10</sup>

The restructuring program consisted of a reduction in the work force (since the mid-1970s, the number of workers has been reduced from 340,000 to approximately 210,000), rationalization of production (since the mid-1970s the number of blast furnaces dropped from eighty four to forty); modernization of technology (90% of raw steel is produced using the advanced continuous casting technique; worldwide only 55% of raw steel is so processed); and product diversification (fabrication and production of high grade steel and related high tech products). Thyssen is one of the major enterprises in the steel sector that has pursued a diversification strategy. Raw steel, the industry's classic product, now accounts for little more than a quarter of Thyssen's

sales and further reduction seems inevitable despite Thyssen's comparative advantage in modernization over its European competitors. In contrast, high grade steel now accounts for a growing share of Thyssen's business because new markets are opening up. Mechanical engineering offers good growth opportunities, as do transportation, environmental technology, industrial components, auto bodies, robotics, and even large scale plant construction and trade in steel products. Steel workers, however, have complained that steel plants, steel regions and steel workers are still suffering and that they have received little from the transformation of the industry. Investments have flowed into other divisions of the firms, often benefiting other regions and creating jobs in other lines of work.<sup>11</sup>

All the Western European steel-producing nations have undergone this process of contraction, but only the Germans have managed to reduce production capacity and eliminate jobs with minimum industrial unrest due to the cooperation of the representatives of the state, the banks, the firms, and the labor unions in the decision making process. The steel industry and the government have shared a long and intimate relationship. The current form of this relationship reflects the sum of economic and political forces that emerged during the years of reconstruction following World War II. The Marshall plan gave the highest priority to the redevelopment of the strategically important sectors of the economy: steelmaking, coal mining, shipbuilding, and electric power generating. The government also promoted the reconstruction of the steel industry through indirect subsidies: special tax credits and approval of accelerated depreciation for tax reporting purposes, relaxation of regulatory standards and deadlines, and access to credit on favorable terms. The culmination of these policies came with the investment aid law of 1952 which obligated all industries in West Germany to put aside DM 1 billion to complete the rebuilding of the economy. This governmentally mandated private effort was administered by a federally owned bank that specialized in allocating credit for pressing investment needs in coal, steel, and energy.<sup>12</sup>

## **II. Regional Aids**

Regions were selected for assistance according to three criteria: i) presumed future excess supply of labor, ii) low regional per capita income relative to West Germany's average, and iii) poor quality of regional infrastructure.

The incentives which were given to private investment in the government/state joint action regions consisted of the following: i) investment grants that were commonly financed by the government and the state governments out of their own resources, ii) investment allowances provided according to an investment allowance law, applicable in the areas selected for federal/state joint action, and iii) credits at subsidized interest rates from the European Recovery Program (ERP) Fund<sup>13</sup>, also restricted to areas selected for joint action and applicable to small and medium-sized enterprises only.<sup>14</sup>

In addition, the government created a number of programs which were to supplement the above by either channelling funds to regions not covered by traditional regional policies, or by granting additional aid to regions which had already been assisted but were particularly hard hit. For example, in 1975, a program was implemented aiming at the support of regions which suffered from the employment losses of the Volkswagen company. Although the government refused to aid the company per say, it offered subsidies of

100 million DM for a three year period, supplemented by state subsidies, in order to create 18,250 new jobs in alternative industries. Similarly, some 200 million DM was channelled to the Saar and Western Palantinate regions in order to create 17,300 new jobs outside the iron and steel industry.<sup>15</sup>

### **C. Employment Adjustment**

In West Germany, works councils have played a major role in the employment adjustment process. Works councils are independent bodies from the trade unions and represent only the workforce in plants. In every firm with more than five employees, a works council has to be elected by the whole workforce by means of a secret ballot. The council enjoys the rights of co-determination and supervision with regard to all questions of payment, working hours, layoffs or dismissals of workers and voluntary social services that relate specifically to the particular firm. The collective agreements concluded by unions cannot take such specific matters into account, but they set minimum standards. Consequently, there is much scope for bargaining at the level of the firm, where the works council (not the union) negotiates with the management. Although the unions will normally control the majority of the votes in the works council, the works council have much more understanding for the individual firm and will usually follow the interest of the firm within the prevailing market environment.<sup>16</sup>

The union-management response to the crisis in the iron and steel industry is an example of how the process of employment adjustment has worked out in a problematic industry. While the IG Metall, the German Metalworkers Union, negotiates collective agreements covering the steel industry, at the company and plant level, workers are represented by a works council whose members are chosen in elections in which all plant employees have a right to vote (although in practice, lists nominated by IG Metall tend to dominate the choices for works council members in the steel industry).<sup>17</sup>

Under the 1951 and 1972 laws, before employment adjustments can take place, company and works councils must agree on a social plan. As a consequence, each major adjustment will vary somewhat from company to company. In general, the social plans have resorted heavily to the early retirement of older (over 50) steel workers as a means of minimizing layoffs and dismissals. In 1979, for example, when the Thyssen Company, a major steel producer, was confronted with the necessity for downward employment adjustment, it negotiated a social plan with the works council. Earlier, Thyssen and the works council had agreed on an extensive work-sharing plan under which the regular 40-hour week was reduced to as low as 30 hours in some plants to avoid lay-offs. Under this arrangement workers received 30 hours of full pay. In addition, they also received unemployment compensation (approximately 68% of the regular pay) for the 10 hours lost. In 1982, some 8,000 of the 35,000 employees were working anywhere from 22 to 34 hours per week under these arrangements. In 1979, however, the company was confronted with the necessity to make some absolute reductions in employment. Under the social plan negotiated, a number of workers were moved into early retirement at the age of 59. During the year before their 60th birthday, employees were to receive unemployment compensation, plus a supplement from the company which would leave them at about their previous net pay level. During that year, they also were eligible for the regular 13th month salary bonus, and they could continue to live in company housing during retirement. Employees who were transferred to other jobs under the 1979 social plan were guaranteed their old salaries for one year. Fuller compensation for

longer periods was guaranteed to older workers and to those employees with longer service. Similar plans were negotiated in other German steel plants when employment cuts had to be made. In some cases provision for early retirement were made for employees at ages as low as 56 and 55.<sup>18</sup> Although IG Metall did not press for a general national restructuring agreement, it struggled to negotiate a cut back in the work-week to 35 hours in an effort to ease the employment situation. A 1978 strike was defeated by the employees, although night-shift workers as well as workers over 50 made some slight gains in the reduction of weekly hours. A major strike in 1984 ended with agreement for a 38-hour work-week.<sup>19</sup>

#### **D. Role of the Banks in the Adjustment Process**

Due to low profits during the 1970's, investment grew far less than in the preceding decade, averaging 23.7% of GNP versus 25.5% in the 1960's. Also, the equity capital basis of companies declined from 33% (for industrial companies) in 1965-69 and from 28% (average for 1970-74) to 25% in 1980. Because of the declining ability of companies to finance investment out of their own proceeds or by attracting further equity capital, the banks attained greater importance in the financing of companies. Banks in West Germany have provided every type of banking service: they lend and borrow capital, they arrange new issues, they take shares in any kind of enterprise, including other banks, they offer advice on long-term investments, and so on.

Universal banking has allowed banks to exert influence on managerial decisions.<sup>20</sup> It is believed that this allows for a smoother adjustment to structural change. As the most important source of credits, they are not only allowed to take shares in enterprises but also can exercise voting rights in respect of shares deposited with them by their customers.<sup>21</sup>

#### **E. The Impact of Industrial Policies in Declining Industries**

Government subsidies have been concentrated in declining sectors but have been highly controversial in that they have been widely considered as serving to maintain existing structures, rather than fostering structural change. Between 1979 and 1982, aid to the coal mining, shipbuilding and iron and steel production sectors rose rapidly, but the strong increase in subsidies was accompanied by weak output trends. This was particularly true for iron and steel industries. There was general agreement among economic research institutes that in the most subsidized sectors, regardless of the initial intention of the government financial aid became self-perpetuating, without contributing much to actual adjustment while in other sectors, where aid from the government was negligible, such as the clothing industry, the adjustment process was more dynamic.<sup>22</sup>

A total of 89,000 million DM, in the framework of the state/government joint action, was paid in subsidies between 1972 and 1980. According to the figures provided by the subsidized enterprises, the resulting investments led to the establishment of 700,000 new jobs and the protection of 90,000 which otherwise would have been endangered. However, these figures are taken from the application form of the enterprises; an effective control as to whether the jobs mentioned above were in fact established or protected does not exist.<sup>23</sup>



With regards to regional policies, it would be hard to demonstrate that these policies in fact reached their basic aims, namely to mobilize reserves for growth in structurally weak regions and to diminish the risk of damage from cyclical change and structural weakness. It is argued that one major reason for the limited success of regional policies has been the uneven promotion of investment. Consequently, the number of jobs created has been relatively small in relation to the investment made, and since the investment aids have been allotted regardless of the quality of the jobs involved, the international competitive ability of the resulting production has been low. Also, the formation of capital has contributed little to the formation of human capital, from which the structurally weak regions normally suffer. It also is argued that it is because of regional policies and the regional rescue programs that adjustment measures for individual enterprises or industries have been so rare. In implementing regional policies, the government could to a large extent refuse selective aids to sick enterprises or industries. Throughout the 1970's no industry was granted specific aid in addition to those for which the government had stated the need for temporary adjustment assistance in 1969. Despite what the government had announced, the aid was not of a temporary nature but became a permanent feature of the industries which were supposed to be supported.<sup>24</sup>

Shipbuilding is a good example of an industry which, despite substantial subsidies, was not able to adjust to new conditions and probably will not be able to do so in the foreseeable future. With regard to the production of ships, the different programs enabled the yards to offer ships at prices which, from the customer's point of view appeared competitive. To this extent, production of ships on German yards was higher than without subsidies, but even the increasing subsidization of shipbuilding could not prevent the decline of production and the loss of world market shares. Since 1962, the return on investment in the shipbuilding industry remained below that of total manufacturing. Even with subsidies, capital owners were not able to obtain a return on investment comparable to investment in other activities. Nevertheless, investment in shipbuilding was undertaken continuously. Private capital owners counted on state intervention and believed that politicians would take the responsibility for the ship building industry's welfare. To the extent that the production of ships was higher than it would have been without subsidies, the number of persons employed was also higher than otherwise would have been the case. But subsidization could not prevent world-wide demand for ships from going down and the German yards from losing international competitiveness. Therefore a reduction in employment was unavoidable. Between 1962 and 1987, the shipbuilding industry reduced its workforce by 52%; however, wages rose more than wages in total manufacturing. To the extent that subsidization caused high wages in the shipbuilding industry, it obstructed the adjustment process of those regions where the yards were located. Since other economic activities had to compete with the high wages in the shipbuilding industry, the opening of new businesses, the expansion of existing ones as well as the establishment of firms from other regions were hampered. In assisted regions, where the shipbuilding industry is relatively more important for the labor market, the desired effect of regional policy was more than offset by the subsidies given to shipbuilding. As pointed out before, government programs focused on the large shipbuilding yards. At the end of the 1960's, some large yards were supported to provide facilities for the building of large ships. When it became obvious that large shipbuilding was an obsolete activity, government and states assisted in the rediversification of big yards to those segments of the market in which the medium- and small- sized yards had been fairly successful at that time. Thus the government distorted competition within the shipbuilding industry in favor of large yards and at the expense of the smaller ones.<sup>25</sup>

**ENDNOTES TO ANNEX 4**

1. Specific attention has been paid to the small- and medium-sized firms for two reasons. First, it is argued that they are put at a disadvantage because of market imperfections and, in particular, because of the reluctance of the banks to grant credits on the same terms as to larger enterprises. Second, it is a broadly supported view that small and medium-sized enterprises are a seed-bed for economic development and that they merit the support for this potential (Schatz and Wolter, p. 92).
2. The German antitrust law is based on the 1957 Act Against Restraints on Competition (ARC) which has been amended several times since. Exemptions can be granted for certain types of cartels or mergers including the rationalization of depressed industries and the attainment of economies of scale by small- and medium-sized firms (Boner and Krueger, 1990, pp. 29-30).
3. Schatz and Wolter, pp. 49-51.
4. Ibid., p. 81
5. Ibid., p. 52.
6. Ibid., p. 53.
7. Lammers, pp. 3-7.
8. Ibid., pp. 7-8.
9. Ibid., pp. 8-9.
10. Katzenstein, p. 225.
11. Ibid., pp. 226-228.
12. Ibid., p.
13. The European Recovery Program Fund was created out of the United States' aid to West Germany. In 1987, its financial assets amounted to about 10 billion DM. The fund is at the disposal of the government, which has used it mostly for structural policy purposes. In 1980, the Fund granted credits totalling 2.7 billion DM at subsidized interest rates. The Fund is totally financed out of credit repayments and interest repayments on outstanding credits.
14. Schatz and Wolter, p. 86.

15. **Ibid., pp. 86-87.**
16. **Ibid., p. 57.**
17. **Kassalow, p. 353.**
18. **Ibid., p. 354.**
19. **Ibid., p. 355.**
20. **German banks have had a direct influence in the steel industry. Representatives of the Deutsche Bank, Dresdner Bank, and the Commerzbank sit on the board's of each of the steel firms. For example, under the guidance of the banks Krupp was saved from bankruptcy and reorganized into a modern firm.**
21. **Schatz and Wolter, pp. 62-65.**
22. **OECD, 1984, pp. 47-48.**
23. **Schatz and Wolter, p. 89.**
24. **Ibid., p. 90.**
25. **Kassalow, pp. 14-15.**

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## **SPAIN**

### **A. Overview**

Heavy investment in energy intensive industries, the rapid growth of real labor costs, inadequate pricing policies, overmanning, and delays in the modernization of the capital stock all contributed to a sharp deceleration of industrial activity in Spain in the late 1970's.<sup>1</sup> Spanish industry turned out to be so heavily concentrated in sectors affected by worldwide excess capacity that, by early 1980's, the need for some form of capacity reduction became apparent. The Law of Industrial Reconversion was passed in 1981 (revised in 1983) in an effort to deal with problems of excess capacity and lack of international competitiveness in a number of industrial sectors in Spain. The law is based on the principle of minimum government intervention, i.e., the initiative and responsibility for restructuring should rest with the private sector. The government would not assist individual firms but provide financial and other support for the scheme as a whole.

### **B. Government Assistance Programs**

The first comprehensive attempt to integrate financial support through the budget with a restructuring of Spanish industry began in 1981 with the signing of the Industrial Reconversion Act. The law envisaged a significant retrenchment in a number of Spain's declining sectors including shipbuilding, specialty and carbon-based steel, home appliances (washing machines, fridges, etc.), electronic components, textiles, footwear, fertilizers, and automobiles. Employment reductions were to be accompanied by the restoration of enterprises balance sheets and the subsequent implementation of an investment program designed to speed up the technological modernization of those sectors with good profit prospects.<sup>2</sup> The plan was to achieve the former objective through lending budgetary support in the form of transfers, loan guarantees, and subsidized credits by the state holding company INI (National Industries Institute), and the Official Credit Institute. The program soon ran into difficulties of implementation because of monitoring problems, underestimation of the financial costs involved and the negative repercussions of restructuring process stemming from anticipated employment cut backs and their impact on industries and geographical areas. From 1979 to 1982, state transfers for industrial restructuring amounted to around Ptas. 171 billion. Yet, these transfers mostly went to absorb losses rather than to solve the underlying problems.<sup>3</sup>

In 1983, a comprehensive White Paper on reindustrialisation was published, soon followed by a Decree in November 1983, subsequently announced as a new Law on Reconversion and Reindustrialisation and approved in mid-1984. The key element of the strategy pursued was to improve productivity and restore a healthy profit position by cutting excess capacity and overmanning and by restructuring the financial liabilities of excessively indebted enterprises.<sup>4</sup>

In contrast to past efforts, the law tackled in detail the main socio-economic and technical problems involved, ranging from the large labor force cuts required and the concentration of ailing industries in certain regions, to the creation of administrative and monitoring bodies in charge of implementation (e.g. Commissions of Control) and the choice of special financial instruments.<sup>5</sup> The sectors covered by the law were

broadly the same as those of 1981 legislation, thus including both private and public enterprises (mainly INI holdings), the latter being dominant in certain key sectors such as iron and steel and shipbuilding (see Box 1 for more details on structural adjustment in public enterprises). The new law also retained the previous approach based on the cooperation between the government, employers and unions.<sup>6</sup>

The program called for a target reduction in employment of approximately 67,000 over the period 1984 to 1986, equivalent to about 26% of total employment in the firms affected or 2% of industrial employment.<sup>7</sup> The shipbuilding industry and the steel industry accounted for more than half of the jobs to be eliminated, resulting in a reduction of 35% of employment in the shipbuilding industry and 42% of employment in the steel industry.<sup>8</sup> Further reductions of about 20,000 were planned for 1987-90.<sup>9</sup>

The financial costs of the program have been considerable. By the end of December 1986 about Ptas. 820 billion (equivalent to 2.5% of GDP) had been spent in an effort to restore enterprises' balance sheets through subsidies, other transfers, and various loan guarantee schemes through INI and the Official Credit Institute. Well over four fifths of these resources had been absorbed by the steel, shipbuilding, and textile sectors (see Box 2 on restructuring of the wool industry). In 1988, the total cost of the program was estimated at over Ptas. 1.1 trillion.<sup>10</sup>

As the employment reductions and financial restructuring foreseen in the reconversion program approached their expected targets, the associated investment program was scheduled to come on stream. Investments in the second half of 1986 in the sectors affected by the reconversion effort amounted to Ptas. 208 billion.<sup>11</sup>

### **C. Employment Adjustment**

The restructuring program has sought to lessen the social costs associated with the process of retrenchment through a number of complementary measures aimed at facilitating the return to the labor force of those workers who lost their jobs.

One of the measures taken was to encourage new business initiatives in areas most affected by the adjustment such as the creation of Zones of Urgent Reindustrialisation (ZUR). Tax deductions, credit and investment subsidies were provided for existing firms and new enterprises willing to settle in those areas.<sup>12</sup> Some 280 projects were approved by 1986, generating about 9,500 new jobs at a total cost of Ptas. 88 billion, of which 16% were in government subsidies.<sup>13</sup> In early 1988, however, the government announced the scrapping of the ZURs and their replacement by a more restricted system.<sup>14</sup>

## Box 1: Structural Adjustment in Public Enterprises

The aggregate losses of public sector enterprises, mainly those controlled by INI (almost 60% of the total) but also losses of other public sector companies such as railway companies FEVE and RENFE (more than 40%), rose from Ptas. 2.4 billion (about 0.3% of GDP) in 1977 to a peak of Ptas. 379 billion (about 1.5% of GDP) in 1983. In the same year, these enterprises received state transfers amounting to 7.4% of central government expenditure or 25% of its deficit (Hudson and Rudenko, p. 66). These losses were the result of a multiplicity of factors: the marked change in relative prices and demand patterns following the two oil shocks; an extensive policy of nationalization of loss-making enterprises in the services and securities; overmanning; wage increases, which especially since 1977, had been well above the average in the private sector and, in certain cases a policy aimed at keeping prices low (OECD, 1986, pp. 35-37). The measures taken since 1983 succeeded in reducing aggregate net losses of the public sector companies to Ptas. 323 billion by 1985 (representing a cut in real terms of about 14% relative to 1983), and further reductions were achieved in 1986 and 1987 (Hudson and Rudenko, p. 66).

INI, Spain's largest state holding company which controls a large number of basic and strategic industries including several in communications and transport sectors, conducted a far-reaching and long-overdue program of financial restructuring. INI was established in the 1940's with the goal of creating an industrial base to meet the rapidly expanding needs of the domestic market and of fostering the development of industries necessary for national defense. Throughout the 1950's and 1960's, INI invested heavily in large-scale energy-intensive industries. As this was a period of buoyant economic growth in which Spain performed well, INI grew in size and influence, eventually including in its portfolio dozens of enterprises, employing over 200,000 people and responsible for over 15% of total industrial production. By the early 1970's, INI had become the largest industrial concern in Spain and was among the 20 largest in Europe. Most of INI's output was absorbed by the domestic market. In the mid-1970's, however, as a result of the adjustment imposed on the Spanish economy by the oil crisis, INI began to be increasingly used by the Government as an escape valve, absorbing the substantial employment losses being registered in virtually every sector of the Spanish economy but which were particularly pronounced in the industrial sector. This role frequently included the take-over of failed or bankrupt enterprises. As a result losses mounted rapidly, with the burden of financing largely falling on the budget (Lopez-Claros, p. 20).

A process of rationalizing INI's enterprises was set in motion by the new government, aimed at the containment of the losses of its enterprises and the restoration of sound balance-sheet positions. At the same time there was a shift in its overall industrial strategy, with greater emphasis being placed on adapting its firms' production capacity and type of products to the present and prospective nature of domestic and external demand, with particular accent on the requirements and needs of the European market (Lopez-Claros, pp. 20-21).

A key element in the consolidation and improvement of the financial position of INI was the realization that a number of firms under its control, deemed neither to be of strategic national interest nor to fulfill some other essential public role, such as providing employment opportunities in particularly disadvantaged regions of the country. It was thought that such firms might, for technological or economic considerations, fare better in private hands benefit from some type of mixed ownership, or else be closed down if they did not have good prospects (e.g. a potassium mine in Alcazar de Navarra with 1300 employees was closed down and other smaller enterprises in the mining sector have also stopped production altogether). Thus in 1985 and 1986, a number of key enterprises in both the industrial and the services sectors were sold to private concerns. The Swedish firm SKF, for instance, acquired total ownership of ball-bearing enterprise in which it had a minority interest. On a larger scale, Volkswagen acquired a controlling interest in SEAT, Spain's largest auto manufacturer, with a commitment for total ownership by 1990. INI's decision to part with SEAT had been precipitated by mounting losses (over US\$3 billion between 1980 and 1985) and the recognition that it lacked the technical expertise and marketing skills needed to make the firm viable. In 1987, the government announced its intention to sell minority holdings, through the stock exchange, in several large state-owned companies, including Iberia Airlines and the oil company REPSOL, S.A. Progress in this area was exemplified by the reduction of IBERIA's losses by about two-thirds between 1983 and 1985. Such sales, while still permitting the government to retain control over the companies' long term strategies, were expected to make the firms more responsive to market signals and thus to enhance efficiency (Lopez-Claros, pp.20-21).

### Box 1: Structural Adjustment in Public Enterprises (cont.)

Due to these measures, INI's operational losses fell for the fourth consecutive year in 1987, reaching an estimated Ptas. 50 billion (i.e., over Ptas. 150 billion below 1983 levels). Employment which had peaked in 1982 at 219,000 had fallen by 1986 to 169,000 and was estimated to have fallen by an additional 6,000 in 1987. This process of retrenchment had a beneficial impact on the budget. Whereas in 1982 state transfers covered over 71% of INI's participation in the financing of the operational losses and capital expenditure of its enterprises, by 1986 this share had fallen to 30% (Lopez-Carros, p. 20). In 1989, INI recorded an operating surplus (OECD, 1990, p. 53).

A similar approach to that of INI was followed by RENFE including excess labor, wage moderation, elimination of excess capacity, rationalization of the internal structure, the application of strict profitability criteria to all new investment, and a more realistic pricing policy in line with cost developments. These measures stopped the steep rise in the railway's losses (OECD, 1986, p. 35-37).

Furthermore, the losses of INI firms in sectors covered by the reconversion plans under the 1984 law (e.g. Ensidesa and AHM, iron and steel; and Astano and AESA, shipbuilding) were expected to be cut by half between 1984 and 1986 as a result of a reduction in excess capacity, eliminating overmanning, wage restraint, and investment in modernizing equipment (OECD, p. 35-37).

### Box 2: Restructuring of the Wool Industry in Spain

The Catalan wool industry, a geographically highly concentrated industrial sector, underwent a major crisis between 1975 and 1985. Both the government and the industry took action to combat the crisis.

#### A. Government Assistance Programs

Two plans were set up for the restructuring of the wool industry in Spain: (i) the Wool Restructuring Plan of 1975-79; and (ii) the Textile Reconversion Plan of 1981-86. The administration of these plans were left to professionals who were proposed by the employers themselves. The government, however, supplied the necessary funds.

The Wool Restructuring Plan (WRP) was based on the supposition that an enormous excess capacity of production existed in the sector. The plan's measures were therefore geared to reducing machinery and personnel through the destruction of excess machinery and dismissal of workers by means of retirements and compensation. The cost of these readjustments was divided between the government and the firms.

The plan had a greater impact in worker layoffs and plant closing than in getting rid of excess machinery. Actually, part of the machinery was not destroyed and was sold to the autonomous workers (drapaires) either directly or through intermediaries, or was simply given to them as payment for dismissal. As a result, these workers were able to renovate their equipment and increased in numbers. A crucial factor in this process was a real absence of public and union control in the process of the machinery's destruction. Most of the job dismissals were in the area of weaving and in the auxiliary areas associated with spinning. Job losses were less significant in the area of spinning itself.



**Box 2: Restructuring of the Wool Industry in Spain (cont.)**

The Textile Reconversion Plan (TRP) covered particular areas of the textile sector (from fibers to clothing). The goal of the plan was not reduction in capacity but rather the search for policies that produced conditions permitting firms to compete in European markets. It was fundamentally a plan that provided aid to firms that took new initiatives. The assistance provided to qualifying firms consisted of subsidies (up to 30% of investments), official credit on good terms, public guarantees for private credit, fiscal exemptions, and moratoriums in the payment of taxes and social security. The plan also included the possibility of reducing staff or of applying the seasonal industry criterion which allowed the seasonal dismissal of workers whilst a bad period lasted. Other forms of assistance included publicity campaigns, labor training, fashion design, etc. This last activity was going to be retained, once the TRP plan was concluded, as part of a Fashion and Design Promotion plan. The management and control of the TRP, though formally in public hands (through an executive commission), has in practice been carried out by people who have very close relations with employers' organizations.

Compared to the WRP, a smaller number of firms and staff were affected by this plan. Firms involved in the plan were dominated by large enterprises (in relative terms for the sector), but only a limited number of small firms have joined. For the firms that accepted the plan, the most important thing seemed to be that their acceptance resulted in an important injection of funds.

**B. Role of the Industry in Adjustment**

Individual firms also proceeded with reorganization of their enterprises. Basic to this restructuring was the dismemberment of a series of activities and the encouragement of productive specialization. Specialization in large firms involved the retention of certain essential processes and the externalization of all phases of the productive process which were considered technologically less developed and more risky. Basically, spinning was the activity that had been retained most whilst weaving, as well as other lesser activities like bobbin making, reeling, cone-making, and retailing had been displaced to the outside. These activities were transferred to lesser firms that did subcontract work, sometimes carried out by family units working in small workshops or in the home. The subcontracting process was also associated with selling the obsolete machinery to autonomous weavers and dismissed textile workers.

The most important industrial groups, however, maintained the coordination and control of the whole process and frequently became trade companies.

**C. The Impact of Restructuring**

The introduction of flexibility into the sector due to this restructuring allowed an improvement in the production situation in the short term, but in the medium and long term, new problems were likely to appear due to a failure to renew machinery and the excessive dependence on government aid.

The type of restructuring depends, in part, on the characteristics of a pre-existent industrial structure and, in part, on the institutional environment that determines the possibilities and resistance to the process. The existence of a weak workers' organization and the absence of control on part of the government facilitates the ability to marginalize and externalize activities. In this sense the restructuring of the wool industry varied from other processes in sectors such as steel and shipbuilding with high unionization and strong worker resistance (Recio, pp. 161-178).

In order for the ambitious employment cuts to take place, the government provided a variety of incentives to both employers and employees. About one fourth of the total employment losses were to come from early retirement of workers over 55. The rest of the workers involved were given the choice between either a considerable severance payment and unemployment compensation for up to 18 months or surrendering their severance payment to the Employment Promotion Fund (EPF).<sup>15</sup> The revenue from EPF would be used to pay 80% of their previous wage, provide free retraining and to assist workers seeking new employment opportunities by offering subsidies to firms willing to hire them on a permanent basis.<sup>15</sup> By 1986, of the total

number of workers affected by the program, 25% had taken early retirement, 35% had decided to participate in EPF and the rest had been made redundant.<sup>17</sup>

In addition to the above, a number of general measures were introduced in 1984-85 to make the labor market more flexible. These measures included: (i) encouragement of fixed-term contracts and part time employment, (ii) fiscal incentives to reduce firm's labor costs, (ii) reduction in social security contribution rates, (iv) granting of direct subsidies for the hiring of the youth, (v) early retirement age with full pension, and (vi) relaxation of the rules governing layoffs. These measures played an important role in the recovery of employment since 1985.<sup>18</sup>

#### **D. The Impact of Industrial Policy in Declining Sectors**

Despite the slow pace of the restructuring program, progress has been evident. Provisional estimates through the end of 1986 on profitability and productivity in the sectors affected pointed to significant improvements in the cash flow positions of all sectors (except shipbuilding, where the improvement was marginal on account of weak sales), and an acceleration of productivity growth.<sup>19</sup>

The main elements of reconversion have been labor force reductions, sectoral mergers and specialization agreements, helped by subsidized credits, social security payment deferrals and major investment outlays. The aim has been to sort out the financial mess in which many sectors existed, to create logical manufacturing and marketing units and to do something for those adversely affected by the measures. Altogether 791 firms have been involved, including 29 shipbuilding companies, 14 steel firms, 18 home appliances and 17 electronic components companies, 683 textile firms, 10 fertilizer companies, and 20 firms in other sectors. By the end of 1986, 77% of the planned 84,000 work force job losses had been achieved with particularly pronounced cut backs in the shipbuilding, steel, and textile sectors, 66% of the investments had been made and 75% of the envisaged credit granted (Table 1). Laid off workers have received generous redundancy pay, but efforts to find new employment have not been particularly successful, though there are special employment and investment incentives in some of the worst affected areas.<sup>20</sup>

Restructuring of enterprises under the control of INI proved to be successful. By 1983, INI accounting for some 15% of total industrial production, was registering annual losses equivalent to 1% of GDP. As a result of the privatization of several enterprises under its control, INI's losses had been virtually eliminated by 1987.

**Table 1: INDUSTRIAL RECONVERSION PLAN AND IMPLEMENTATION**

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**Employment**

<b>Initial work force</b>	<b>280,349</b>
<b>Target Reduction</b>	<b>83,763</b>
<b>Reduction by 12/31/86</b>	<b>64,184</b>
<b>Further reduction planned, 1987-90</b>	<b>20,000</b>

**Investment**

**Ptas. bn                      \$ bn**

<b>Made during 1982-86</b>	<b>400</b>	<b>2.5</b>
<b>Planned during 1987</b>	<b>125</b>	<b>1.0</b>
<b>Planned during 1988-89</b>	<b>83</b>	<b>0.7</b>

**Credit & guaranteed Loans**

<b>Granted up to 12/31/86</b>	<b>248</b>	<b>1.5</b>
<b>Planned during 1987-88</b>	<b>84</b>	<b>0.7</b>

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**Source: Hudson and Rudcenko, p. 65.**

**ENDNOTES TO ANNEX 5**

1. Lopez-Claros, p. 18.
2. Ibid.
3. OECD, 1986, p. 33.
4. Ibid.
5. These include state transfers, long-term credit, guarantees and, notably new "Creditos Participativos" which have a fixed return plus a variable return related to the improvement in the profitability of the enterprise.
6. OECD, 1986, p. 33.
7. Lopez-Claros, p. 18.
8. Kroner, p. 23.
9. Hudson and Rudcenko, p. 65.
10. Lopez-Claros, p. 18.
11. Ibid., p. 19.
12. Ibid., p. 32.
13. Kroner, p. 23.
14. Hudson and Rudcenko, p. 65.
15. The EPF was created by Royal Decree 335/1984. It covers only four sectors: shipbuilding, carbon-based steel, specialty steel and home appliances. The rest of its resources come from the state, voluntary contributions from employees and firms under reconversion and from the management of its financial portfolio.
16. OECD, 1986, pp. 33-34.
17. Lopez-Claros, p. 18.

18. Ibid., p. 26.
19. Ibid., p. 19.
20. Hudson and Rudcenko, p. 66.

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## **GREECE**

### **A. Overview**

In the early 1980's, faced with an increasing number of firms in financial distress, the government decided to intervene and implement policies for industrial restructuring. In 1983, Law No. 1386/1983 was passed specifying the terms under which these firms would be taken over and their management transferred to the public sector. The Business Reconstruction Organization (OAE) was established with a capital of 5 billion Dr and assigned the task of rehabilitating or liquidating enterprises in financial trouble. The organization was also given access to bank credit for any necessary additional funds.<sup>1</sup> Since the Greek bankruptcy law only contemplates liquidation proceedings and does not contain provisions for corporate reorganization, the operation of financially troubled enterprises can only occur through OAE intervention and management.

Government assistance has mainly been provided to traditional industries whose long term viability would be otherwise compromised. Most of the firms classified by OAE as "problematic" are large business units, constituting a substantial component of the country's industrial network. Although representing less than 2% of the total number of industrial companies, they employ 7.2% of the total labor force and 11.5% of productive capacity. Their average capital is seven times larger than that of other industrial firms. These companies also have extensive links with other parts of the Greek industry, thus creating severe problems for a number of small firms cooperating with them.<sup>2</sup> Particularly large has been the support to textiles and paper production, the sectors that include the biggest problematic enterprises. For example, problematic firms in the textiles industry, employing 12,000 persons, represent nearly one-third of the total number of problematic firms.<sup>3</sup> Similarly, had the problematic firms been left to declare bankruptcy and cease operations, the paper industry would have lost 60% of its productive capacity, 55% of its production and 75% of its exports.<sup>4</sup> Other sectors with financially distressed enterprises include wood, cork, and furniture industries, nonmetallic minerals (glass, cement, ceramic, and marble industries), metal products, and shipbuilding.

Although the problematic firms taken over by the government have continued to make losses, almost all of them are still in operation, thus raising questions about the efficacy of the government's program for industrial restructuring. Section B reviews the procedural aspects of government intervention in the operation of problematic firms, and the status of employment adjustment is discussed in section C. The economic impact of industrial policy for problematic firms is highlighted in section D, followed by a discussion in section E of the barriers to the rehabilitation of these enterprises.

### **B. Government Assistance Program**

The process of OAE intervention starts with the filing of a petition for reorganization of a financially troubled firm by a qualified interested party, such as shareholders, managers, labor unions, the Greek Unemployment Fund, or public sector creditors and private creditors who are owed at least 20% of the debt of the troubled enterprise. Once such a petition is received, OAE reviews the application to assess the viability of the enterprise.<sup>5</sup> The filing of a petition, however, does not result in an "automatic stay", meaning

that during the intervening period, creditors can take over the debtor's assets. However, once a petition is approved and the enterprise is in OAE's control, even creditors with security interests in the assets of the debtor cannot repossess their collateral or foreclose their security interests. Several complaints regarding OAE's operations have been filed with the European Commission (EC) and also with Greek courts by various creditors and shareholders who claim that their property have been the subject of an uncompensated expropriation (due to their inability to retrieve their assets once OAE has assumed managerial responsibilities). These complaints are currently under investigation by EC and pending decisions in Greek courts.

Of approximately 250 applications received between 1983 and mid-1987, 44 were accepted by OAE.<sup>6</sup> Acceptance of a petition by OAE results in a suspension of debt and interest repayments for a period of up to 36 months. During this period new management (including a new board of directors) is appointed by OAE whose responsibility is to assess the economic viability of the firms.<sup>7</sup> If the firm is considered viable, a financial restructuring plan is immediately put into operation which involves conversion of part of the debt of the enterprises into equity with the remainder of the debt being rescheduled. Through this capitalization process, many banks, in particular the National Bank of Greece, have become the largest shareholders in the problematic firms.<sup>8</sup>

If firms are ultimately found to be nonviable, procedures are initiated to liquidate them. Of the 44 initial petitions approved, 21 were subsequently found nonviable.<sup>9</sup> In 1986, 5 of the nonviable firms were sold at a public auction. In 1988, 9 new firms were added to the nonviable list of enterprises and 2 firms were liquidated by sale. In 1989, 2 firms were reclassified as nonviable and 2 new firms were added to the list. As of early 1990, OAE controlled 21 viable and 27 nonviable firms.

Although nonviable firms are in principle subject to immediate liquidation, the liquidation process can take a long time (sometimes years) under the Greek law. Liquidators are given a salary during the entire period that they are trying to dispose of the property, thus giving them an incentive to delay the process. Of course enterprises that are the subject of ownership disputes at courts cannot be liquidated anyway until the disputes are resolved. Also, municipal authorities often claim the land on which the firm is built for the purpose of building public parks, and this makes the job of attracting buyers for the firm more difficult. The problem is further exacerbated by regulations that require the buyer of an enterprise to comply with existing labor agreements and obligations to the firm's employees. Once a buyer is found, however, the proceeds are to be distributed in the following order: expenses of liquidation, unpaid wages (up to a maximum of two years' wages), debts owed to public bodies or insurance companies, secured creditors, unpaid taxes, and finally unsecured creditors. These priorities are very different from those under the laws of most industrial countries where tax claims are entirely nondischargeable and unpaid wage claims are treated the same as unsecured creditors.

### **C. Employment Adjustment**

Due to the employment security provisions of the labor law in Greece, there have been virtually no layoffs in the ailing industries. In general, layoffs and redundancies are subject to government control. Large enterprises are required to notify the government of massive dismissals (defined as reductions in the labor



force exceeding 2% per month). Although the government has reduced its intervention in such cases, the Ministry of Labor can prohibit proposed dismissals and plant closures in order to prevent large-scale redundancies. The economic effect of these employment security provisions has been to increase the cost of labor. This has in turn increased unemployment by creating incentives to hire fewer workers and to rely on overtime in order to meet temporary increases in the work load.

However, even if lay-offs were to be allowed, unemployment benefits in Greece are low by both international standards and in relation to wages and salaries in Greece. Redundancy payments are differentiated between white-collar and blue-collar workers. Under the regulations, white collar workers receive about one month's salary per year of service. The provisions for blue-collar workers are significantly smaller, averaging about 5 days' pay per year of service. Therefore, unemployment benefits are not sufficient to alleviate social dislocations resulting from economic restructuring and consequently have increased resistance of labor unions to large-scale layoffs.<sup>10</sup>

Also, there are no provisions for retraining or relocation of displaced workers. Legislation has been in preparation for a fund for retraining of laid-off workers, but it has not been introduced as yet.

#### **D. The Impact Industrial Policy for Problematic Enterprises**

Almost all of the problematic firms have been kept in operation by state-controlled banks or other official institutions through extension of credit lines beyond economically warranted limits.<sup>11</sup> Because of their extensive indebtedness to the banking sector, the widespread distress of industrial companies has had an adverse impact on the soundness of Greek banks, especially the major state-controlled commercial banks that account for over 70% of the Greek deposit and loan markets.<sup>12</sup> Also, by absorbing a great part of the credit flows to the industry, they have prevented the development of other, possibly more efficient activities.<sup>13</sup> In general, political criteria have influenced credit allocation decisions throughout the postwar era. Whether government intervention or the banks are most to be blamed for inefficient credit allocation is a controversial issue. It is clear, however, that loans have been granted to companies without reference to their business performance.<sup>14</sup>

As mentioned before, as of early 1990, 27 firms categorized as nonviable had not been liquidated. Only 7 enterprises had been sold since 1983, 2 of these to OAE itself. Together, the 21 viable enterprises have registered losses in every year of the period 1983-89. Over the period 1983-86 the losses averaged about 3/4 of 1% of GDP. The reduction of losses by half in recent years has been solely the result of capital restructuring in the form of debt equity conversions since 1986.

Because of their role in supporting problematic enterprises, banks have undermined considerably the soundness of their investment portfolios. They have exchanged a large part of the bad debt for equity (often at book value rather than market values) in these enterprises as well as for government guaranteed bonds issued by OAE. They also have carried out extensive rescheduling of loans, including a three year postponement of debt service, and have provided new financial support. For example, the National Bank of Greece (the major creditor of problematic enterprises) has invested almost twice its equity capital in industrial companies, the greatest part of it in ailing ones. Its 10 largest holdings, representing 157% of its equity base,

are in major industrial firms which have been making losses since the beginning of the crisis. In addition, the bank holds 65.6 billion Dr in bonds issued by OAE.<sup>15</sup> In 1987, the bank reported provisions for bad debt amounting to 39 billion or 93% of its equity base (share capital and reserves). This figure, however, underestimates the real magnitude of nonperforming loans since the 1987 annual report of the bank also states that the bank had converted nonperforming loans of 122 billion Dr into equity and also had suspended interest accrual on another 100 billion.<sup>16</sup> In exchange for issuing bonds as well as cash transfers to the enterprises, OAE also has acquired equity in the enterprises. However, the firms have continued to register losses, which have been financed by government grants to OAE (amounting cumulatively to 1.5% of the average GDP during 1984-89) and new bank credits (mainly by the National Bank) to OAE and its enterprises under a government guarantee. In the event, even the new bank assets have largely proved nonperforming; in particular, OAE's payments on its bond obligations have been postponed and its interest capitalized, as the banks have refrained from activating government guarantees in the difficult fiscal situation. As a result, OAE's financial needs for 1990--mainly to finance projected losses of problematic enterprises and to service its overdue and current debt obligations to banks--were estimated at 2.5% of projected GDP.

#### **E. Reasons for Failure of Industrial Policy for Problematic Enterprises**

There are several reasons for the lack of progress in the rehabilitation of problematic enterprises in Greece. The desire by the government to prevent layoffs, forward and backward linkages with other industries and firms, as well as defence and other political considerations have played an important role in keeping the problematic enterprises in operation.

The rehabilitation process has been significantly hampered by the Greek labor law which virtually assures workers the right to continued employment in an OAE-operated enterprise irrespective of the financial condition of the enterprise. Total employment in the 21 viable firms has remained about 24,000 during the period 1983-89, of which about one third are considered redundant. The poor performance of these enterprises and the failed attempts to privatize them are therefore partly attributable to government constraints on labor layoffs.

Given the lack of managerial skills (even among the new management appointed by OAE), conditions have failed to improve. In general, a considerable number of Greek firms do not employ professional managers. Firms are administered by their owners, who in many cases lack the appropriate background, qualifications and managerial experience. Inadequate management is an acute problem in the public sector at large, including banks and enterprises under public control. The appointment of professional managers is a necessary condition for ensuring the future efficient administration of viable problematic firms. In an effort to attract efficient managers to firms under public sector control, the rules putting a relatively low ceiling on top salary levels have been partially relaxed.

Furthermore, there have been no efforts to reorganize the existing operations of the problematic enterprises. Being under financial distress for many years, these companies have not made adequate investments in new machinery and therefore their capacity is obsolete. Promoting efficiency and reducing production costs requires extensive replacement of machinery and reconsideration of existing production

structures. In some of the largest problematic firms, part of their operation could become profitable while the rest have poor prospects. Reducing the production of some products or even completely abandoning them may be the best solution in some cases.<sup>17</sup>

The large size of the problematic firms also has been a barrier to development. Decentralization of management with the aim of increasing flexibility and specialization of the emerging smaller units has been one of the goals of OAE. For example, one of the largest firms in the textiles industry--employing over 7,200 workers--has been divided into ten smaller units taking into account the regional distribution of plants and product differentiation. There are similar plans for other large problematic firms.<sup>18</sup>

In an effort to address the continuing problems of the ailing enterprises, the new government has recently amended the law governing the operation of OAE. Under the amended law, OAE's management of enterprises is limited to a period of at most 9 months. During this management period, OAE is required to prepare a plan for reorganization and present it to the shareholders and creditors who will vote on it separately. If 60% of each shareholders and creditors approve the plan, the temporary management of OAE is terminated and the enterprise is returned to private management. Failing such approval, the firm would be liquidated under court supervision. The bankruptcy court is required to appoint a liquidator within 5 days, who is to conduct the first public auction within 6 months of his appointment. The bankruptcy court is authorized to extend the term of appointment of the liquidator for a maximum additional period of 6 months.

The Government also has undertaken a revaluation of the viability of all the enterprises under OAE's control, and no new enterprises have been taken over. In 1991, six of the viable firms were listed in the Athens Stock Exchange where new shares would be sold. The procedure for registering another three were under way. Although the intention of the new government is to scale back the size of the public sector, whether the ownership of viable firms will be totally transferred to the private sector is still not clear. It is probable that some of them (those considered to be of strategic importance) will remain under direct state control.<sup>19</sup> Also, several auctions have been held to sell the assets of some of the nonviable enterprises; however, none of the important enterprises have been sold. Therefore, much remains to be done to restructure or close down enterprises in distress and remove their burden from the Greek banking system.

**ENDNOTES TO ANNEX 4**

1. **Antoniades and Kouzionis, p. 4.**
2. **Ibid., p. 6.**
3. **OECD, 1987, p. 35.**
4. **Antoniades and Kouzionis, p. 6.**
5. **OECD, 1987, p. 33.**
6. **In 1986, these companies had total assets of 220 billion Dr, debt of 350 billion Dr (15% of the total debt of manufacturing industry), and negative book equity of 130 billion Dr. Although the companies whose petitions were rejected may have been suffering from losses as well, they have not been classified as problematic either because they were small or because they were affiliated to, and thus supported by, the main banks or because they were supported directly by the State (Antoniades and Kouzionis, p. 2).**
7. **The board of directors of each firm is composed of representatives of the OAE, the firm's employees, labor unions, banks which hold a significant portion of the equity or are main creditors, regional delegates, and members of the new management (OECD, 1987, p. 54).**
8. **OECD, 1987, p. 33.**
9. **Ibid., p. 35.**
10. **There have even been demonstrations by workers requesting the takeover of ailing enterprises by OAE in order to save their jobs.**
11. **OECD, 1987, p. 33.**
12. **Antoniades and Kouzionis, p. 2.**
13. **Ibid., p. 8.**
14. **Ibid., p. 16**
15. **Ibid., p. 18.**
16. **Ibid., p. 16.**

17. **Ibid., p. 27.**
18. **OECD, 1987, p. 35.**
19. **Antoniades and Kouzlonis, p. 27.**

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