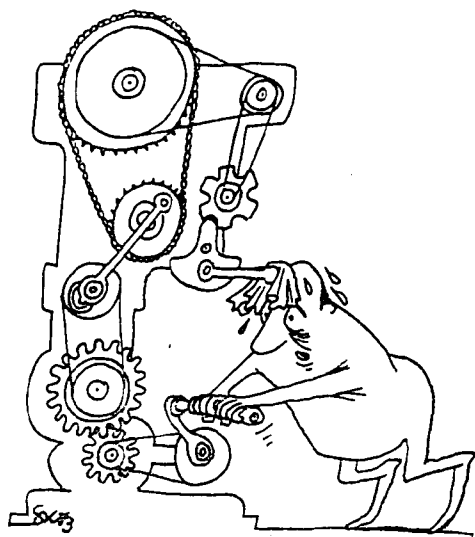


The Distorted World of Soviet-Type Economies



Jan Winiacki

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Abbreviations

CMEA	Alternative abbreviation for COMECON
COMECON	Council for Mutual Economic Assistance
CPE	Centrally planned economy
CPI	Consumer price index
CPSS	Communist Party of the Soviet Union
ECE	Economic Commission for Europe (UN)
FYP	Five-year plan
GDP	Gross domestic product
GNP	Gross national product
ISIC	International Standard Industrial Classification
LDC	Less developed country
MDC	'Middle' developed country
ME	Market economy
NMP	Net material product
PIG	Physical-indicators (global) methodology
R and D	Research and development
SD	Standard deviation
STE	Soviet-type economy
SYP	Seven-year plan
YP	Yearly plan

Introduction

The need for a book on system-specific economic distortions and their impact on economic performance of the Soviet-type economies was, not for the first time, strongly felt by me in the spring of 1983 in a Warsaw ice-cream parlor, while I discussed the latest developments in the area with an American friend, an expert on Eastern Europe. The friend, looking at the quite crowded place, remarked casually: 'I can imagine how crowded it will be after office hours.' 'Wrong', I said: 'After office hours, it will become half empty, since most people will go home or, more probably, go queueing somewhere.' Since there was so much to discuss, my friend saw for himself the place getting emptier and emptier as 4 p.m. approached.

I then realised once again that it was something more than a case of the misunderstanding of labour supply reactions in the Soviet-type economy.¹ It also furnished anecdotal evidence of the fact — and the umpteenth case of it — that even Western experts tend to take for granted the normality and, consequently, the universality of behavioural patterns grounded in the rationality of the Western system. Behind each piece of such anecdotal evidence of the misunderstanding by Western experts of one or another facet of the Soviet system was usually the underlying belief in 'a common rationality for both the market-type and the Soviet-type economies — a largely mistaken view.

Consequently, deviations from what may be regarded as behavioural normality in Western eyes seemed desirable as a focus of analysis for Soviet-type economies. Moreover, since behavioural deviations tend to translate themselves into economic distortions, in the sense of lasting adverse effects upon economic performance, it has been important to point out the links between deviations from Western rationality at the behavioural level and resultant economic losses — or gains forgone — at the aggregate level. Thus, the behaviour of economic agents in the Soviet system is rational at the micro level, but this rationality is clearly different from that of agents in the market system; and, what is more, there is no concordance between micro and macro rationality in the former, as there is in the latter. On the contrary, it is precisely the contradictions between the two that generate fundamental economic distortions.

A few comments about the book itself are in order. To begin with the readership, this is a researcher's book, and as such, it was

written with other researchers in mind. I hope that at least some of them find enough new and provocative material herein to stimulate further discussion on the distortionary world of Soviet-type economies. However, given its non-mathematical presentational style, this is also a book for other readers as well — for scholars who are non-specialists in comparative economic studies and/or East European area studies, but are nonetheless interested in the subject; for officials dealing with East–West issues; and — last but not least — for business men involved in or envisaging trade or other deals with Eastern European institutions or enterprises. Readers from each group may find in this study answers to some vexing questions which are unanswerable on the basis of the rationality governing the behaviour of the economic agents in the system with which they are familiar.²

As to the style, the material in this book is presented in a largely non-mathematical fashion. This has not been done merely to attract the wider readership that I had in mind: for much of the theory — if not most of it — of the Soviet-type economy ought to take into account the distinctively different institutional and behavioural features of the system, such that its formal modelling in the tradition of modern Western economic theory would become a very precarious exercise.³

Readers will themselves be able to judge to what extent the presentational style has indeed become lighter as a result of the scattering throughout the pages of the book of the ‘system-specific’ jokes heard in Eastern Europe. However, the occasional joke was not only intended to give the reader a ‘laughing space’, but also to offer a joke *as a shortcut to understanding*. In addition, anecdotal evidence is sometimes presented along similar lines, since — in the words of a 1981 Polish cabaret song — life in the Soviet system surpassed anything cabaret writers could invent. An example would be the story of an enterprising Pole who took advantage of irrational relative prices and bought bottles of sorrel soup, poured the soup into the nearby streams, cleaned the bottles there, and sold empty bottles to salvage storehouses, with a profit rate of 150 per cent (less the cost of cleaning and transportation).⁴ Or another story, this time from the long list of Potemkin village-type cases: a new Soviet factory was reported to be completed and a document putting it into commission was signed — although it existed only on paper! (*Pravda*, quoted in Dyker, 1982).

As regards the terminology, this author concurs with the view that Soviet-type economies (or STEs) represent a distinctive type of

economic system and the term used reflects their most important feature (Clarke, 1983). Another term, 'centrally planned economies' (or CPEs) was more widely used in the past, but some countries (e.g. Hungary) claimed that they had shed the institutional characteristics of CPEs. Regardless of the validity of that claim, Hungary continues to be an STE since it retains the linkages between the political and economic system, both formal and informal, characteristic for the Soviet system as a whole.

On the other hand, the term 'Eastern Europe' (or East for short) has a distinctive usage in this book. The term covers both the Soviet Union *and* six smaller STEs: Bulgaria, Czechoslovakia, East Germany (GDR), Hungary, Poland, and Romania. The exclusion of the Soviet Union from 'Eastern Europe' found in many studies is not justified, because it is precisely the fact that they are within the Soviet sphere that makes the six smaller STEs *Eastern European* countries. After all, in earlier (and happier) times, the same area was called Central Europe . . .⁵ Finally, the terms, STEs and East European countries are used with respect to *countries*, while the terms the Soviet-type economy, the Soviet system and central planning are used interchangeably with reference to *the economic system* dominant in Eastern Europe.

The content of this book and its order of presentation reflect the author's ideas concerning the fundamental distortions generated by STEs, as well as the linkages among them. Thus, the book is divided into three parts. The first part deals with the dynamics of the system, i.e. distortions affecting economic growth and price changes; the second with the structure of national economies as influenced by the dynamics of the system and the policies pursued (with special regard to the distortionary role of Soviet-type industrialisation); and the third with the impact of the dynamics and structure upon foreign trade performance and technology imports.

Some of the issues taken up in this book have already been studied extensively, as is the case with the so-called macroeconomics of central planning, i.e. aggregate quantity and price changes. What I have added to the picture is a behaviourally grounded clarification of the investment cycle concept, as well as the empirical evidence of the distortionary and inherently wasteful nature of the said phenomenon. Uncertainty has also been put into sharper focus. Another novel feature is a disaggregation of hidden inflation on the basis of establishing who is hiding it from whom, i.e. inflation hidden by the centre, by the public (meaning the enterprises) and half-hidden by both at the same time. Another classification of hidden inflation,

according to whether hidden price change appears in the guise of quantity change or is hidden price change pure and simple, contributes in my view to the clarification of the somewhat muddled perception of the STE distortions existing in the price-quantity area.

If the first part of the book is mainly reinterpreting, reclassifying and empirically verifying concepts already in use in the literature on the subject, the second is different due to the presentation and later empirical verification of my own concepts. This change has been necessitated by the dearth of studies examining structural change and the inexorable structural distortions under central planning. Here I was venturing upon almost untouched ground. I used in particular the concept of twofold underspecialisation — at the level of a national economy and at that of an enterprise — to explain the empirically established distortions in the structure of production and employment of STEs that increasingly set them apart from the rest of the world in this respect. The concept may be seen as an intermediate explanation, since underspecialisation is itself caused by the dynamics of the Soviet system and that of its inward-oriented policy formation. The distortionary role of industry — or, more specifically, of the socialist industrialisation process — is a central theme of this second part of the study.

The third part of the book concentrates upon the foreign trade performance of the Soviet-type economies. Many thorough empirical studies in the literature on the subject freed me from the necessity of repeating my approach in the second part, where the evidence had to be built from scratch. Rather, I tried to link the characteristics of the dynamics and structure of STEs to their (poor) performance on the world market. Both the evolving theory of the STE and the received Western theory were useful in this exercise. In addition, my own theoretical considerations suggested why STEs failed in their attempt to reduce the developmental gap with the West through the import of technology and capital (contrary to what one would expect from the latter theory grounded in Western economic rationality).

In my conclusions, I restate the fundamental problems, i.e. the distortions generated in the areas of dynamics, structure and foreign trade, as well as stress the linkages between them and their mutually reinforcing character. Since distortions are increasingly costly, I also highlight the stagnation and decline facing the distorted world of the STEs.

Many of the chapters are based on or adapted from previously published articles. Thus Chapter 1 appeared in condensed form in

Banca Nazionale del Lavoro Quarterly Review, no. 157, 1986. Chapter 2 is an adapted version of an article in *Rivista Internazionale di Scienze Economiche e Commerciali*, nos. 10–11, 1986. Chapter 4 appeared in extended form in *Studies in Comparative and International Development*, vol. 23, 1988. Chapter 5 is an extended and rewritten article that appeared in *Economic Notes* of the Monte dei Paschi di Siena, no. 2, 1985. Chapter 6 is an adapted version of an article in *Technovation* vol. 6, 1987. The several publishers allowed me to integrate and elaborate upon these materials in this book, for which I express my appreciation. Also, I would like to thank MAW Publishers, Warsaw, for allowing the editors to use a cartoon published by them on the cover of this book.

NOTES

1. Quite a common occurrence for some economists: see the critique of Portes *et al.* in Winiecki (1985b).

2. For example, business men may find herein reasons for the failure of, or disagreement over, many licence-related deals (called 'industrial co-operation' in the official bureaucratic parlance).

3. For a critique by this author of disequilibrium modelling as applied to Soviet-type economies, see Kemme and Winiecki (1984) and Winiecki (1985b). See also Nove (1985).

4. At approximately the same time, a second entrepreneur bought bottles straight from the glass factory and sold them to salvage store-houses for a fat profit, given the large price differential in favour of price established for used bottles (in theory, to encourage recycling). The former found his profits taken away by *ad hoc* confiscatory taxes, and the later finished up in prison.

5. Or more rarely, East Central Europe.

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Part One

The Distorted Macroeconomics of Central Planning

Quantities

1.1. PERMANENCE OF EXCESS DEMAND: A STATIC VIEW

The pitfalls awaiting analysts of Soviet-type economies (STEs) using a coherent framework have often been underestimated. These pitfalls are generally of two kinds: firstly, difficulties in explaining macro-economic relationships in terms of the received theory (whether neoclassical or Keynesian); and secondly, difficulties in using the distorted official data. Both sets of problems stem from the same sources. It is system-specific features which make the characteristic macro effects under central planning — excess demand, shortage, uncertainty — mean something somewhat different from those terms as they are understood by many Western economists (which is, by the way, an important source of misunderstanding). Moreover, the same features generate quantity and price distortions that again make STE statistics different from those in market economies (or MEs).

The author has tried to avoid both types of pitfalls. System-specific terminology and theoretical concepts that make otherwise valuable Eastern European contributions incomprehensible for the Western reader have either been eliminated or explained in understandable terms. On the other hand, the author has also rejected as no less unsatisfactory, simplistic applications of Western disequilibrium theory to a different institutional setting.

In my view, the starting point for the analysis of the distorted dynamics of STEs is the perennial excess demand and shortage plaguing these economies. Both problems appeared in STEs almost from the start, and have become a permanent feature ever since. Over the years writings accumulated in both the East and in the West that tried to explain their sources and concomitants. To an extent we may even talk about a kind of consensus explanation, especially with

respect to the incentive structure that generates excess demand.¹ In a condensed form it runs as follows. There exist certain system-specific features that result in what Kornai (1971, 1972, 1979, 1980) has called 'rush growth' and a group of Polish economists centred at one time around Wakar², less well known than Kornai in the West, dubbed 'expansive formulas of management'. According to these authors, enterprises in STEs have from the start felt the impact of the structure of incentives that motivated them to expand production almost at any cost. In other words, incentives to execute and exceed plan targets were positively correlated with volume or value of production, but were not at the same time negatively correlated with production costs. This structure of incentives did not change substantially and has been dominant under both traditional (command-type) and modified (mixed command/parametric-type) policy instruments.

Central planners, in their fundamentally autarkic approach, usually react to perceived needs in only one way — i.e. by trying to increase production of goods in short supply. Thus, plans are drawn up, which with respect to aggregate economic growth and the production structure (especially the latter!) cannot be executed due to the shortage of resources. There may be many simultaneously existing causes for this shortage. The first may be that the resources are not there because *the quantities reported earlier by enterprises were* — to some degree — *fictitious*. It is a perennial problem in STEs where everybody at the enterprise level, from manager to worker, is interested in showing doctored performance figures.³ This 'imaginative reporting' may take the form of pure fiction, i.e. reporting higher output volume than the actual one. Possibilities of such imaginative reporting are enormous. According to A. Shitov, first deputy chairman of the USSR Committee for National Control, 'to a greater or smaller extent additions [to the actual output figures] and other distortions were discovered in every third enterprise' (*Planovoye Khozyaistvo*, no. 11, 1981).

Doctored reports may concern everything from sophisticated machinery (again, see Shitov, *ibid.*) to homogeneous commodities, like coal or cotton, as was the case some years ago with respect to the former in Poland and Romania, and in Uzbekistan (USSR) with respect to the latter. Other methods of doctoring are probably much more numerous, i.e. reports of higher output volume when in fact only output value increased.⁴ Thus, plan targets are executed or even exceeded, but a part of output — that constitutes input for other enterprises — exists only on paper.

The second reason for resource shortage may be that *the resources are not of the right quality*. To stay with the simple example of coal, enterprises, in their attempts at executing or exceeding plan targets, lower the quality of output (that is, coal's calorific content) by adding more non-coal ingredients. This not only plays havoc with the central planners' balancing activity, but also has further negative repercussions for domestic⁵ coal users; and if downward quality shifts exist with respect to homogeneous goods like coal, they are all the greater with respect to differentiated ones.

The third reason may be that *the resources are not of the right type*. The suppliers are usually interested in producing as few types, grades, sizes, etc., as possible. Since enterprises in STEs cannot turn to another supplier, they either have an option of producing from, say, thicker steel plates and using more labour and capital inputs, more energy and — by definition — more costly material (steel), or that of not producing at all.⁶ The inability of an enterprise in a STE to obtain the right type of inputs does not stem from the fact that it is tied to a specific supplier (because under the modified system of central planning it is not so tied), but because it knows that other domestic suppliers behave in the same way (this explains, *inter alia*, the permanent preference for imports, and, more specifically, for imports from the West.⁷

The fourth reason for resource shortage may be that *the resources are not there at the right time*. Even the most centralised planning cannot dream of allocating everything in detail, and such details are left to enterprises. And for an enterprise that was given a command to produce something, it makes a difference whether an input-producing enterprise ships a given input at the beginning, in the middle or at the end of a planning period (a month, quarter or a year). A command to supply inputs does not specify such details and it should not be forgotten that a supplier is itself coping with shortages of its own. Thus, delayed shipments may interrupt production schedules.

The fifth reason may be that *the resources are not given at the right place*. In the aggregate, there may be enough of a given input of the right quality and type to allocate among enterprises but there are general priorities (producer, i.e. intermediate and investment, goods), specific priorities (investment projects on a priority list) and *ad hoc* priorities (created by political interventions — see next section) which together result in the misallocation of inputs.

At this point it is worth noting that the first three causes outlined

above stress the existence of shortages due to the system-specific structure of incentives, while the last two highlight the other institutional and policy characteristics of a STE. They also imply the impossibility of proper plan-execution in the (theoretical) case of a plan that is feasible, i.e. in which the aggregate amount of inputs is exactly that needed for plan execution (on this point, see Ericson, 1983).

The above shortages interact, creating *the overall climate of shortage*. Shortage is further aggravated by the behaviour of enterprises which, being aware of shortages and trying to minimise the risk of non-execution of the plan stemming from shortages, demand excessive labour, spare parts for the equipment, and material inputs. As every enterprise behaves in this way — and everybody else knows that others behave thus — additional excess demand is generated (on hoarding and inventories, see, *inter alia*, Goldmann and Kouba, 1969; Kornai, 1980; Winiecki, 1982; and Porket, 1984). It should be noted that in a STE, shortage is a *relative* rather than an absolute phenomenon. The amount of inputs expended per unit of output is inordinately high in STEs. Table 1.1. illustrates this with respect to energy and steel.

It will be shown elsewhere that the excessive use of inputs is partly related to the overgrown industrial sector in STEs (see Chapter 3). However, the fact that the industrial sector, so large relative to that of MEs, is unable to eliminate persistent shortage is yet another indictment against central planning, not a justification of inordinately high input use. The same may be said with respect to the aggravating factor considered here, i.e. much higher inventories per unit of output in STEs than in market economies (in Hungary, for example, they are twice as high: Kornai, 1982).

It should not be surprising, then, that actual figures for inventories deviate from plan targets by more than those for other indicators: for example, in Poland during the three consecutive five-year plans (or FYPs), actual figures for inventories exceeded planned ones by between 23.5 and 48.8 per cent (Maciejewski and Zajchowski, 1982). Even if shortages are more relative than real, however, excess demand is very real, for indeed, there are no adequate resources of the right quality and type at the right time and place.⁸

The results are well known. An important one is *increased costs* of production in the rush when enterprises are striving to execute or exceed planned quality targets or they are trying to make up for the time lost due to late deliveries of material inputs. Another result is

Table 1.1: Resource intensity of East European STEs and industrialised West European MEs: the cases of energy and steel, 1979–80

<i>Countries</i>	Energy intensity in 1979 (in kg of coal equiv. consumption per 1000 US dollars ^b of GDP	Steel intensity in 1980 (in kg of steel consumption per 1000 US dollars ^b of GDP
<i>East European STEs^a</i>		
Bulgaria	1464	87
Czechoslovakia	1290	132
Hungary	1058	88
GDR	1356	88
Poland	1515	135
Soviet Union	1490	135
Average, unweighted (6)	1362	111
<i>West European MEs</i>		
Austria	603	39
Belgium	618	36
Denmark	502	30
Finland	767	40
France	502	42
FRG	565	52
Italy	655	79
Norway	1114	38
Sweden	713	44
Switzerland	371	26
United Kingdom	820	38
Average, unweighted (11)	660	42

Notes: a. Except Romania

b. US\$ of 1979

Sources: *World development report* (1981); *Yearbook of international statistics* (1981); own calculations.

the *decline in quality*, when enterprises decide not to wait for inputs of the right quality and use inputs of a sub-standard quality. In fact, lower quality is also a concomitant of 'rushed production'. Not only specific supply problems, but also the general climate of buyers' pressure for more output, imbues suppliers with a careless attitude towards cost and quality; and this, in turn, demoralises, to a varying extent, the labour force which in turn takes an equally careless attitude towards materials and equipment. (After all, both enterprises as goods suppliers and workers as labour suppliers perform on the seller's market!)

The results are cost overruns that are compensated at higher levels of the bureaucratic hierarchy by subsidies, lower taxes, price