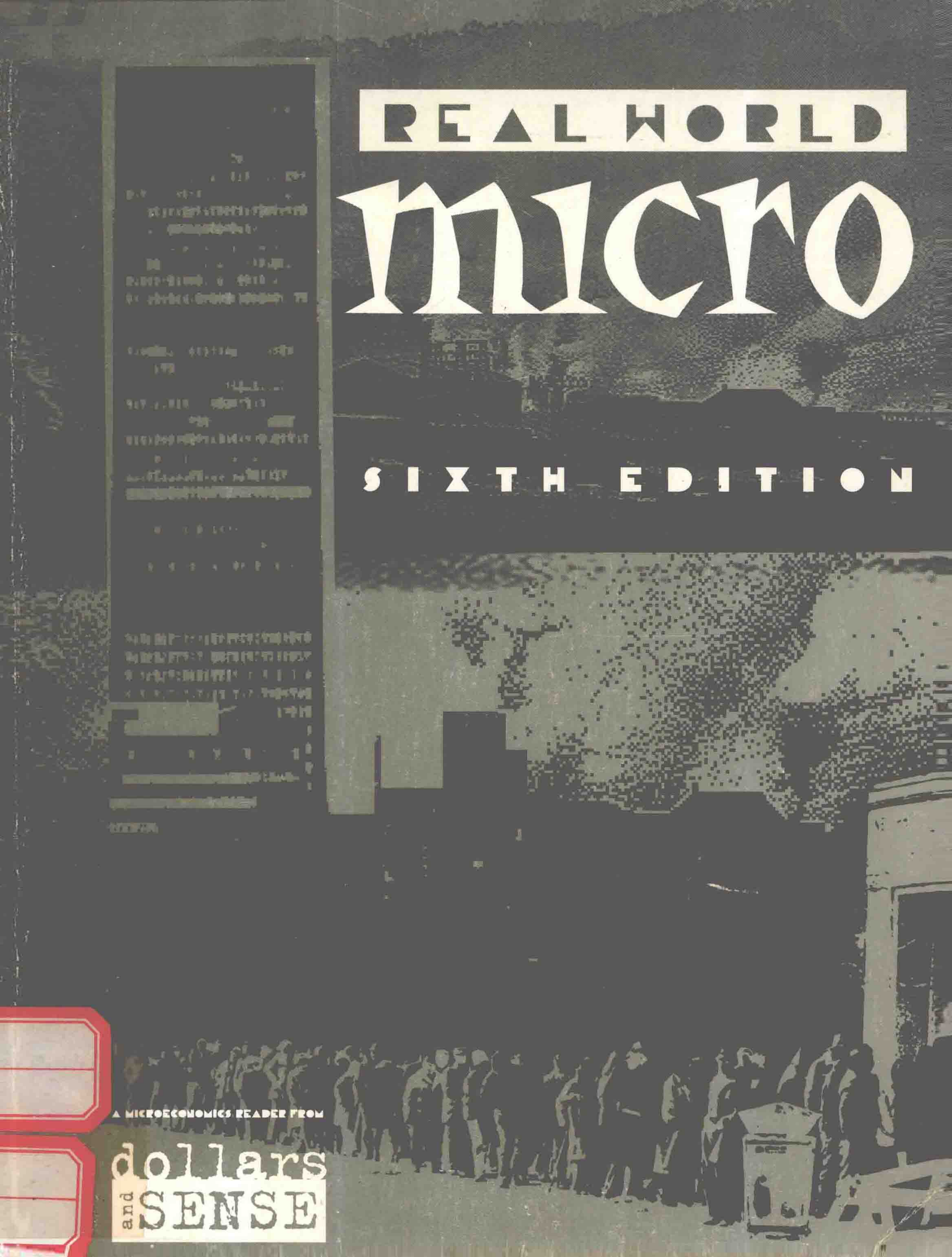
REAL WORLD micro

SIXTH EDITION



A MICROECONOMICS READER FROM

dollars and SENSE

REAL WORLD MICRO

SIXTH EDITION

edited by
Randy Albelda, Marc Breslow,
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Dollars & Sense Collective

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INTRODUCTION

Conventional microeconomic theory assumes that the market system, with minimal regulation, provides the best of all possible worlds. Consumers acquire exactly what they want (within their budgets) and firms produce the most socially desirable goods and make a profit at the same time. The articles in this book challenge such assumptions, demonstrating that markets are *not* producing ideal results for the majority of people in the world today.

The sixth edition of *Real World Micro* contains 37 articles that have appeared in *Dollars & Sense*, a monthly economic affairs magazine. Together, they present an alternative vision of how markets work — a vision based on real markets and real people.

Chapter 1 critically examines some basic microeconomic concepts, such as the "invisible hand" and market power. "Who Gains from Trade" examines the theory of comparative advantage, assessing its implications for different countries and populations. And "The Case of Hungary: Free Markets Aren't Always a Solution," explores the pitfalls of some forms of privatization.

The second chapter, "Real World Markets," looks at the imperfect functioning of markets as they respond to supply and demand. Traditional theory disposes of the hard questions in this area by assuming that markets naturally maximize social welfare. The articles in this chapter analyze why this is frequently inaccurate, through case studies of child care, health care, and the minimum wage.

Much of the conventional microeconomics curriculum is devoted to consumers, who account for the bulk of spending in the economy. Consumers are typically assumed to have complete and perfect information about both their own economic resources and the products they buy. In contrast, Chapter 3 demonstrates how consumers' choices are constrained by their resources or manipulated by external forces, most notably advertising.

Microeconomics treats firms as profit-maximizing enterprises. This is one assumption the editors of *Dollars & Sense* don't challenge. However, unlike most texts, the articles in chapters 4 and 5 of *Real World Micro* argue that profit maximization can be dangerous to an employee's health — and to the overall health of the economy. In Chapter 4, we examine the individual firm, showing how different management structures, from traditional top-down management to worker participation programs to co-ops, yield contrasting results for workers. In Chapter 5, the articles show how different market structures — monopoly, oligopoly, and competition — affect consumers and workers in industries such as banking, trucking, pharmaceuticals and manufacturing.

Chapter 6 covers labor markets, which differ sharply from markets for pizzas, haircuts, or airplanes. Unlike other factors of production, labor is a human input. These articles explore the human dimensions of labor markets, examining the low-wage labor market facing welfare recipients, the role of unions, the cause of falling real wages, and the debate over the labor market consequences of immigration.

Chapters 7 and 8 confront pressing issues facing society today: discrimination, poverty, and inequality, and the health of the environment. Chapter 7 uncovers the extent and origins of poverty and inequality in the United States, and documents the inadequacy of government responses. The articles also address racism and sex discrimination in the labor and mortgage markets.

In chapter 8, which focuses on the environment, the articles reveal both strengths and weaknesses in market-oriented approaches to solving environmental problems. "Trading Away the Earth" critiques the use of tradeable pollution credits, while "Taxing Trash" shows how taxes can help clean up the environment.

The final chapter examines the global economy, with the first article providing a basic critique of free trade and investment. Two concluding articles address the effects of the North American Free Trade Agreement outside U.S. borders.

As you'll see, Real World Micro is a lively and provocative supplement to your standard microeconomics textbook. We hope you enjoy it.

— The Editors of *Dollars & Sense* magazine

CHAPTER 1
The Basics

ARTICLE 1

November 1989

SHAKING THE INVISIBLE HAND

THE UNCERTAIN FOUNDATIONS OF FREE-MARKET ECONOMICS

BY CHRIS TILLY

"It is not from the benevolence of the butcher, the brewer or the baker that we expect our dinner, but from their regard to their own interest...[No individual] intends to promote the public interest... [rather, he is] led by an invisible hand to promote an end which was no part of his intention."

Adam Smith,
The Wealth of Nations, 1776

Seen the Invisible Hand lately? It's all around us these days, propping up conservative arguments in favor of free trade, deregulation, and tax-cutting.

Today's advocates for "free," competitive markets echo Adam Smith's claim that unfettered markets translate the selfish pursuit of individual gain into the greatest benefit for all. They trumpet the superiority of capitalist free enterprise over socialist efforts to supplant the market with a planned economy, and even decry liberal attempts to moderate the market. Anything short of competitive markets, they proclaim, yields economic inefficiency, making society worse off.

But the economic principle underlying this fanfare is shaky indeed. Since the late 19th century, mainstream economists have struggled to prove that Smith was right — that the chaos of free markets leads to a blissful economic order. In the 1950s, U.S. economists Kenneth Arrow and Gerard Debreu finally came up with a theoretical proof, which many orthodox economists view as the centerpiece of modern economic theory.

Although this proof is the product of the best minds of mainstream economics, it ends up saying surprisingly little in defense of free markets. The modern theory of the Invisible Hand shows that given certain assumptions, free markets reduce the wasteful use of economic resources — but perpetuate unequal income distribution.

To prove free markets cut waste, economists must make a number of farfetched assumptions: there are no concentrations of economic power; buyers and sellers know every detail about the present and future economy; and all costs of production are borne by producers while all benefits from consumption are paid for by consumers (see box for a complete list). Take away any one of these assumptions and markets can lead to stagnation, recession, and other forms of waste — as in fact they do.

In short, the economic theory invoked by conservatives to justify free markets instead starkly reveals their limitations.

THE FRUITS OF FREE MARKETS

The basic idea behind the Invisible Hand can be illustrated with a story. Suppose that I grow apples and you grow oranges. We both grow tired of eating the same fruit all the time and decide to trade. Perhaps we start by trading one apple for one orange. This exchange satisfies both of us, because in fact I would gladly give up more than one apple the theory, competition between apple farmers insures that consumers will get apples produced at the lowest possible cost. Government intervention still can only make things worse.

This fable provides a ready-made policy guide. Substitute "Japanese autos" and "U.S. agricultural products" for apples and oranges, and the fable tells you that import quotas or tariffs only make the people of both countries worse off. Change the industries to airlines or telephone services, and the fable calls for deregulation. Or re-tell the tale in the labor market: minimum wages and unions (which prevent workers from individually bargaining over their wages) hurt employers and workers.

FRUIT SALAD

Unfortunately for free-market boosters, two major shortcomings make a fruit salad out of this story. First, even if free markets perform as advertised, they deliver only one benefit — the prevention of certain economically wasteful practices — while preserving inequality. According to the theory, competitive markets wipe out two kinds of waste: unrealized trades and inefficient production. Given the right assumptions, markets ensure that when two parties both stand to gain from a trade, they make that trade, as in the apples-and-oranges story. Competition compels producers to search for the most efficient, lowest-cost production methods — again, given the right preconditions.

Though eliminating waste is a worthy goal, it leaves economic inequality untouched. Returning once more to the orchard, if I start out with all of the apples and oranges and you start out with none, that situation is free of waste: no swap can make us both better off since you have nothing to trade! Orthodox economists acknowledge that even in the ideal competitive market, those who start out rich stay rich, while the poor remain poor. Many of them argue that attempts at redistributing income will most certainly create economic inefficiencies, justifying the preservation of current inequities.

But in real-life economics, competition does lead to waste. Companies wastefully duplicate each other's research and build excess productive capacity. Cost-cutting often leads to shoddy products, worker speedup, and unsafe working conditions. People and factories stand idle while houses go unbuilt and people go unfed. That's because of the second major problem: real economies don't match the assumptions of the Invisible Hand theory.

Of course, all economic theories build their arguments on a set of simplifying assumptions about the world. These assumptions often sacrifice some less important aspects of reality in order to focus on the economic mechanisms of interest. But in the case of the Invisible Hand, the theoretical preconditions contradict several central features of the economy.

For one thing, markets are only guaranteed to prevent waste if the economy runs on "perfect competition": individual sellers compete by cutting prices, individual buyers compete by raising price offers, and nobody holds concentrated economic power. But today's giant corporations hardly match this description. Coke and Pepsi compete with advertising rather than price cuts. The oil companies keep prices high enough to register massive profits every year. Employers coordinate the pay and benefits they offer to avoid bidding up compensation. Workers, in turn, marshal their own forces via unionization — another departure from perfect competition.

Indeed, the jargon of "perfect competition" overlooks the fact that property ownership itself confers disproportionate economic power. "In the competitive model," orthodox economist Paul Samuelson commented, "it makes no difference whether capital hires labor or the other way around." He argued that given perfect competition among workers and among capitalists, wages and profits would remain the same regardless of who does the hiring. But unemployment — a persistent feature of market-driven economies — makes job loss very costly to workers. The sting my boss feels when I "fire" him by quitting my job hardly equals the setback I experience when he fires me.

PERFECT INFORMATION?

In addition, the grip of the Invisible Hand is only sure if all buyers and sellers have "perfect information" about the present and future state of markets. In the present, this implies consumers know exactly what they are buying — an assumption hard to swallow in these days of leaky breast implants and chicken a la Salmonella. Employers must know exactly what skills workers have and how hard they will work — suppositions any real-life manager would laugh at.

Perfect information also means sellers can always sniff out unsatisfied demands, and buyers can detect any excess supplies of goods. Orthodox economists rely on the metaphor of an omnipresent "auctioneer" who is always calling out prices so all buyers and sellers can find mutually agreeable prices and consummate every possible sale. But in the actual economy, the auctioneer is nowhere to be found, and markets are plagued by surpluses and shortages.

Perfect information about the future is even harder to come by. For example, a company decides whether or not to build a new plant based on whether it expects sales to rise. But predicting future demand is a tricky matter. One reason is that people may save money today in order to buy (demand) goods and services in the future. The problem comes in predicting when. As economist John Maynard Keynes observed in 1934, "An act of individual saving means — so to speak — a decision not to have dinner today. But it does not necessitate a decision to have dinner or to buy a pair of boots a week hence ... or to consume any specified thing at any specified date. Thus it depresses the business of preparing today's dinner without stimulating the business of making ready for some future act of consumption." Keynes concluded that far from curtailing waste, free markets gave rise to the colossal waste of human and economic resources that was the Great Depression — in part because of this type of uncertainty about the future.

FREE LUNCH

The dexterity of the Invisible Hand also depends on the principle that "You only get what you pay for." This "no free lunch" principle seems at first glance a reasonable description of the economy. But major exceptions arise. One is what economists call "externalities" — economic transactions that take place outside the market. Consider a hospital that dumps syringes at sea. In effect, the hospital gets a free lunch by passing the costs of waste disposal on to the rest of us. Because no market exists where the right to dump is bought and sold, free markets do nothing to compel the hospital to bear the costs of dumping — which is why the government must step in.

Public goods such as sewer systems also violate the "no free lunch" rule. Once the sewer system is in place, everyone shares in the benefits of the waste disposal, regardless of whether or not they helped pay for it. Suppose sewer systems were sold in a free market, in which each person had the opportunity to buy an individual share. Then any sensible, self-interested consumer would hold back from buying his or her fair share — and wait for others to provide the service. This irrational situation would persist unless consumers could somehow collectively agree on how extensive a sewer system to produce — once more bringing government into the picture.

Most orthodox economists claim that the list of externalities and public goods in the economy is short and easily addressed. Liberals and radicals, on the other hand, offer a long list: for example, public goods include education, health care, and decent public transportation—all in short supply in our society.

Because real markets deviate from the ideal markets envisioned in the theory of the Invisible Hand, they give us both inequality and waste. But if the theory is so far off the mark, why do mainstream economists and policy-makers place so much stock in it? They fundamentally believe the profit motive is the best guide for the economy. If you believe that "What's good for General Motors is good for the USA," the Invisible Hand theory can seem quite reasonable. Business interests, government, and the media constantly reinforce this belief, and reward those who can dress it up in theoretical terms. As long as capital remains the dominant force in society, the Invisible Hand will maintain its grip on the hearts and minds of us all.

ARTICLE 2 *September/October 1994*

WHO GAINS FROM TRADE?

BY MEHRENE LARUDEE

Classical economic theory favors free trade among nations. Each country specializes in what it makes most efficiently, so that everyone can buy goods as cheaply as possible. Imagine two countries, Riceland and Beanland. At first, each grows its own rice and beans. Riceland is blessed with a wet climate ideal for growing rice, but its bean fields require constant, backbreaking work to drain the soil and keep the beanstalks from rotting. Beanland's climate is ideal for beans, but the people sweat and strain hauling water to the rice fields.

Then the countries discover each other and start trading. Riceland is delighted to make just rice, selling half of it to Beanland, while Beanland makes just beans and sells half to Riceland. The people save the time they used to spend draining and watering. Now they have leisure to sing, dance, and compose odes to free trade, plus energy left to make other things. Some Ricelanders start dabbling in vegetables, and some Beanlanders develop ways to build stronger huts. The economy flourishes, and everyone gains.

The theory of "comparative advantage" claims, moreover, that the two countries would benefit from trade even if Riceland is better at producing *both* rice and beans than is Beanland. Each country should still specialize in whichever crop it is *relatively* more efficient at producing, so Beanland would keep growing beans and selling them to Riceland.

In reality, however, trade is not always so simple or blissful, especially among capitalist economies. Sometimes one group benefits at another's expense. And sometimes countries compete on grounds less admirable than efficiency.

Suppose that unemployment increases in Riceland due to the decline of its bean industry, and in Beanland due to the end of rice production. In a primitive system, perhaps people would spread the work and enjoy more free time. But not in the contemporary world of the 9-to-5 job.

Defenders of free trade concede that some people may lose out, but they argue that the benefit to society outweighs the loss to any one group. In addition, it is possible to tax the winners in order to compensate the losers, offering financial aid to dislocated workers while they look for other jobs, as well as retraining for other occupations. In reality, though, the losers have rarely had the political clout to get what they deserve. The U.S. government has set up such "trade adjustment assistance" programs, but they have been inadequate.

There is another pitfall to free trade. Suppose one country produces relatively expensive goods because employers offer decent pay and working conditions for labor, and take pains to protect the environment. If that nation suddenly has to compete with one where companies treat workers poorly and pollute with abandon, it will be forced to sacrifice either its standards or its jobs. This was a major point of protest against the North American Free Trade Agreement (NAFTA) among the United States, Canada, and Mexico.

THEORY VERSUS POLITICS

Governments pursue free trade when it suits them. England frowned on barriers when it held sway in the 19th century, whereas its struggling former colonies, the United States, had an interest in sheltering its fledgling producers from world competition. Had the United States followed the prescriptions of free trade theorists, it would have specialized in furs from early colonial days. Instead, the United States established tariffs (taxes on imported goods) to protect its infant manufacturing industries while it developed the capacity to make tools and machinery at competitive prices. Protectionism served a strategic role, as it can today for many developing countries.

IT IS NO LONGER NATIONS, BUT COMPANIES, THAT TRADE.

After World War II, the United States was in a stronger position and pushed to erode trade barriers through the General Agreement on Tariffs and Trade (GATT), founded in 1948. For the next two decades, trade liberalization was on balance a benefit to workers and consumers in the United States. The economy was growing rapidly and new jobs proliferated, easily compensating for the few jobs lost to foreign competitors. U.S. exporters reinvested their profits at home, helping to create new jobs and boost incomes. And a variety of cheap foreign goods became available. In general, capital and labor both supported free trade.

Then sales abroad got tangled up with something else: investment abroad. Increasingly, companies based in the United States were setting up plants overseas and hiring workers there. Free investment coupled with free trade frequently meant freedom for corporations to hire low-wage labor elsewhere and sell their products back to consumers at home. While U.S. residents benefitted as consumers, they suffered as workers. Not only did certain industries suffer job losses; more unemployment in the economy at large also meant less bargaining power for workers overall. A whole community can be devastated when a plant shuts down, spurring divorce, alcoholism, crime, and suicide. As more and more jobs were exported, especially to overseas auto plants, the AFL-CIO abandoned its longstanding support for free trade. By 1970, the union was pressing for protections. The interests of labor and multinational capital diverged.

FAIR TRADE

If free trade and investment have their problems, so does protectionism. True, it can save jobs in targetted industries. Import quotas have kept the U.S. textile industry in business, for example. But wherever tariffs or quotas save jobs, consumers pay more for goods. The Federal Trade Commission estimated that each $27,000 auto industry job saved by Japan's voluntary export limits costs U.S. consumers $241,000 in higher car prices. Whatever the accuracy of such estimates, free traders argue, with some reason, that protectionism means higher prices.

In addition, protective measures often fail, because other countries simply retaliate with their own barriers. And protectionism often comes packaged with a narrow-minded, racist nationalism. Consider the recent wave of anti-Asian sentiment and Japan bashing. Such ugly attitudes can lead to violence, even war. And a protectionist stance by wealthy nations can punish developing countries striving for a higher living standard. A pillar of South Korea's development strategy, for example, has been exporting to the huge and lucrative U.S. market.

Labor advocates have at times urged us to simply "buy American." But with the spread of international investment, the concept of American versus foreign goods is slowly losing meaning. It is no longer nations, but companies, that trade. GM and Toyota own a plant together in Fremont, California where they build Geo Prizms and Corollas. Which car is more American? In 1988, the hottest selling imported car in Japan was the Honda Accord, a "U.S. export" produced by Honda in Ohio. Even autos built domestically by GM, Ford, and Chrysler are full of components from all over the world.

Instead of debating tariffs and quotas, we should work for fair trade — standards for wages, working conditions, and environmental safeguards that all countries must meet. In Europe, labor and community leaders knew that hard-won protections for labor, the environment, and consumers would be threatened when poorer countries such as Spain and Portugal joined the European Community. They drew up a social charter setting minimum standards in these areas that all members would have to meet. Following that lead, a coalition of groups in the United

States is developing the idea of a social charter to apply to any free trade area that the country joins.

Trade is a tough issue. We want U.S. workers to keep their jobs and incomes without fostering the racism that often accompanies protectionism. We want the rest of the world to get the good life, without losing it ourselves. Free trade offers the potential for more efficient production and lower prices. But it also poses dangers. If companies compete on wages, the real gains from trade could be minimal, compared to the shift from wages to profits. When coupled with free investment, free trade often means huge dislocations as shops run away. These threats will disappear only when wages and working conditions are similar around the world. We help ourselves by working to raise standards everywhere. Trade can benefit all, if only people unite across borders.

ARTICLE 3

January/February 1995

THE CASE OF HUNGARY

FREE MARKETS AREN'T ALWAYS THE SOLUTION

BY PHINEAS BAXANDALL

In return for free market reforms, instead of riches East Europeans got plunging living standards and economic output, sharp declines that make this country's Great Depression look easy. National incomes have dropped by 10% to 20%, wages are similarly depressed, and even productivity is down. Even if the rosiest predictions of growth come true, it will be a number of years before output returns to pre-1989 levels. In a 1994 poll, East Europeans not only said the current situation is worse than five years earlier; they also said that they expect the situation five years down the road to be even worse than it is today.

It has been a while since the heady days of 1989, when the Berlin Wall fell and a starry-eyed East Europe embraced free markets. Today, the headlines speak of disillusionment and despair. Branko Milanovic, a baffled senior economist for the World Bank, recently admitted, "No one expected declines of such magnitude. The first idea was that the economies would grow immediately because the systems were so inefficient."

East Europeans were urged to give up the shabby security of state socialism for the glamour and get-rich dreams offered by free markets. Proponents gave four major reasons the privatized economy would pick up steam: it would shed the burden of inefficient state-owned enterprises and "bloated" social welfare programs; it would bring enormous gains in efficiency; foreign aid and investment would flood into the region; and new Western markets would fuel exports.

None of these promises has been fulfilled. Privatization, to the small extent it has occurred, hasn't led to the automatic efficiency gains foretold by Western economists. Foreign aid has been a pitiful trickle, lucrative Western markets have not opened up to Eastern goods, and Hungary's social programs are even more vital today.

SHEDDING AN INEFFICIENT STATE SECTOR

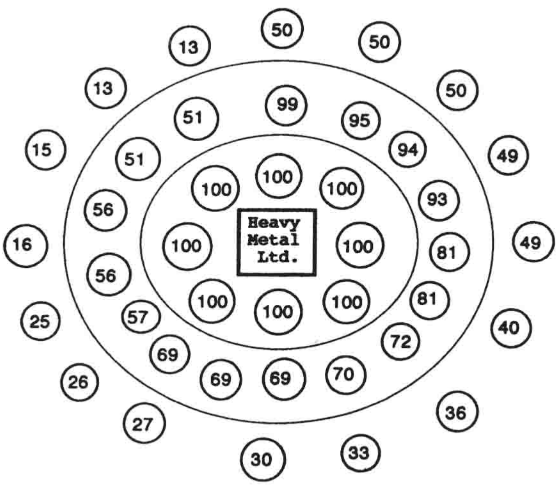
In Hungary, the often-quoted figure is that social spending accounts for an obscenely large 60% of the state budget, compared to about 25% of government expenditures in most countries in the European Community (EC). As one Hungarian economist at Harvard has argued, "The Hungarian welfare state was born 'prematurely.'" In other words, the problem is that Hungary has followed an incorrect path for developing nations by spending too much money on areas like health, education, and pensions. Have Hungarians been overly generous in building a welfare state they have not yet "earned"?

Hungarians certainly don't think their benefits are excessive. The typical pension is not enough to keep an elderly person out of poverty. Doctors' salaries are so low that they require large "tips" from their patients. Benefits for the unemployed or elderly are often guided by official wage levels, but since Hungarians typically moonlight at second and third jobs, their official earnings often yield inadequate benefit levels.

Much of the impressive size of the "social" portion of the budget results from the fact that the rest of the economy has been shrinking. Back in 1980-1981, when Hungary's economic health was comparable to Western Europe's, the state spent about 20% of the gross domestic product (GDP) on social programs, the same portion spent by the United States, and far less than the 30% or more spent by Scandinavia, Germany, Belgium, and the Netherlands. But Hungary has experienced an 18% drop in gross domestic product (GDP) over the last five years.

Still, Hungary has had to step up its social spending in absolute terms to contend with a deep depression. These spending increases are a reaction to the 16% fall in real wages since 1989. Never before did the government have to support homeless shelters and soup kitchens, or provide unemployment benefits to 12% of its population. The high levels of social spending in Hungary are the result of the *collapse* of state socialism, not a previous welfare binge.

PUBLIC OR PRIVATE?



State-owned company Heavy Metal Ltd. and its satellites of "private" corporations. The numbers inside each circle are the percentages of each satellite company's shares owned by Heavy Metal. The remaining shares may also be owned by public corporations, which may officially be private even though the state is the largest owner.

STATE SOCIALISM'S STRUCTURES

Hungary's past is far more complex than Western economists have assumed. The government's social programs, so often depicted as irrationally bloated, were inextricably linked to its agenda as a major employer. Under the guise of "building the productive base of socialism," wages were kept so low that workers could not make ends meet without additional social benefits, which were sometimes contingent on job performance.

Low wages ensured that people would not have extra discretionary income, which the state viewed as frivolous. But this also meant that people could not save for hard times or raising a family. State benefits for particular needs, such as old age or dependent children, thus complemented a general drive to keep wages low enough so that households without such needs would not enjoy a surplus. As one recent report from a Budapest think tank explained, "The means to pay for social services are not 'built into incomes.' Hence if social subsidies are withdrawn from the middle class, large numbers of people will be impoverished."

Here in the United States, the tendency has been to blame the economic problems of East Europe on the laziness and passivity of its workers. *The New York Times* reports, "Working habits and egalitarian attitudes drilled into minds by 40 years of enforced Communism remain deeply embedded five years after its collapse, making it difficult for people to work through the painful first stage of a conversion to a market economy." But in fact, Hungarians work multiple jobs, and in scrambling to do so life expectancy has consistently fallen since the mid-1980s.

When a survey asked Hungarians, "Do you get enough money from your regular job to buy what you really need?" only 36% responded that they received enough, even barely enough. The percentage in neighboring Austria was twice that. When the IMF (International Monetary Fund) or other critics say that social benefits are too high, they are callously implying that Hungary's low wages of $300 a month are high enough by themselves to take care of people's basic needs. While the shift to free markets was supposed to create a broad middle class, current trends will lead only to the creation of a tiny elite, with the rest of the population struggling to stay out of poverty.

WHERE ARE THE PRIVATE PARTS?

The push for privatization in East Europe arose largely from the infectious ideological fervor of emissaries from Western organizations, such as the World Bank and the U.S. Agency for International Development. Reaganites and Thatcherites, frustrated by the compromises of their crusades at home, found a new chance to preach the magic of the marketplace.

By transferring property to private owners, such advocates argue, privatization will create the proper incentives for greater efficiency (see box, page 13). "A market economy," according to former Polish finance minister Leszek Balcerowicz, "generates the quickest improvement in the living standard of citizens. This is so because economizing costs, good organization of work, high quality of production, the effective search for new markets, and technical progress and development are in the interest of the proprietors who direct the work of enterprises."

In Hungary and elsewhere, there was some talk at first of giving ownership shares back to the citizens, a move that would have ensured continuing dispersed ownership and egalitarian incomes. But the government, under pressure from Western lending agencies, rejected these schemes. Diluted ownership and "give-aways," according to Western advisors, helped cause the inefficiencies of the past.

In 1990, Hungary's conservative government, led by prime minister Joszef Antall, announced that the State Privatization Agency would quickly find owners for over half of all state property. Small retail shops and apartments were relatively easy to sell to managers and tenants. In order to auction off industrial enterprises, however, the agency had to wrest control from the managers, who had effectively gained many property rights over 25 years of slow decentralization. The government initiated a special program to get privatization going, by speeding twenty of the most attractive state firms onto the auction block. But two years later, according to the agency's Privatization Research Institute, only about 3% of the state-owned total productive capital had been privatized.

Among the flagship twenty firms, only four had been sold, one to a consortium of public companies. Private domestic owners were hard to come by, because East Europeans didn't have the money to buy the property they had built up while working for the state. The combined savings of all Eastern Europeans in 1989 was estimated at less than 10% of the value of the state's capital stock. But there is great pressure to make it appear as if privatization is rapidly advancing. After returning from an international conference where Polish officials had proudly displayed figures showing that their country had replaced Hungary as the region's most private economy, Hungarian officials reportedly urged the use of different statistical measures and cut-offs to restore Hungary's standing.

Frustrated with the snail's pace of privatization, the government in late 1992 introduced a new program for "self-privatization," which encouraged private consulting firms to help reorganize and sell state-owned enterprises. This move was little more than an official licensing of the existing process of "spontaneous" or "nomenklatura" privatization.

Since 1989, well-connected enterprise managers had been cutting up and selling their firms. They took advantage of a much-extended 1990 law which mandated that enterprises transform themselves into joint-stock companies. But through this process, the self-interest of private owners did not always translate into greater efficiency. In many cases, managers "cannibalize" their state-owned companies by fixing sweet-heart leasing, pricing, or rental arrangements with companies in which they personally hold control. Some have even purposefully driven state-owned firms into bankruptcy, so they might later use their insider knowledge to buy the firm, or its most valuable subsidiaries, on the cheap.

The result is an odd kind of ownership, which is in many ways more centralized and fragmented than before, and in

ELUSIVE EFFICIENCY

In theory, privatization is supposed to bring prosperity. Mainstream economists believe that private property rights promote greater efficiency. These rights include a bundle of distinct and often separable rights: to receive income from property, to transfer ownership, to control it, to exclude others from it, and so on. When property rights are exclusive and exactly specified, they are supposed to promote efficiency by creating clear incentives.

If a number of people (or firms) perform a task and share the benefits, economists believe that each will only have an incentive to contribute to the extent that they reap rewards. The greater the number of participants, the more diluted the incentives, and the more likely it is that each will "free-ride" off the efforts of the group. The feared situation resembles a bunch of people carrying a piano, when each person decides to rely on the others to exert themselves. A supervisor may be assigned to monitor tasks, but even in large operations with many levels of hierarchy, the assumption is that there should be an owner overseeing it all. Economists believe that in "efficient capital markets," stockholders play a similar role overseeing their property as a single proprietor would.

As one conservative member of the British parliament, John Redwood, told the newly established Budapest Stock Exchange in 1989: "When privatization was tried in Great Britain, old industries were renewed and economic performance was improved. In the case of the British Steel industry, a heavy loss-making industry in permanent decline was turned round. It became profitable, modern, and one of the best in the world."

What he failed to mention was that the improvements occurred before privatization, not after. The much-touted gains from privatization in the West were often due to factors that have nothing to do with efficiency. Firms like British Steel and British Air were reorganized,

removing the unprofitable parts of the organization in preparation for sale. Privatized firms are also left free to bid down the value of workers' wages and benefits, or to take advantage of a monopoly position by raising prices. A lack of public accountability also allows privatized firms and subcontractors greater "flexibility" in cutting labor costs by refusing to hire from strong public unions, threatening to relocate elsewhere, and evading social security taxes.

Mainstream economics simply looks at the before and after, and anything that survives is called efficient. The idea of adaptations that aren't more efficient just doesn't compute. Firms that survive in the real world, however, may be simply those with the right connections to state banks, or those that are adept at evading taxes and labor laws.

Firms that don't survive, on the other hand, are sometimes the victims of cash-flow problems that economic theories also fail to acknowledge. The assumption of "efficient capital markets" prevents economists from considering the possibility of otherwise viable firms that go bankrupt because they can't get loans.

Economists who theorize about efficient capital markets also make unfounded assumptions about oversight in Eastern Europe. Stockholders don't function as the watchdogs economists imagine. East European stock markets trade for only a handful of firms, and nobody except for a few insiders has many details about the value, much less potential, of assets.

The Russian economists Grigory Yavlinsky and Serguey Braguinsky, stunned at how Western advisors have misunderstood their economy, expressed their dismay this way: "In the old days engineers who constructed a railway bridge in Russia had to stand under it when the first train crossed.... [We] ask all those advisers who care so little about the countries they try to help that they are unable to even theorize properly to stay at home."

which the state still plays a substantial role. It is not even clear that this form of ownership deserves its official designation as private. Shares are cross-owned by suppliers, the users of final products, sometimes municipal governments, and usually state-owned banks. State-owned firms can have partial or majority ownership in a host of other so-called "private" corporate satellites, each of which may also be owned by other state institutions and private firms (see diagram on p. 12).

In 1994, industrial sociologist David Stark conducted a study of Hungary's top 205 banks and enterprises. In only 12 of the largest enterprises and banks did Hungarian individuals hold a quarter or more of the shares. Most often, other banks and enterprises largely owned by the state possessed most of the shares. In Poland, the little privatization of industry that has occurred has mostly been through a loophole in the original law, which allowed essentially the same kind of maneuver with a greater role for work councils. The Russian and Czech republic governments have implemented elaborate privatization schemes, but then have protected firms from bankruptcy. Moreover, the state is the biggest behind-the-scenes owner of the intermediary institutions that own the growing "private" sector.

In Hungary, this unusual sort of property reorganization created a number of banking fiascos. Many firms threatened with bankruptcy have paid off their debt by selling ownership shares to banks, which are mostly public. As banks acquired an increasing load of bad debt, Hungary's government was forced to launch a $3 billion dollar bailout program to pay it off and to "consolidate" enterprise loans that might some day be paid back. This sum amounts to about 10% of the Hungarian GDP. By comparison, the $105 billion Savings and Loan bailout in the United States was 1.6% of the GDP.

Studies of new entrepreneurial private firms show that they are no better models of future capitalism — rarely paying their taxes, using sophisticated technology, or providing guarantees of job security. Many "private firms" are fabrications, existing only so that professionals can write off expenses such as heat, rent, and telephone for their apartments. An early study of private companies in Poland found the average sized "firm" to include about two people. Private ventures merely provide most people with a second job, and rarely offer a primary means of employment.

As David Stark asks about the new attempts at entrepreneurship, "Is this the vaunted free market capitalism, or is it just flea market capitalism?" Privatization is supposed to encourage incentives for investment, but East Europe has an extremely low investment rate, partly the result of a sluggish economy, partly a symptom of overall economic uncertainty. Hungarian fixed capital accumulation in 1992 was barely three-quarters of what it had been in 1989. Property is being reorganized, but the outcome is not necessarily greater efficiency, nor even increasingly decentralized and private firms.

NO MARSHALL PLAN FOR THE EAST

The first foreign aid to Eastern Europe was a shipment of pesticides that had been banned in the United States. A recent shipment from the British government to Albania was full of 50-year-old biscuits left over from World War II. Western corporations have shown little interest in producing anything in Hungary; when they do invest it is often to set up distribution for their own products or to buy up potential competitors.

In the first two years after the political changes, approximately $3 billion dollars in foreign direct investment came to Czechoslovakia, Hungary, Poland and their 64 million inhabitants. About the same amount of money fattened the endowments of Harvard, Stanford, and Cornell Universities over the same period. Because of its political stability and relatively well developed market infrastructure, Hungary continues to get the lion's share in the region, despite the fact that its wages are the highest. It appears that if foreign investors want low wages, they'll go to Asia or Latin America. The real reason they invest in Eastern Europe is for market access: for the country's future consumers, for the well-established links with markets in the former Soviet Union, and to avoid West European tariffs once East European nations become more integrated with the European Union.

BROKEN PROMISES OF REJOINING EUROPE

Free markets have brought a flood of Western consumer goods with slick marketing and high prices. But Eastern European countries have often found the doors of Western markets closed to their goods. Hungary, once the breadbasket of the Soviet Bloc and before that the Austro-Hungarian Empire, has become a net food importer for the first time in history. The EC dumps its agricultural surplus on East European markets while tightly restricting the Eastern foodstuffs that can be sold in the West. Eastern farmers are occasionally even locked out of their own markets because Western corporations have bought up distribution networks. The Russian town of Nevel, for example, is a large producer of fresh milk. But the Western distributors there stock the shelves with milk from France, forcing the town to powder its milk and export it to Spain.

Trade is extremely important to Eastern European nations, because they are generally small and all were part of the old Soviet COMECON trading system. With the collapse of COMECON, Eastern European nations need to trade with the countries of the EC. In fact, they are clamoring to join the EC in part because the community has been stingy in opening up its markets to them. The kinds of cheap goods Eastern Europe has to offer, such as steel, coal, textiles, and agriculture, are in precisely the industries experiencing politically contentious downsizing in Western Europe, so Western governments are especially wary of new competition in those areas.

In a string of recent elections in Hungary, Poland, and Lithuania, voters have rejected neoliberal plans to follow most of the Third World in IMF-designed austerity plans and economic restructuring. In Russia and the Ukraine, the strong showing for candidates against Western reform has unfortunately taken more nationalist tones.

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Western advisors have backed off from pushing the "shock therapy" of rapid privatization and deregulation. The whole idea of shock therapy was a kind of anti-democratic trickery, in which the shock therapists anticipated the inevitable political backlash from "transitional" pains, and pushed for quick and decisive reforms that could not be rolled back. After the first election in Russia, the State Department had to concede that it had pursued a policy of "too much shock, not enough therapy."

Each of these elections has been greeted by the Western press with condescending scorn. Have these people learned nothing from the ravages of Communism?

What they have learned is to distrust grand plans for social engineering, including untried neoliberal blueprints from Western academics and bankers. As Polish dissident Adam Michnik puts it, Western advisors and recent Eastern converts are "right wing Bolsheviks." This time the magical elixir the people are being asked to swallow is no longer "planning" and "nationalization of production" but "the market" and "private property." This time society is not being turned upside down for an as-yet-unformed proletariat, but an as-yet nonexistent middle class. The actors have changed, but the hollow promises of glorious transformation are familiar.

IS SMALL BEAUTIFUL? IS BIGGER BETTER?

SMALL AND BIG BUSINESS BOTH HAVE THEIR DRAWBACKS

BY CHRIS TILLY

Beginning in the late 1980s, the United States has experienced a small, but significant boom in small business. While big businesses have downsized, small enterprises have proliferated. Should we be glad? Absolutely, declare the advocates of small business. Competition makes small businesses entrepreneurial, innovative, and responsive to customers.

Not so fast, reply big business's boosters. Big corporations grew big because they were efficient, and tend to stay efficient because they are big — and thus able to invest in research and upgrading of technology and workforce skills.

But each side in this debate omits crucial drawbacks. Small may be beautiful for consumers, but it's often oppressive for workers. And while big businesses wield the power to advance technology, they also often wield the market power to bash competitors and soak consumers. In the end, the choices are quite limited.

BIG AND SMALL

Is the United States a nation of big businesses, or of small ones? There are two conventional ways to measure business size. One is simply to count the number of employees. By this measure, small businesses (say, business establishments with less than 20 employees) make up the majority of businesses (Table 1). But they provide only a small fraction of the total number of jobs.

The other approach gauges market share — each firm's share of total sales in a given industry. Industries range between two extremes: what economists call "perfect competition" (many firms selling a standardized product, each too tiny to affect the market price) and monopoly (one business controls all sales in an industry). Economy-wide, as with employment, small businesses are most numerous, but control only a small slice of total sales. Sole proprietorships account for 73% of established businesses, far outnumbering corporations, which are 19% of the total (the remainder are partnerships). But corporations ring up a hefty 90% of all sales, leaving sole proprietors with only 6%. It takes a lot of mom and pop stores to equal General Motors' 1993 total of $138 billion in sales.

Industry by industry, the degree of competition varies widely. Economists consider an industry concentrated when its top four companies account for more than 40% of total sales in the industry (Table 2). At one end of the spectrum are the chewing gum, beer, and aircraft industries, where four or five firms account for most U.S. production.

No market comes close to meeting the textbook specifications for perfect competition, but one can still find industries in which a large number of producers compete for sales. The clothing and restaurant industries, for example, remain relatively competitive. Overall, about one-third of U.S. goods are manufactured in concentrated industries, about one fifth are made in competitive industries, and the rest fall somewhere in between.

BEATING THE COMPETITION

Those who tout the benefits of small, competitive business make a broad range of claims on its behalf. In addition to keeping prices low, they say the quality of the product is constantly improving, as companies seek a competitive edge. The same desire, they claim, drives firms toward technological innovations, leading to productivity increases.

The real story is not so simple. Competition does indeed keep prices low. Believe it or not, clothing costs us less — in real terms — than it cost our parents. Between 1960 and 1995, while the overall price level and hourly wages both increased fivefold, apparel prices didn't even triple. And small businesses excel at offering variety, whether it is the ethnic restaurants that dot cities or the custom machine-tool work offered by small shops. Furthermore, however powerful small business lobbies may be in Washington, they do not influence the legislative process as blatantly as do corporate giants.

But those low prices often have an ugly underside. Our sportswear is cheap in part because the garment industry increasingly subcontracts work to sweatshops — whether they be export assembly plants in Haiti paying dollar-a-day wages, or the "underground" Los Angeles stitcheries that employ immigrant women in virtual slavery. Struggling to maintain razor-thin profit margins, small businesses cut costs any way they can — which usually translates into low wages and onerous working conditions.

"There is a rule of survival for small business," Bill Ryan, president of Ryan Transfer Corporation, commented some years ago. "There are certain things you want to have [in paying workers] and certain things you can afford. You had better go with what you can afford." Bottom line, workers in companies employing 500 or more people enjoy average wages 30% higher than their counterparts in small businesses.

Part of this wage gap results from differences other than size — unionization, the education of the workforce, the particular jobs and industries involved. But University of Michigan economist Charles Brown and his colleagues controlled for all these differences and more, and still found a 10% premium for big business's employees. A note of caution, however: Other recent research indicates that this wage bonus is linked to long-term employment and job ladders. To the extent that corporations dissolve these long-term ties — as they seem to be rapidly doing — the pay advantage may dissolve as well.

Small business gurus make extravagant claims about small businesses' job-generation capacity. An oft-quoted 1987 report by consultant David Birch claimed that businesses with fewer than 20 employees create 88% of new jobs. The reality is more mundane: over the long run, businesses with 19 or fewer workers account for about one quarter of net new jobs. One reason why Birch's statistics are misleading is that new small businesses are created in great numbers, but they also fail at a high rate. The result is that the *net* gain in jobs is much smaller than the number created in business start-ups.

For companies in very competitive markets, the same "whip of competition" that keeps prices down undermines many of competition's other supposed benefits. The flurry of competition in the airline industry following deregulation, for example, hardly resulted in a higher quality product. Flying became temporarily cheaper, but also less comfortable, reliable, and safe.

Technological innovation from competition is also more myth than reality. Small firms in competitive industries do very little research and development. They lack both the cash needed to make long-term investments and the market power to guarantee a return on that investment. In fact, many of them can't even count on surviving

TABLE 1
SMALL BUSINESS NATION?
Most businesses are small, but most employees work for big businesses

Company size (number of employees)	*Percent of all firms*	*Percent of all workers*
1-4	55%	6%
5-9	20	9
10-19	12	11
20-49	8	16
50-99	3	13
100-249	2	16
250-499	0.4	9
500-999	0.2	7
1,000 or more	0.1	13

Source: County Business Patterns, 1993.

Note: "Businesses" refers to establishments, meaning business locations

TABLE 2
WHO COMPETES, WHO DOESN'T

Industry	*Percent of sales by top four firms*
Chewing gum	96%
Malt beverages	87
Cereal breakfast foods	87
Greeting card publishing	85
Aircraft	72
Soaps and other detergents	65
Blast furnaces and steel mills	44
Electronic computers	43
Machine tools, metal cutting types	31
Bolts, nuts, rivets, and washers	16
Women's and misses' dresses	6
Wood pallet skids	4

Source: 1987 Census of Manufacturers, Subject Series MC87-S-6