

**Economic Reform in Socialist Countries**  
**The Experiences of China, Hungary,**  
**Romania, and Yugoslavia**

Peter T. Knight

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## ABSTRACT

Since the early 1950s, most countries that adopted Soviet-style central planning have attempted to reform this system. Despite considerable differences among these countries in the timing, extent, and persistence of the reforms, certain commonalities stand out: the thrust of the reforms has been to decrease the role of centralized planning in physical terms and to increase the autonomy of enterprises or subnational entities (such as industrial associations and local governments) in determining investments, wages, hiring, input purchase, product mix, and the conduct of foreign trade; the economic authorities have relied primarily on the price system and financial mechanisms to guide enterprise decisionmaking; the reforms have linked the earnings of managers and workers more closely to enterprise and individual performance; and a constructive role for the private sector, especially in agriculture but also in small-scale service and industrial activities, has been recognized. At the same time that they have considered reform, however, the Soviet-style centrally planned economies have been remarkably resistant to change. With the exception of Yugoslavia, reforms originally proposed have been more comprehensive than those eventually approved; those implemented have fallen short of those eventually approved, and many already implemented reforms have been reversed.

Experience suggests that the success of reform depends largely on the strength of political support, the comprehensiveness and internal consistency of the reforms, the length of time they are pursued without interruption, and the availability of some economic slack (for example, in the form of foreign exchange reserves, stocks of key materials, or access to foreign credit or aid) to help the country cope with the initial disruption and increase in imports that almost always occur when far-reaching changes are introduced.

It is instructive to examine the model the reformers have been trying to change alongside the pressures for reform, principal loci of resistance, and issues in reform design. Useful case studies of reform implementation are provided by Romania, China, Hungary, and Yugoslavia since their current economic systems span the range of decentralization in the socialist countries. Topics of particular interest here are how the reforms affected ownership of the means of production, the locus of decisionmaking, price formation, incentives to workers and managers, and the degree of competition--interrelated factors important for reform success.

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## Foreword

This study is one in a series of World Bank Staff Working Papers devoted to issues of development management. Prepared as background papers for the World Development Report 1983, they provide an in-depth treatment of the subjects dealt with in Part II of the Report. The thirteen papers cover topics ranging from comprehensive surveys of management issues in different types of public sector institutions (for example, state-owned enterprises, the public service, and local government agencies) to broad overviews of such subjects as planning, management training, technical assistance, corruption, and decentralization.

The central concern underlying these papers is the search for greater efficiency in setting and pursuing development goals. The papers focus on the role of the state in this process, stress the importance of appropriate incentives, and assess the effectiveness of alternative institutional arrangements. They offer no general prescriptions, as the developing countries are too diverse--politically, culturally, and in economic resources--to allow the definition of a single strategy.

The papers draw extensively on the experiences of the World Bank and other international agencies. They were reviewed by a wide range of readership from developing and developed countries inside and outside the Bank. They were edited by Victoria Macintyre. Rhoda Blade-Charest, Banjonglak Duangrat, Jaunianne Fawkes, and Carlina Jones prepared the manuscripts for publication.

I hope that these studies will be useful to practitioners and academicians of development management around the world.

Pierre Landell-Mills  
Staff Director  
World Development Report 1983

## Glossary

BOAL	Basic Organization of Associated Labor
CIFER	Community of Interest for Foreign Economic Relations (Yugoslavia)
CMEA	Council of Mutual Economic Assistance
COAL	Contractual Organization of Associated Labor (Yugoslavia)
COI	Community of Interest (Yugoslavia)
ICOR	Incremental Capital Output Ratio
NEM	New Economic Mechanism (Hungary)
SOLW	State Office for Labor and Wages (Hungary)
VVB	Associations of People-Owned Enterprises (East Germany)

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## I. Introduction

After the Second World War, the newly established socialist states of Asia and Europe adopted, with few modifications, the system of centralized physical planning practiced in the Soviet Union. Attempts at reform of this system began in the 1950s and have continued since that time. By and large, they have stemmed from the perceived need to increase economic efficiency, except in Yugoslavia, where political considerations have been a primary cause of reform. The reforms vary from country to country in their timing, extent and persistence, but they also have certain elements in common. The role of centralized planning in physical terms has decreased, while the autonomy of enterprises or subnational entities (such as industrial associations and local governments) in determining investments, wages, hiring, input purchase, product mix and the conduct of foreign trade has increased. The economic authorities have relied on the price system and financial mechanisms to guide enterprise decision-making. The reforms have linked the earnings of managers and workers more closely to enterprise and individual performance, and they have provided a constructive role for the private sector, especially in agriculture but also in small-scale service and industrial activities.

Existing alongside the reform movement in the Soviet-style centrally planned economies, however, has been a strong resistance to change. Implemented reforms have often been reversed. In view of the partial and shifting nature of the reforms in most countries--not to mention the exogenous

changes in the international economic environment and the limitations of the data available--it is hard to determine whether the reforms have indeed spurred economic efficiency. Nevertheless, the general movement toward change is quite clear, as this paper illustrates.

The analysis begins with a brief description of the model that reformers have been trying to change, as a prelude to the discussion of the pressures for reform, the principal loci of resistance, and the main issues in reform design. The evidence for change comes primarily from the reform experience of China, Hungary, Romania, and Yugoslavia--all of which are members of the World Bank and the International Monetary Fund (IMF), and whose current economic systems are quite diverse, spanning the range of decentralization found in socialist countries--and to a limited extent from that of Bulgaria, Czechoslovakia, the German Democratic Republic (GDR), Poland, and the USSR. Of particular interest are the various changes in ownership of the means of production, the locus of decisionmaking, price formation, incentives to workers and managers, and the degree of competition. In addition, some lessons from the reform of these countries are noted that may be relevant to future efforts at improving the efficiency both of socialist economies and state sectors of mixed economies. The discussion concludes by indicating some important areas for research.

## II. Traditional Central Planning

The following description of what may be called traditional central planning does not correspond perfectly to any particular national economic system. Rather it refers to a simplified abstraction or model.

A. Ownership of the Means of Production

In industry, all significant means of production are state owned. In agriculture, there are three types of ownership: cooperatives, which are the dominant form, and are under strict state control; state farms, which are owned and operated on the same principles as industrial enterprises; and private farms on individual household plots, assigned to, but not formally owned by the families which cultivate them.

B. The Locus of Economic Decisionmaking

Economic decisions on both macro- and microquestions of resource allocation are in the hands of the state authorities. The central plan specifies a large number of value aggregates and physical inputs and outputs in the economy; in this system money plays a passive accounting role. The structure of the plan is strictly hierarchical, so that the lower levels are formally subordinated to those above. Decisionmaking is concentrated near the top. Different levels in the hierarchy bargain over production assignments and the allocation of resources to carry them out. The plans are enforced by rationing the means of production--materials through administrative orders; labor via controls over the size (and sometimes distribution) of wage expenditures; and capital through the allocation of investment funds, construction materials, machinery, and equipment. In principle, households retain freedom of choice with regard to consumer goods and services on one hand and occupation on the other; the result is a consumer goods market and a labor market in which state control is exercised by indirect means (price and wages policy). In practice rationing of goods and services and the administrative allocation of manpower are relied on frequently and in China are still routine practices.

### C. Price Formation

Since capital is centrally allocated, investment funds are generally provided in the form of grants. Basic wages and salaries are regulated by fixed wage scales established for different categories of skill and effort. Prices for other goods and services are set administratively and changed now and then to facilitate plan elaboration and help monitor plan implementation. Industrial producer prices are fixed on a branch-wide cost-plus basis, so as to enable most branches and enterprises to cover current (but not necessarily capital) costs and show a small profit. Enterprises that cannot cover costs plus planned profit receive subsidies; those whose profits are higher than planned are taxed, as are most commodities. Agricultural producer prices are fixed centrally, usually at low levels relative to the price of industrial inputs to agriculture (Marer 1982). As a result, direct controls (compulsory delivery quotas) and sometimes coercion have been needed to obtain supplies. Consumer prices are supposedly set at market-clearing levels. In practice, the retail price level is frequently lower and thus gives rise to persistent shortages. Relative retail prices often differ substantially from the structure of producer prices owing to the pervasive use of taxes, subsidies, and nonuniform planned profit rates. The exchange rate plays no significant role in domestic price formation. Foreign trade is carried out by special export-import firms, and domestic prices are separated from international prices by a plethora of taxes and subsidies. Producing firms have no direct contact with foreign customers or suppliers.

### D. Incentives to Producers

Although material incentives are widely used, they are limited by the extent to which policymakers are willing to tolerate personal income

differentials. Piecework systems are frequently coupled with basic wages, and management bonuses are generally linked to the degree of fulfillment of obligatory plan targets, usually defined in physical or gross value terms. A multiple-tier price system in which prices are higher for above-quota deliveries may be used in agriculture. The reward and penalty system for managers leads them to be cautious about overfulfilling the plan by too large a margin, since production levels in one period will be the planners' basis for setting targets in the next period. This behavior of planners--combined with the signals provided by cost-plus pricing and the free availability of capital, material, and labor up to rationed levels--leads to predictable kinds of behavior among enterprise managers. Many managers, for example, pay insufficient attention to controlling cost, productivity, and quality; decide to produce output assortments unsuited to the needs of customers; attempt to hoard capital, materials, and labor; hide some reserve capacity from superiors; and exert strong pressure to obtain additional investment. There is little incentive to innovation.

#### E. Competition

In general enterprises interact "vertically" through their respective hierarchies rather than "horizontally" through the market. Production and distribution enterprises tend to be large and many have regional or country-wide monopoly in their specified activities. Enterprises are seldom liquidated as a result of inefficient production. By and large, competition is limited to efforts at plan fulfillment and overfulfillment, except for a small (legal, semilegal, and illegal) private market for some goods and services. In the labor market, enterprises compete for workers; in part by offering nonwage benefits such as access to housing.

### III. An Overview of the Economic Reform Movement

In its home country and in the countries that adopted it, Soviet-style central planning produced significant achievements: the industrialization of backward countries, the buildup of military power, survival in a hostile environment, victory in war; impressive improvements in standards of education, health, social and private consumption; full employment of labor; price stability; and the development of natural resources, science, and technology (Nutti 1981). But the system has also had its drawbacks, as is well documented (Wiles 1962; Nove 1969; Kaser 1970). One fundamental problem that has been cited is that "...the center is out of touch with popular wishes. 'Democratic centralism' is in theory the central execution of decisions democratically reached, but in practice turns into 'voluntarism', the arbitrary pursuit of the wishes of the leadership of the day, as each new leader reveals to have been the case with his predecessor" (Nutti 1981b, p. 11). The drawbacks of the Soviet-type model have been felt sooner and more deeply in the socialist countries of Eastern Europe than in the USSR itself. Unlike Russia in 1917, these countries had already reached a higher level of economic development, social diversity, and growth of democratic institutions when they adopted traditional central planning.

The first country to make fundamental changes in the traditional model was Yugoslavia, after its expulsion from the Cominform in 1948. The economic reforms begun in that country in 1950 were regarded by their designers as part of a broader attempt to build a selfmanaged socialist society distinctive from Soviet-type state socialism. The role of the state was to be gradually curtailed in favor of self-managed enterprises that would increasingly respond to market forces rather than state directives. Since

1950 this process has continued, though not without fluctuations. In 1965, a major step in this direction put an end to central planning in Yugoslavia. Its socialist market system--which underwent another major change in the 1970s in an attempt to develop a form of planning compatible with the concept of self-management as well as extensive guidance by market forces--remains unique. At present Yugoslavia is again moving toward greater reliance on market forces to guide enterprise decisionmaking.

In the rest of Eastern Europe and in China, economic reform has been basically an outgrowth of the quest for greater economic efficiency, although some reforms can be traced to broader movements of political change. Even the most radical "blueprint" for reform, that of Czechoslovakia in 1968, upheld the principle of central planning, which was to become more efficient and better adapted to economic needs through a regulated market mechanism (Brus 1980). Economic reform within the Soviet bloc appears to have come in three waves, during 1953-60, 1964-70, and from the late 1970s to the present. Since the first wave of reform was relatively weak, this paper concentrates on the latter two.

At one stage or another, every East European country--the Soviet Union (1965) included--has announced the intention to proceed with decentralization of economic decisionmaking and wider use of market instruments. But for various reasons, some of which will be discussed below, all but two countries, Yugoslavia and Hungary, turned back, (if not fully, at least basically) to the traditional model. Hungary introduced its New Economic Mechanism (NEM) in 1968. After some backsliding during the period 1972-78, Hungary renewed its reform thrust in 1979. Since 1968 Hungary has been the most market-oriented economy within the Council of Mutual Economic Assistance



(CMEA). <sup>1/</sup> Although Romania's reforms have fit the general East European pattern, since 1979 this country has clearly moved toward aligning domestic prices with world market prices which could facilitate Hungarian-style reforms in the future should the Romanian authorities decide to take this course.

China's system of central planning was created in the 1950s, and the central control resource allocation continued for the next two decades. Since the late 1950s, however, central planning (in the sense of a medium- to long-term plan) has been practiced only infrequently owing to the disruptions caused by the Great Leap Forward (1958-60) and the Cultural Revolution (1966-76). A debate in the mid-1950s on the role of planning and the market led to a few experiments with the use of market forces to guide enterprise-level decisionmaking, but not to serious reforms. Some significant efforts at administrative decentralization were made between November 1957 and October 1958, but most of them were reversed by 1961 (Brus 1980; Solinger 1981). No fundamental reform was attempted during the 1960s and early 1970s, though periodic moves away from centralization occurred. Since 1977 system reform has again become an issue of debate, but now criticism is directed at the performance of the economy, particularly the slow improvement in the general standard of living (despite high levels of investment) in the two decades following the completion of the socialist transformation in the late 1950s, and the persistent poverty in some parts of the country (World Bank 1981a). Since 1979 China has experimented with market mechanisms and greater enterprise autonomy on a large scale in both agriculture and industry, and has given considerable attention to foreign experience, particularly that of Hungary.

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<sup>1/</sup> The CMEA currently includes Bulgaria, Cuba, Czechoslovakia, GDR, Hungary, Mongolia, Poland, Romania, the USSR, and Viet Nam.