

COMMENTS ON PAPERS PREPARED IN THE WORLD BANK
ABOUT SOCIALIST COUNTRIES

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Abstract

The first part of the paper analyzes some important common characteristics of socialist economies: chronic shortages in the markets for goods, labor and capital; the limited role of prices and the low price responsiveness of economic units; weak financial discipline and the accountability of State-owned firms; investment and import hunger and forced exports; and the phenomenon of extensive forced growth. The paper gives an assessment of how these characteristics of socialist economies are reflected in the reports on these countries prepared by the World Bank. The second part discusses some of the dilemmas which the reform process is facing in socialist countries: the conflict between short-term macro-adjustment and long-term institutional change, and the time-phasing of the reform measures.

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I. Introduction

1. The Country Policy Department of the World Bank ^{1/} asked me to review the reports prepared by the World Bank about socialist countries. ^{2/} I read 20 volumes which were written during the period 1979-1984. These notes present my comments.

2. My general impression was very favorable. Most papers showed high professional quality and great expertise. They approached the socialist economies in an objective and impartial manner, with a willingness to help the economic progress of these countries. Most of the studies were written by economists who are not specialists in the field of socialist economic systems. This may have drawbacks and I shall pursue the problem at a later stage. It has, however, an advantage as well: the socialist systems have been looked at with a fresh eye, without the influence of a priori established theories and hypotheses. In short, I learned a great deal from reading this very instructive and rich material.

^{1/} The author gratefully acknowledges the valuable suggestions given by Luis de Azcarate, Basil Kavalsky, Parvez Hasan, Aziz Khan, Mark Leiserson, Ed Lim, Kenneth Meyers and Martin Schrenk. The first draft of the paper was presented to a seminar at the World Bank in June 1984; the author expresses his gratitude to the participants for many interesting questions and comments which were of help in the final formulation of these notes. Of course, the views presented here are those of the author and they should not be interpreted as reflecting those of the World Bank.

The paper does not deal with Hungary. Nevertheless, the author, as a Hungarian, received much inspiration from the debates on Hungarian reform. Without implying any order of importance or completeness, the following is a list of Hungarian economists whose work influenced my thinking and the ideas expressed in this paper: L. Antal, T. Bauer, Zs. Dániel, A. Deák, J. Gács, J.M. Kovács, M. Lackó, I. Mérey, T. Nagy, R. Nyers, G. Péter, M. Pulai, A.K. Soós and M. Tardos.

^{2/} In these notes, the following member countries of the World Bank are regarded as centrally-planned socialist countries: Afghanistan, China*, the People's Republic of the Congo, Ethiopia*, Hungary, Lao People's Democratic Republic, Nicaragua, Romania*, Viet Nam, the People's Democratic Republic of Yemen* and Yugoslavia*.

All of these countries have at least two common attributes: (a) the country is ruled by the Communist Party; and (b) public ownership plays the dominant role in the economy, or at least in industry, foreign trade and banking.

The reports I read for the present notes covered the countries marked with an asterisk in the list above.

3. Some further improvement is, of course, possible and I shall offer a few suggestions with that end in view. I wish to draw the reader's attention to a few limitations of the present review. I did not comment on papers written about Hungary. I did not appraise the Bank's lending policy in socialist countries. I reviewed only those chapters of the reports which provided a description and analysis of the economies, their operation and their performance. I regarded the reports as analytical studies and tried to compare their findings with my own understanding and experience.

4. I am aware that writing a report about a country under the auspices of the World Bank inevitably involves certain "diplomatic" considerations as it may affect the relationship between the Bank and the government of the country. In many cases, the text of the report must be agreed upon with government officials. Being a researcher and not a diplomat, I applied my usual yardsticks. I looked at each report as if it were written by an independent scholar. It is for the reader of the present notes to decide what can and what cannot be accepted of my suggestions, taking into account the requirements of "diplomacy".

5. Finally, one more word of caution. I do not pretend that I really know the nature and characteristics of socialist systems adequately to be able to offer well-demonstrated and irrefutable theorems. The study of socialist economies is not yet a mature discipline. Most of us dealing with the subject have only conjectures and hypotheses. The emphasis in my comments is on the questions and not on the answers. I have suggested a set of questions that the analyst should raise when exploring a socialist economy. I have also briefly indicated my tentative answers, at least to some of the questions. My answers must be treated with due caution and tested one by one for each country. I do hope that, even if the analyst does arrive at answers different from mine, my questions will have helped him in future studies of socialist countries.

II. Common characteristics of socialist economies

6. Let us begin with two quotations from a report about China.

"China's economic management is, by international standards, extraordinarily centralized...." and "What distinguishes these enterprise plans and targets from those common in businesses in other countries is the degree of external influence and the amount of detail involved.... These factors have tended to allow enterprises...very little independence."

7. With what is the "international standard" to be compared? What is the "common business practice in other countries" which serves as a frame of reference? If we compare China with the United States or West Germany, the statement is true: China is very different as far as centralization of firms' independence are concerned. But if we compare the Chinese State-owned firm of the 1970s with that in the Soviet Union or East Germany,

there is no striking difference. The degree of centralization or the limitations on the autonomy of the enterprise is about "normal".

8. Wlodzimierz Brus, the renowned Polish economist, in reviewing a recent collection of articles by contemporary Chinese economists about the problems of today's China, wrote that the reading of the book "has been the source of a strange sensation...a feeling of 'déjà vu'".^{1/} He felt that China was confronted with the same set of problems which he and other Polish economists faced in the Eastern European part of the world.

9. It is my theoretical conviction that all socialist economies - or at least the State-owned sector in all socialist economies - have some common characteristics. There are significant differences between the countries due to differences in historical background, size, culture, geopolitical location, national policies, etc. (There are also differences between historical periods within each country to which I shall return later.) Yet the differences can be much better understood if we make comparisons with the common pattern, i.e., with a general model of socialist economies. Accordingly, an important element of the suggested set of questions is: what are the differences and similarities between the particular country to be analyzed and the standard socialist pattern?

10. There is very little of such comparison with other socialist countries in the reports I read. As a rule, the phenomena, which are possibly different from what occur in non-socialist countries, but are quite "normal" or "regular" in socialist countries, are not perceived by the analyst as different^{2/} from other phenomena which are really unique and country specific. It is important to make clearer distinctions between these two sets of facts.

11. I do not suggest that meaningful comparisons between socialist and non-socialist countries, relating their performances and analyzing their similarities and differences, should not be made. Such comparative exercises can lead to important conclusions.^{3/} However, the analyst must be aware that he is comparing members of two different "families", or two different "species", which have in many important aspects quite different

^{1/} Book review on G.C. Wang (ed.), "Economic Reform in the PRC", in the Journal of Comparative Economics, 1984.

^{2/} For example, the investment drive in Yugoslavia is "normal", i.e., very similar to the situation in other socialist countries (see paragraph IV (d)). At the same time, the institutional framework of control, property rights and management in a Yugoslav firm is unique. This kind of distinction does not come out sharply in the reports on Yugoslavia.

^{3/} A good example is the paper by Bela Balassa and Laura Tyson: Adjustment to External Shocks in Socialist and Private Market Economies, 1983.

behavioral characteristics. The conduct that is "normal" in one species may be "abnormal" in the other one, and vice versa.

III. Three phases and three ideologies

12. Socialist systems typically go through three phases. Phase 1 is the heroic-enthusiastic period. It lasts for the years of revolution, external and internal war and possibly a few years thereafter. This is the time of swift nationalization, confiscation and radical redistribution of private wealth and the rapid spread of revolutionary ideology. Moral incentives play the predominant role. Phase 2 is the construction and consolidation of the bureaucratic-hierarchical command economy. Phase 3 is when the reform processes evolve in the direction of a less centralized market socialism. In theory, a Phase 4 could be conceived: a full-blown, mature market socialism. Perhaps this will be feasible, but up to now there has not been an existing socialist system which could be regarded as the genuine representative of Phase 4.

13. Some qualifications must be added. The time sequence serves only as a mental construction, a general model of the historical course of events. Actual historical development in a country can be different. For example, in the Soviet Union, Phase 1 was followed not by Phase 2, but for a short interval (NEP) by a formation which bore resemblance to Phase 3. It was only after the abolition of this temporary Phase 3 that Phase 2 appeared, i.e., the creation of the command economy in the Stalin epoch. In China, Phase 2 was not immediately succeeded by Phase 3, but the establishment of a command economy similar to the Soviet system was followed by a partial return to Phase 1: the Cultural Revolution. It was only after the end of this period that the transition to Phase 3 started. In general, there can be cycles of decentralization and recentralization, movements back and forth between the three phases.

14. In other words, the terms "Phase 1, 2 and 3" refer more to a logical order than to a temporal order. A possible interpretation of these terms is to regard them as "ideal types" in the Weberian sense. They are stylized archetypes or "panels" of which the actual complex system is composed. China before the death of Mao could be regarded as a combination of Phases 1 and 2, and contemporary China as a combination of Phases 2 and 3.

15. Behind the three archetypes, there are three ideologies. ^{1/} examples for the first are different Maoist, radical and New Left ideologies. The second is represented by the official economic textbooks of the command economy. The third is advocated in the writings of "market socialists", starting with the classical paper by Oscar Lange in the 1930s, and later on in the studies of Yugoslav, Hungarian, Polish, Czech, Soviet and Chinese economists from the 1950s to the present. ^{2/}

16. As for the general pattern of socialist development, I offer four observations:

- (a) The heroic-enthusiastic first phase is provisional. It may last a few years, but cannot be sustained for an extended period. It must give way to Phase 2 or Phase 3 since strong material incentives are indispensable. The most dramatic examples are the transition of Cuba from Phase 1 to Phase 2, and the transition of China from Phase 1 (or, more exactly, a particular combination of Phase 1 and Phase 2 under Mao's Cultural Revolution) to Phase 3.
- (b) Phase 2, i.e., the bureaucratic-hierarchical command economy, must be regarded as the most common "classical" case of the socialist economy. This formation is not provisional, but is persistent. It is durable, characterized by institutional inertia, and is resistant to change. It is viable in its ability to coordinate social and economic activities, to sustain considerable growth and to ensure a substantial increase of consumption for the population.

^{1/} Different classifications are used in the literature. The author has discussed three basic "coordination mechanisms" in one of his studies: the bureaucracy, the market and "voluntary-ethical coordination" ("Bureaucracy and Market", Osteuropawirtschaft, 1984, No. 4, pp. 306-319). Charles Lindblom distinguishes control and coordination through the political system, through the market and through "persuasion" (C.E. Lindblom, Politics and Markets, New York, 1977). Concerning ideologies, I have followed the classification of D.J. Solinger (Three Visions of Chinese Socialism, Boulder, 1984, and "Marxism and the Market in Socialist China", in V. Nee and D. Mozingo (eds.), State and Society in Contemporary China, Ithaca, 1983).

^{2/} For an overview of the writings on market socialism, see A. Bergson, "Market Socialism Revisited", Journal of Political Economy, 1967, and A. Nove, The Economics of Feasible Socialism, London, 1983.

- (c) Phase 3 may or may not occur in all countries. It has not yet been proven that all socialist economies move from Phase 2 to Phase 3. Some of them have already made these moves, some others have not - although the ideas of reform may have been put forward a long time ago.
- (d) Phase 3, having begun in a certain country, is not guaranteed to be irreversible. The system may fall back to Phase 2. To avoid misunderstanding, let me reiterate that Phase 3 is not inevitably prone to a return to Phase 2. I am only saying that a reversal is possible. There is no built-in institutional warranty assuring irreversibility. On the contrary, the socialist economy has a kind of "natural inclination" towards a highly centralized bureaucratic structure. During Phase 3, there is a constant danger of reversal to Phase 2.

17. I suggest to analysts of socialist economies to check very carefully the four hypotheses listed above. Perhaps, in some countries, the study of facts will support these conjectures. As mentioned in the Introduction, I have stressed the questions to be raised and not my own answers to the questions. It will be useful to clarify questions such as the following: where could the country under examination be located in the framework of Phases 1, 2 and 3? Can it be placed clearly in one of these three "archetypes"? Or is it a combination of two or three of them? If so, which type is predominant? Or is it a different structure which cannot be fitted into the analytical framework outlined here?

18. In addition to the questions concerning the system, there is also the issue of ideologies. Which one is prevalent? Are there signs in the literature of the country, in past and present disputes among economists and politicians, that other ideologies exist? Even if the analyst does not want to discuss the issues of ideologies and intellectual disputes in his report, some insights can be very helpful in understanding what is going on - and, even more importantly, what will be going on in the future - in the economy under scrutiny.

19. Several studies that I read gave interesting answers to some of the questions raised in this section, but many others did not even touch upon these issues. Let me give an example. I have never studied the economy of People's Democratic Republic of Yemen. Reading a report prepared by the World Bank on this country, I was unable even to guess if it was in Phase 1, Phase 2 or Phase 3, or if it can be characterized by a combination of the three phases, or if it was a different, unique formation. It would be very instructive to put the analysis of current economic problems more in the historical and institutional context.

IV. On the nature of the command economy

20. This section focuses on Phase 2, i.e., the mature command economy. There are some common characteristics which prevail in all Phase 2 socialist systems. There are hundreds of books and thousands of articles discussing such characteristics. I would have been hopelessly ambitious to survey the extensive literature. Instead, I arbitrarily selected only five common characteristics which I considered to be significant in the context of World Bank reports on socialist countries.^{1/} Other researchers in the field may put forward a different list of common characteristics, perhaps no less relevant than mine.

21. In the context of the common characteristics of Phase 2, my comments have repeatedly referred to the borderline between Phase 2 and Phase 3: where the classical command economy ends and where a serious reform (and not only the illusion of a reform) begins. Some "litmus tests" are offered in the hope that they can help determine whether the economy is in Phase 2 or Phase 3.

IV (a). Shortage economy

22. The bureaucratic-hierarchical command economy is always a shortage economy. There is chronic excess demand and, associated with it, shortage-generated forced adjustment (forced substitution and forced saving, rationing, queuing, etc.). Overall abolition of chronic shortages is an indispensable element in a consistent set of reform measures. The disappearance of shortages is also an important litmus test, checking the depth of reform. If stubborn shortages prevail in certain important segments of the

^{1/} I can present some of my ideas on socialist economies only in a nutshell and inevitably this leads to extreme simplification. The five issues briefly discussed in the present paper are analyzed in more detail, together with other characteristics of socialist economies in the following books of the author: Overcentralization, Oxford, 1959; Rush versus Harmonious Growth, Amsterdam, 1972; Economics of Shortage, Amsterdam, 1980; and Growth, Shortage and Efficiency, Oxford, 1982. As introductions or summaries, the following articles are available: "Resource-Constrained versus Demand-Constrained Systems", Econometrica, 1979; "Adjustment to Price and Quantity Signals", Economie Appliquée, 1982; and "Some Properties of the Eastern European Growth Pattern", World Development, 1981.

For partly overlapping, partly different viewpoints about the common characteristics of the classical socialist command economy, see the following books: W. Brus, The Economics and Politics of Socialism, London, 1973; A. Nove, The Soviet Economic System, London, 1977; P.R. Gregory and R.C. Stuart, Soviet Economic Structure and Performance, New York, 1981; and P. Wiles, The Political Economy of Communism, Oxford, 1962.

economy, it is certain that the reform process has not penetrated into these areas and that there is no competitive pressure on the producer.

23. A shift from a seller's market to a buyer's market has a very strong impact on the behavior of economic agents, both buyers and sellers. A study prepared by the Bank by B. Byrd and G. Tidrick, Adjustment and Reform in the Chongqing Clock and Watch Company (1983), has provided an excellent description of such a change. The company participated in the experimental introduction of decentralization reforms. It received more autonomy, and the enforcement of centrally-prescribed obligatory output targets became weaker. Some profit incentives were applied: for example, a part of the profit could be retained in the firm and used for investment. Despite the remarkable changes, the attitude of the firm did not alter too much as long as the demand for the output of the firm at given State-fixed prices persistently exceeded supply. The enterprise exhibited the usual investment hunger and expansion drive (I shall return to this issue in Section IV (d)) limited only by the availability of the resources needed. The firm was more interested in the substantial increase of the quantity of production than in the improvement of quality and in the fine adjustment of supply to demand. But then suddenly the supply of the firm hit the demand constraint. The central authorities were not willing to lower the price. Under such circumstances, the former quick expansion exhausted the selling possibilities: the firm jumped from the usual state of a seller's market to the highly unusual state of a buyer's market. As a consequence, and as would be expected, the attitude of the firm changed completely. The new characteristics were that more attention was paid to the quality of output and that the producer tried to adjust the composition of production to the structure of demand. To outwit the rigidity of central price control, perverse "disguised price decreases" appeared: e.g., first-grade watches were sold for the price of second-grade ones, or an improvement in quality was hidden behind a second-grade face. ^{1/}

24. The case study on the Chinese clock and watch company represents an exception in the large set of those prepared in the Bank on socialist economies. In most of the other papers, brief references to shortages were made here and there. For example, the otherwise highly illuminating 1981 report on China had a few words on hoarding on p. 148 (hoarding is a typical side effect of chronic shortages and delayed or unreliable deliveries). The follow-up report of 1983 contained several lines on shortages on pp. 22-23 and pp. 65-66, but, reading through the extensive report, the reader cannot obtain a clear picture. Was China in these years an exception to the rule? Was it or was it not a chronic shortage economy? As far as I can judge, China was not an exception.

^{1/} In socialist countries, we usually find the opposite phenomenon: under chronic shortage, the firm may easily apply disguised price increases. Second-grade products are sold for the price of first-grade ones.

25. The 1980 and 1983 reports on Romania did not discuss the shortage syndrome at all, although there was ample evidence that this was (and probably still is) a rather fundamental issue in the country. Yugoslavia is a very special case in this respect: a peculiar combination of the buyer's market segments and the seller's market segments. Unfortunately, the otherwise very interesting reports did not offer a clear overview concerning excess demand or supply. The 1983 report made remarkable observations on shortage phenomena on the markets of investment resources (pp. 46-47) and on the unsatisfied demand for foreign exchange (p. 69), but did not connect these issues with the more general problem of overall macro excess demand. Also, the difficulties in energy supply are, in my opinion, related to the same overall question, but again this connection was not recognized in the paper. Earlier reports on Yugoslavia did not discuss this aspect at all. There was no discussion of the shortage issue in the reports on People's Democratic Republic of Yemen and Ethiopia.

26. I found the neglect of the shortage problem to be one of the main weaknesses in the reports. Of course, the shortcoming is more serious if the issue has not been studied at all. And scattered hints to one or another shortage phenomenon are not much better. It should be recognized that here we are facing an interdependent system of persistent imbalances: unsatisfied demands and shortage-forced adjustments, which spill over from one segment to the other. It can usually be found in seven areas, the details of which follow.

27. The first area is consumer goods for the household. Grave shortages of larger groups of commodities, or partial shortages in the assortment of supply, occur: e.g., certain types, models or colors are missing and spare parts are not available, etc. It is typically a random, stochastic phenomenon: one commodity is missing here today, another one at some other place tomorrow. (This random character applies, of course, not only to consumer goods, but to all other shortage events listed in the following paragraphs.)

28. The second area is services for the household. One of the most serious troubles in many socialist economies is housing shortage. In addition, there are shortages in telephone services, repairs, hotels and restaurants, the retail trade, public transport, health and education, cultural services, etc.

29. The third area is in the domain of private production activities (e.g., in agricultural production on a farmer's small private lot), where there is usually a shortage of certain producer's goods, e.g., fertilizers, pesticides, machines, equipment spare parts, etc. Also, shortages prevail in building materials for "do-it-yourself" private residential construction.

30. The fourth area is in production: shortages of material, energy, semi-finished goods, parts, unpredictability of deliveries and too few stocks on the side of the suppliers, with an assortment of goods not adjusted to the rapid and flexible service of the buyer firm. (This is complementary to hoarding of the same goods on the user's side:

excessively large stocks of inputs.) The recurrent shortages cause bottlenecks, improvised adjustments and ad hoc forced substitutions in the production process. (Usually, an observer would recognize these facts and would put them under the heading of "inefficiencies", but would never connect them analytically to the more general problem of chronic shortage.)

31. The fifth area is the shortage of manpower. It usually starts with excess demand for certain skilled categories. Later on, it grows wider with the rapid expansion of industrial activities, absorbing open and latent unemployment and underemployment. At the end of the extensive growth process, the labor market shifts from a buyer's market to a seller's market.

32. The sixth area is the shortage of investment resources. (This will be discussed in more detail in a later section.)

33. The seventh and last area is shortage of imported goods and, associated with it, shortage of foreign currency and foreign credit. (This will also be discussed later.)

34. As spelled out before, all these shortages are linked together and not only by spontaneous spillovers. In fact, policymakers have certain freedom to reallocate shortages (i.e., the lack of goods) in the same fashion as they are able to reallocate the availability of goods. The waiting line for building materials of private households can easily be shortened by lengthening the queue of enterprises for building material. Food shortages can readily be eased or even eliminated by imports through increasing the shortage of foreign exchange.

35. Shortages and surpluses are not mutually exclusive. On the contrary, they are closely associated. Since in a chronic seller's market the producer-seller is not particularly interested in fine tuning his product, it may happen rather frequently that he produces output which even the most indiscriminating buyer is not willing to accept. However, it does not matter as the producer can wait, since there eventually will be a buyer willing to purchase. Another relationship between shortage and surplus has been mentioned before: the tendency of hoarding. One more important linkage is that bottlenecks in some inputs lead to underutilization of some complementary inputs that are available at the time of the appearance of the bottleneck. Excess demand and excess supply are therefore not mutually exclusive on a more aggregate level.

36. Shortage ^{1/} is the basic form of imbalance in the Phase 2 type socialist economy. Not to analyze the shortage syndrome in depth is equivalent to going to a non-socialist Third World country and analyzing it without the examination of unemployment-underemployment and open or repressed inflation.

37. I am aware that there are great difficulties in obtaining data. Not only observers, but inside analysts as well experience similar problems. In many countries, important shortage indicators for a number of fields, such as waiting time, length of queue, backlog of unfilled orders, refusal of orders, ratios of forced substitution and so on, are either not observed or not published. There are deep theoretical difficulties in aggregating and/or synthesizing partial shortage indicators. Nevertheless, it is not impossible to obtain some data. It is rather common in the history of economic statistics that new demand for observation and measurement sooner or later creates its own supply. I would be willing to be more modest: even some "anecdotal evidence" is better than none. We could use the following analogy. Consider two reports on the Great Depression of the 1930s. One contains hundreds of figures - but does not discuss unemployment. The other one cannot offer serious numerical tables on unemployment, but at least gives some verbal description of the mass unemployment situation. I am sure that the second study will provide a much better understanding of the state of the economy of that period.

38. I think that the reports wishing to give an overall analysis of the economy should have a chapter or section on the "seller's market versus buyer's market" situation of the economy. Such a section could cut across the usual organization of the reports (internal versus external issues, industry versus agriculture, short term versus long term, etc.) and may offer important insights into the nature and performance of the economy.

IV (b). Weak price responsiveness and soft budget constraint

39. In contrast to the neglect of the shortage question, the problem of prices received a great deal of attention in most of the reports. There were many valid observations about the distortions and arbitrariness of relative prices, e.g., energy prices, interest rates, exchange rates and

^{1/} It is not my intention to enter into terminological disputes in the present notes. Just for clearer understanding: the set of phenomena I call "shortage" (or a subset of the same phenomena) is called by some other economists "overall excess demand", or "repressed inflation" or "persistent overheating", etc. I also use as a synonym the term "suction" in some of my works.

other elements of the relative price system. ^{1/} It is very important to point out these type of shortcomings and the comments I make are not aimed at refusing the legitimate criticism of existing price distortions. I wish to complement the usual World Bank criticism ("wrong relative prices") with another one, which I for one regard as equally or even more important: does the economic agent respond to prices?

40. Let me cite the approach widely applied by Western experts (including the authors of many reports prepared in the World Bank) in the analysis of socialist countries: "the wishful theory of prices". When an excessive demand for and an excessive waste of energy is perceived, the conclusion is to "increase the price of energy". When it is seen that there is an excess demand for investment resources and that there is inefficiency in completion projects, the conclusion arrived at is "increase the real rate of interest". Change the relative price of a product or of a resource and one can expect the same result in a highly centralized bureaucratic-hierarchical command economy as one would get in a decentralized price-sensitive market economy. This is wishful thinking: "get the prices right" - perhaps that can be adequate advice in a system where profit incentives and markets dominate the coordination of economic activities. (Even there, this prescription is of course not sufficient to solve all economic and social problems.) As for socialist countries, this kind of advice is surely insufficient. The degree of price responsiveness is not identical in all social systems, but is highly system specific. It depends on the deeply imprinted behavior of economic agents that determines how strong their response is going to be on the demand and supply side to changes in relative prices. Focusing only on socialist countries, little can be said as yet on which would be equally valid for all sectors in all countries and all the time. Therefore, I shall try to formulate some more qualified observations.

41. The household's purchasing power is strictly limited by its financial resources. Consumer credit is rather restricted and the repayment of credit is rigorously enforced. Hence, the household has a "hard" budget constraint. As a consequence, household demand for goods and services exhibits the usual properties. Demand is an increasing function of income, and a decreasing function of its own relative price. It is true that demand formation in a chronic seller's market is somewhat different from that in a chronic buyer's market. The buyer expects shortages and he therefore will at least partially adjust himself in advance to expected supply. There are important quantity signals which affect the buyer's decision: the length of the queue to be joined, expected waiting time, coupons and rations, selection criteria applied by rationing authorities,

^{1/} See, for example, the 1981 report on China, Vol. I, p. 124, and the 1983 report on China, pp. 23-24. Furthermore, see three studies on Yugoslavia: Raising Productivity in Yugoslav Industry: Some Issues, 1981, p. 41; Employment Strategy and Manpower Policies for the 1980s, 1983, pp. iv and 96; and Adjustment Policies and Development Perspectives, 1983, pp. 95-96.

information about availability of substitutes, etc. Ultimately, however, if the consumer price goes up, then it is rather likely - ceteris paribus - that demand will go down.

42. The same can be said about the behavior of private business within a socialist economy: e.g., about private merchants, craftsmen, free-lance professionals, owners of private restaurants, apartment landlords, private farmers, etc. They also have a hard budget constraint, mostly not separated or not quite separated from the household budget constraint of the owner. If a private economic unit gets into financial troubles, the socialist State will not bail it out but lets it down, and it will therefore suffer all the consequences of insolvency.

43. The situation is quite different with the State-owned and centrally-controlled firm. ^{1/} If the firm gets into financial troubles, the State is willing to bail it out: it will receive subsidies, tax exemptions, soft credits and rescheduling of due payments. The administrative price will be adjusted to the overrun of costs, or other means of covering the losses will be applied. It is built deeply into the expectations of the leadership of the firm that the State will help out the firm in case of insolvency or other great financial difficulties. Under such circumstances, even if there were some profit incentives (e.g., bonus for the managers linked to profits, profit sharing for employees, profit retention for internal welfare expenditures and investment, etc.), profitability still would not be a matter of life-and-death. The enterprise can survive long-lasting or ever-persistent large deficits. There is no automatic penalty because of losses. The correlation between present and expected future profitability on the one hand and the growth of the firm on the other hand is weak or non-existent. I call this set of conditions the "soft budget constraint". The firm has financial accounting. It has a balance sheet, as do all other enterprises in the modern business world, but the budget constraint is "expendable", depending on the success of lobbying and bargaining with different State authorities and on the paternalistic attitude of the State vis-à-vis the State-owned firm.

44. And now we can return to price responsiveness. Conventional demand and supply theory postulates the existence of a hard budget constraint. Demand is finite, constrained, because the budget is constrained. This simple relationship does not hold if the budget constraint is softened. The softer the budget constraint, the closer comes the slope of the demand curve to a vertical position, i.e., to the perfect insensitivity to prices. The firm can be unresponsive to relative price changes, as well

^{1/} The status of a cooperative firm (with collective ownership and more or less autonomy of the elected management) is typically somewhere between the status of the State-owned centrally-controlled firm and the private economic unit. There is a large variance of situations according to the degree of dependence on governmental authorities. In the present short notes, I cannot elaborate on the specific problems of the cooperative sector.

as to expected income from the sale of its output, if any deficit arising from this unresponsiveness and from the consequent inefficiency is sure to be almost automatically compensated for by subsidies, tax exemptions, soft credits and so on. If the firm as well as the medium and higher level officials of the economic administration are motivated to increase production and to speed up growth, then under a soft budget regime run-away demand for production inputs in general (and for investment resources in particular) will be generated. Here is one of the most important roots of chronic shortage in socialist economies.

45. Some qualifications must be added to avoid possible misunderstanding. First, the stringency of a budget constraint is not a binary variable: either soft or hard. It has a scale and intermediate positions are possible. External assistance is usually not granted automatically as some effort is needed to obtain it. The firm's managers must resort to pressure groups, lobbies or to personal connections. Some hidden corruption in the form of reciprocal favors may occur. Thus, softening of the budget constraint is not without costs. Therefore, even if it is softened, the budget constraint has at least some influence on the behavior of the firm.

46. Secondly, the stringency of the budget constraint is an ex ante behavioral variable, a component of the firm's expectations. It is determined by the collective experience of many years. It cannot be altered from one day to the other, e.g., introducing new legal regulations, bankruptcy laws, incentive schemes or credit criteria. It will to a large extent depend on long-term experience with the enforcement of such changes. The managers and also other employees of the firm must witness for a number of years that profitability is "dead serious" and that price and profit signals cannot be neglected since such neglect leads to harsh reprisals in the career of the manager, in the job security of the employees and in all prospects of the whole enterprise.

47. Thirdly, the budget constraint, as it appears in standard micro theory, is a static concept. In real life, the issue is a dynamic one. Assistance fills up the gap between flow of expenditures and flow of sales-generated revenues of the firm.

48. Fourthly is the fact that usually a seller's market prevails results in a particular asymmetry of price responsiveness. It is usually somewhat stronger on the supply side and somewhat weaker on the demand side. The firm, in its capacity of a seller, may give preference to more profitable products. (The firm prefers more profitable production to a less profitable one since, even with a soft budget constraint, it is unpleasant to apply for State support and bail out.) And since the seller is stronger than the buyer, he can force the latter to adjust his demand to given supply. (With arbitrary pricing, relative profitability does not reflect relative scarcities.) At the same time, the firm in its capacity of a buyer will be more insensitive to costs. It is not a consistent cost minimizer: it buys and uses the inputs it has, and it will be glad to get the needed material, to have semi-finished goods delivered and to have the

needed services at hand. It will not be particularly selective concerning the costs of different input combinations.

49. There is no synthetic measurement of the stringency of the budget constraint. It can be observed and measured only indirectly with an appropriate set of indicators. Here are a few examples: frequency of bankruptcy cases and different procedures following insolvency; the "rules of the game" concerning exit and merger; the fiscal redistribution of taxes and subsidies amongst the firms (who gains and who loses with the redistribution); and the business practice of the banking systems (what are the real - and not the publicized - criteria of credit rationing). Again, as in the case of the shortage syndrome, the softness of the budget constraint is an observable and measurable fact of life - but the difficulties of observation and measurement can be rather great.

50. Here again is an important litmus test, one concerning the borderline between Phases 2, 3 and 4, i.e., the transition from the classical command economy to market socialism. Even with more flexible and more realistic prices and some profit incentives, we may be far away from a genuine market socialism if the budget constraint is relatively soft and the response to price signals relatively weak. The hardening of the budget constraint and the strengthening of price responsiveness are among the most reliable indicators concerning the consistency and "seriousness" of the reform.

51. Most of the reports prepared in the World Bank did not raise the issue of the soft budget constraint. ^{1/} In many studies, the secondary (legitimate, but secondary) question, "get the prices right", is completely separated from the primary question, which is does the agent respond to the price because the whole social framework compels him to respond? Or is such compulsion missing?

52. A word of caution is in order here. I consider price responsiveness the primary issue and the correction of the distorted price structure the secondary issue. These adjectives refer only to a logical order of causality and not to the temporal order of practical measures. It does not imply that a reform process defer the improvement of relative prices until the budget constraint becomes hard. What is meant by this is that the hardening of the budget constraint is a precondition of the strong effect of prices. Both the hardening of the budget constraint and the improvement

^{1/} Evidently, I do not complain that the authors of the reports did not use my terminology of "soft budget constraint". This is only a metaphor, which may help explain a complex social phenomenon. It is easy to find synonyms, or other ways of expression. One could speak about financial discipline and strict accountability, intolerance against persistent loss making, the punishment by the market for financial failure, etc. My criticism is that these issues did not get sufficient attention.

of the price system are greatly needed and it is desirable to go ahead with both simultaneously.

53. I am glad to recognize that in the last few years there has been a growing interest in these issues. A good example is the already quoted paper by Byrd and Tidrick about a Chinese clock and watch factory. The authors have tried to examine thoroughly the consequences of a soft budget constraint and the attempts to "harden" it. There is a very stimulating paper on Yugoslavia by P.T. Knight entitled Financial Discipline and Structural Adjustment (1983). The paper is exemplary in finding convincing quantitative indicators: number of loss-making economic units, the size of losses, the relative frequencies of bankruptcy procedures and administrative "rehabilitation" processes. A particularly interesting finding is the role of interfirm credits as "softeners" of the budget constraint. To put it in very simple terms, the budget constraint is really not binding when the firm simply does not pay the bills and the legal system tolerates the acceleration of mutual forced indebtedness. A later follow-up note by Chandra Pant (1984) presented the latest news in this respect. It showed that there are efforts in the direction of hardening the budget constraint, but the enforcement of appropriate legal resolutions seems to be not sufficiently rigorous.

54. In contrast to the growing interest focused on the stringency of the budget constraint, much less attention is paid to price responsiveness. I could not find a single report which examined this issue at length. This, in my opinion, is mainly the fault of economists working within the socialist economies. It is our duty to study the problem in much more detail. It is a very difficult research task; there are unresolved theoretical and statistical problems. For example, energy elasticities decreased, although not to a sufficient degree, in some socialist countries since the first energy crisis in 1973. What are the causal factors? Did the decrease occur because administrative constraints (energy import quotas, energy quotas allotted to productive enterprises, etc.) became tighter? Or because firms responded to an increase of energy prices by decreasing their demand for energy? Probably both factors played a role, but we need some kind of theoretical and statistical separation to understand causality. The same applies more generally to the demand for imported goods. There are administrative quantity restrictions and there are, at least in some countries, changes in the exchange rate. What is the effect of the first and of the second cause on the demand for imports? Much more research is needed to answer these questions. But, given the level of our ignorance at the present moment, even a somewhat vaguely expressed awareness of the issue is better than complete neglect.

55. Here, a short digression to monetary policy will be in order. A repeated suggestion to socialist countries is this: apply a tight monetary policy if you want to restrict runaway total demand. The advice concerning monetary macro policy is based on tacit assumptions concerning the behavior of the micro units. If total money supply is restricted, the micro units will spend less and ultimately will restrict the purchase and the use of real goods and services. In my opinion (shared by some other researchers

of socialist economies), ^{1/} the tacit assumptions underlying the usual macro advice are wrong: the transmission mechanism between total money supply, together with the response of micro units to a change in monetary policies, work rather differently from the underlying tacit assumptions. The "activity" or "passivity" of money is conditional on the stringency of the micro budget constraints. Conventional demand management works with the household; lower wage and less consumer credit - perhaps after some adjustment of saving - will lower consumer expenditure. One does not get a similarly mechanical response from the State-owned and centrally-controlled firm operating with a rather soft budget constraint. Even after tightening the total quota for credits, the firm may go ahead with procurement and actual use of resources. It still may be indifferent to the danger of insolvency as long as it can be more or less sure that somebody else (the Bank or the State) will pay the bill, or, ^{2/} as with many Yugoslav firms, it simply does not pay some bills at all. ^{2/} It will not feel scared by a cut in total bank credit. It simply will not believe in the persistency of such a tightening.

56. Institutional changes altering micro behavior and changes of monetary macro policy must be simultaneous in order to get the expected results from the latter. Space limitation of the present paper does not allow for further elaboration. Here, I can give only a few hints on this rather complicated problem, which surely deserves further serious research. In any case, perhaps these few words may serve as a warning: routine macro advice must not be applied without thorough reconsideration of the micro foundations of macro policy.

IV (c). Expansion drive and investment hunger

57. A very characteristic property of the standard "classical" behavioral pattern is the insatiable hunger for expansion and investment. ^{3/} It can be observed in government agencies, political institutions in charge of economic affairs, non-profit organizations and, last but not least, in State-owned firms. Investment hunger is shown persistently at all levels of the bureaucratic hierarchy, from the shop-floor manager to the director of the large company, to the government cabinet minister.

^{1/} See W. Brus, Ogoline problemy funkcjonowania gospodarki socjalistycznej, Warsaw, 1961, and G. Grossman, "Gold and the Sword: Money in the Soviet Commaney Economy", in H. Rossovsky (ed.), Industrialization in Two Systems, New York, 1966.

^{2/} This is an arbitrary creation of money by credits forced upon the creditors.

^{3/} The papers Raising Productivity in Yugoslav Industry: Some Issues, 1981, and Yugoslavia: Employment Strategy and Manpower Policies for the 1980s, 1983, use the term "investment mania".

58. Different explanations were offered in the literature. Some authors have put the emphasis on the ambitious growth objectives of the top leadership. They wanted to speed up development, to close the gap as soon as possible between the highly developed capitalist countries and the socialist economies. They wanted rapid growth for the sake of strengthening the overall power of the country, its defense capacity and ultimately to ensure a high standard of living. Because the top leadership had these growth objectives, they have forced "output maximization" and/or "growth maximization" upon the lower levels of the hierarchy down to the firm by means of tight output and investment plans and managerial bonuses linked to the fulfillment of the plan.

59. In my opinion, it is true that the leadership of socialist countries gives a very high preference to growth objectives, but this is only the half of the story explaining investment drive. There is a voluntary propensity to invest at a high rate at all levels of the hierarchy. This prevails even in the periods in which for some reasons (e.g., because of external disequilibria) the top leadership would be in favor of less investment.

60. In many socialist countries, a recurrent alternating of "stop-go" policies can be observed. Acceleration of investment and other economic activities is followed by deceleration, or sometimes by absolute contraction. In other words, we see irregular or - in some countries and in some extended periods - regular cyclical fluctuations.^{1/} Some economists point to the restrictive phase of the cycle and conclude that the mere existence of such restrictions disproves that investment hunger is persistently insatiable. I think that this line of reasoning implies an error in logic, confusing the role of the allocator and of the claimant for investment resources.

61. Let us consider a medium-level authority, say, the minister of light industry. He has a double role. He is the allocator of investment resources over the subsector of light industry. (I am using here and in the forthcoming discussion the term "allocation of investment resources" in

^{1/} The most important work in the field is the book in Hungarian on investment cycles by T. Bauer: Tervgazdaság, beruházás, ciklusok (Planned Economy, Investment, Cycles), Budapest, 1981, which elaborates a general theory of cycles based on the experience of several socialist countries. There are many other interesting studies that are available in English: T. Bauer, "Investment Cycles in Planned Economies", Acta Oeconomica 1978; A.K. Soós, "Causes of Investment Fluctuations", Eastern-European Economics; M. Lackó, "Cumulating and Easing of Tensions", Acta Oeconomica 1980; O. Kyn, W. Schrettl and J. Slama, "Growth Cycles in Centrally Planned Economies: An Empirical Test", in O. Kyn and W. Schrettl (eds.), On the Stability of Contemporary Economic Systems, Göttingen, 1979; and M. Maresse, "The Bureaucratic Response to Economic Fluctuation: An Econometric Investigation of Hungarian Investment Policies", Journal of Policy Modeling, 1981.

the following sense. This is a collective term which includes the bureaucratic allocation of investment quotas, permits the start of concrete investment projects, the rationing of investment credits and subsidies, the licensing imports of investment goods, etc.) At the same time, the minister is a claimant for investment resources from the central planning authorities and ultimately from the government and central political bodies. In this second role, he is competing with his fellow ministers of heavy industry, agriculture, transport, etc. Given this double role, his mentality will be Janus-faced. Downward looking he will be restrictive, trying to resist the excessive claims of his subordinates. In the decelerating phase of the investment cycle, he may be more restrictive than usual. Upward looking, however, he will be demanding, urging the superior decisionmaker to give more resources to his sector. Reference is made always to the upward-looking face when talking about the insatiable investment hunger. This hunger never ceases and during restrictive phases it becomes even stronger.

62. The term "insatiable" should not be taken literally. The subordinate must submit a reasonable figure as his claim for the investment quota, otherwise his superiors will not take him seriously. There is some voluntary restraint for the sake of a "reasonable image" and a better maneuvering in the battle for resources. But this does not hinder the creation of claims which to a very large extent exceed in total the available physical resources. The total claim is not infinite in the strict mathematical sense, but sufficiently large and "run away" to be considered insatiable or nearly so.

63. A conclusion for the analyst who wants to understand the nature of a socialist country is that it is not sufficient to look at ex post investment data such as investment expenditures, new capital formation, etc. What is going on ex ante must be studied and this should be done in several stages. The last stage is the investment plan, which can be compared with fulfillment. The plan, however, is already an outcome of a compromise between planners, allocators and claimants. We have to trace the sequence of events and also consider what happened during the planning and project-approving processes and what was the relationship between claims on the one side and the estimates concerning available resources on the other side. This is where the tension of the investment sphere begins: the limitless (or almost limitless) claims for resources.

64. The decisionmaker in his role as a claimant does not respond to the interest rate. This is evident in the case of the hierarchical levels above the firm. Also, the firm does not really respond to interest rates when deciding on investment resource claims. There is systemic bias in ex ante estimates of investment costs. A more modest proposal has a better chance of acceptance. It is reasonable, therefore, to underestimate costs and to overestimate returns. At a later stage, it is hard to stop the execution of the original investment decision.

65. As for causal explanation, there are three mutually interrelated causes:

- (i) the softness of the budget constraint. If the decision was wrong and the increment of output due to the investment project does not pay off the costs, the deficit will be covered. The State acts as a general insurance company. The main area where the softness of the budget constraint appears is not so much in current expenditures than in the sphere of investment;
- (ii) the impersonality and anonymity of the decision process. According to the given legal regulation, someone must have signed the document which gave the starting signal to the project. But the individual who signed this piece of paper surely consulted his superior and perhaps the superior again consulted his own superior, as well as many others, and thus the decision when reached is usually based on a certain consensus. This consensus base brings collective wisdom into the decision - but it undermines personal responsibility. In case of failure, all members of the consenting group are interested in covering up the deficit, i.e., by softening the budget constraint; and
- (iii) chronic shortage. This is a vicious circle as investment hunger contributes to total demand and exceeds physically available resources. At the same time, chronic shortage strengthens the confidence of the investor. He will surely find buyers for the additional output which has been produced with the newly created capital. In a market economy, investment is highly dependent on optimistic or pessimistic expectations concerning future sales prospects. In a chronic shortage economy, such anxiety does not exist.

66. An important litmus test of the transition from Phase 2 to Phases 3 and 4 (from "classical" to reformed market socialism) is the analysis of the investment hunger phenomenon. If there is no voluntary restraint on the claimant's side, the reform did not go far enough.

67. It is remarkable that Yugoslavia, one of the leading countries in the reform process, does not stand this particular test. Investment hunger is not less intensive here than in any other socialist country.^{1/} At least causes (i) and (ii) still prevail in Yugoslavia; as for cause (iii),

^{1/} All World Bank papers dealing with Yugoslavia fully recognize this fact and provide many examples and data to support the observation.

Yugoslavia is not a clear-cut case, but a peculiar mixture of a seller's market and a buyer's market.

68. It is not a litmus test to check the opposite side, the allocators' behavior. Phase 2 socialism, i.e., a highly centralized command economy, is able to apply very effectively a restrictive macro policy by cutting dramatically investment quotas, by stopping or by slowing down investment projects in progress, by prohibiting new starts, by denying licenses for importing investment goods, etc. 1/ The more centralized the economy, the easier to ensure the implementation of drastic restrictive macro policies.

69. As for World Bank reports, most of them have clearly recognized the tendency of excessive investment drive. 2/ This will surely help in understanding the importance of the issue. What is mostly missing in my opinion is a deeper analysis of the causes of the investment-hunger phenomenon. Quite a few studies also apply in this context of what I referred to above as the wishful theory of prices. If there is excess demand for investment resources, the cause must be the incorrect interest rate (too low or, in real terms, even negative interest rate). 3/ And if this is the diagnosis, the therapy clearly follows to get the interest right. My comment carries on from Section IV (b). First, create price and interest responsiveness. Only if this is safely assured, can an interest rate policy become effective. 4/

70. An offshoot of the wishful theory of prices is the suggestion to apply cost-benefit analysis based on rational shadow prices as an

1/ See, for example, China: Socialist Economic Development, Vol. I, 1981, p. 18, or the 1981 Country Program Paper for a vivid description of such dramatic investment cuts. Similar Romanian experiences are described in Romania: Economic Memorandum, 1984.

2/ A few examples: China: Socialist Economic Development, Vol. I, 1981, p. 161; Office Memorandum on Ethiopia, April 13, 1983, p. 7; Country Program Paper on Romania, 1980, p. 3; People's Democratic Republic of Yemen: Economic Memorandum, 1982, pp. 2-3, 20; and Yugoslavia: Adjustment Policies and Development Perspectives, 1983, pp. 46-47.

3/ This is the repeated reasoning for the case of Yugoslavia. See Raising Productivity in the Yugoslav Industry: Some Issues, 1981, pp. iii and 41; Yugoslavia: Employment Strategy and Manpower Policies for the 1980s, 1983, p. 96; and Yugoslavia: Adjustment Policies and Development Perspectives, 1983, pp. 95-96. See, furthermore, China: Recent Economic Trends and Policy Developments, 1983, p. 33.

4/ The word "first" in the former sentence refers to a causal-logical order: price responsiveness is the precondition of an effective interest rate policy. It does not imply any suggestion concerning the temporal order of measures. I shall return to this later in Section V.

instrument of project selection. ^{1/} The proposal assumes tacitly that the planner is an unbiased "homo rationalis", considering nothing else but what follows from the impartial numbers of the cost-benefit calculation. In my experience, people at all levels of a bureaucratic decision process are normal human beings: they have good intentions and do a good job. At the same time, they want to please their superiors: they may succumb to pressures and to lobbying, and may be influenced by personal loyalties vis-a-vis their "own" sector, branch, region, etc. Depending on the preference of the boss, it is all too easy to prepare a tailor-made calculation which either supports approval or supports refusal. Similar wishful thinking is behind the suggestion to make investment decisionmaking less "politicized" ^{2/} and more efficiency oriented. This is not a change which can be achieved by preaching the reasonableness of such a shift. If a decision is not a business-like one, favoring or hurting the financial interest of a well-defined group of individuals, it will inevitably be a part of a "political" (or, more precisely, a politico-bureaucratic) decision process.

71. Many papers put all the emphasis on the governmental macro policy in the control of investment and did not dig more deeply to the micro roots of the problem. The problem has already been discussed in Section IV (b) and will be readdressed in Section V.

IV (d). The typical foreign trade performance

72. The performance of socialist economies in foreign trade can be understood only if it is placed in the context of the behavioral regularities of the system. As with the previous section, what follows will be far from complete. I have presented only a few observations, which are closely related to the issues discussed in other parts of the paper and will focus on Phase 2, the classical command economy.

73. The decisionmakers controlling foreign trade activities are not "profit maximizers": they are either the officials at the higher or medium level of the bureaucratic hierarchy, or the managers in the firm. The responsiveness to prices, costs and exchange rates is weak or nil. The gain or loss from foreign trade is not clearly calculated; it is impossible to make such a calculation with arbitrary prices.

74. The first driving force of foreign trade is "import hunger". The producer enterprises, government agencies in charge of ensuring the supply

^{1/} See China: Socialist Economic Development, Vol. I, 1981, p. 16; China: Recent Economic Trends and Policy Developments, 1983, p. viii; Romania: Economic Memorandum, 1984, p. 71; and Yugoslavia: Adjustment Policies and Development Perspectives, 1983, p. 64.

^{2/} See China: Socialist Economic Development, Vol. I, 1981, p. 161; and Yugoslavia: Adjustment Policies and Development Perspectives, 1983, p. 64.

of goods to domestic firms, non-profit institutions and households are eager to obtain imports. They do not have any strong economic motivation to think about the cost. This is a phenomena parallel with investment hunger. As a claimant, each firm and each agency would like to get as large an import quota and licenses as possible. Furthermore, there is an insatiable appetite at all lower and medium levels of decisionmaking for high quality modern machinery and equipment, which is a phenomenon not only parallel, but practically associated with investment hunger. In the case of acute and intensive shortages, the claims for more imports filling the gaps of domestic supply become more aggressive.

75. Turning attention to the export side: apart from exceptional situations, the producer firm enjoys the easy conditions of the domestic seller's market. It therefore has no endogenous motivation to search for export markets in the convertible currency area, which would demand impeccable quality, delivery exactly on time, etc. If the firm must export, it is still more convenient to supply another shortage economy: a less selective buyer.

76. Of course, the top leadership in charge of national balances is perfectly aware that imports must be ultimately compensated for by exports. But only the top leadership feels that as an endogenous compulsion. For a transmission mechanism, they rely on administrative command methods. Against spontaneous import hunger, prohibitions are used in highly disaggregated quotas and licenses. Instruments of export promotion are mandatory export targets, which are often very detailed instructions as to what to produce for which market, and bonuses for fulfillment or over-fulfillment of the plan. The central organs put pressure on the medium and lower levels of the bureaucracy and finally on the firms to export by all means and at any cost. It is a drive for a maximum quantity of proceeds in convertible currency, irrespective of the true domestic costs. If the quality of the goods and the terms of delivery are not sufficiently attractive in the eyes of the foreign buyer, a lower selling price can achieve the deal. Nobody is directly financially hurt if an export transaction leads to a deficit since, in that case, the softness of the firm's budget constraint also helps.

77. There is a peculiar combination of hard and soft budget constraints. The balance of payments for a long while was a rather soft constraint, easily expandable by increasing foreign debt. Then, after economic and political shocks, it suddenly became very hard. This hardness, however, is felt only by the top leaders and it is not automatically "transmitted" to the producers and consumers through any well-functioning market mechanism. There is a deep contradiction: the convertible currency constraint is hard at the national level, but at the same time the budget constraint of the firm in domestic currency is soft, mellowed through an enormous variety of tax exemptions, subsidies, etc. Under such circumstances, the firm, driven by endogenous motivation, does not participate voluntarily in the improvement of the foreign trade situation. Nevertheless, the balance of trade and the current account can be improved, but only with energetic administrative measures, drastic import cuts and forced

export achievements, accompanied by great losses, inefficiencies and sacrifices.

78. This is, of course, a very crude picture, neglecting many details, exceptions and national differences. Let us now consider the approach in the World Bank papers. They present accurate and well elaborated analyses of the foreign trade and the balance of payments situation of the country under scrutiny. These sections of the reports offer important, interesting and valuable information and they serve as a data source for further investigations and comparative studies.

79. As for the normative aspects, the general advice contained in quite a few papers is surely correct: a more outward-looking, export-oriented policy would be useful. Less emphasis should be laid on import substitution and more on export promotion - this is a convincing recommendation. And yet the question remains as to why these countries do not pursue such a policy. Is it because they have not received similar advice before, or is it because there are endogenous forces, behavioral regularities at work which act against these desirable trends? I am inclined to believe the second hypothesis.

80. A deeper positive analysis of the system, preceding the normative recommendations, was missing in most papers - as in the case of the issues discussed in the earlier sections. Most of the socialist countries, especially the smaller ones, have not been aiming at self-sufficiency or autarky in the last two decades; they are not inward looking at either the national or the CMEA level. Their desire is to make good use of the possibilities offered by foreign trade. In spite of recognizing the desirability of outward-looking policies, they keep falling back to the symptoms just described. Under the circumstances of a command economy, it is much easier to give instructions for import substitution than to penetrate into new markets with exports. An economic system cannot have a "multiple personality", exhibiting one character for the domestic purpose and another character which is quite different for the external purpose: inside, exploiting the easy terms of a seller's market; outside, working hard to sell on a buyer's market; inside, enjoying full security of the survival of the firm and of all existing jobs; outside, behaving as an actor used to tough competition; inside, being careless with costs; and, outside, responding sensitively to profits and losses. In short, there is no therapy for shortcomings in foreign trade without curing the domestic troubles of the economic system.

81. The wishful theory of prices appears here in the form of allusions concerning exchange rate policies. The criticism of an arbitrary exchange rate (or, even worse, a whole set of arbitrary rates for different purposes) is legitimate and useful. This criticism must not, however, lead to the simplistic conclusion that, even if nothing else has changed, a correction of the exchange rate will produce the desired and expected effects. The primary question is again the responsiveness to the price signal. If the

responsiveness is weak, then the impact of exchange rate policies, compared to the influence of administrative regulation, will be weak as well. ^{1/}

82. It is precisely this aspect which offers one more litmus test of the transition from Phase 2 to Phase 3 and Phase 4. Has exchange rate become an effective signal? Is the export or import price - through the intermediation of the exchange rate - an effective signal for the domestic producer and consumer? Are there transparent and self-controlled linkages between domestic and export or import prices? ^{2/} Or are there still administrative barriers which, at the first instance, insulate the domestic market from the foreign market and then allow connections only under bureaucratic regulation through mandatory targets, quotas, licenses, rationing and fixed prices?

IV (e). Forced growth

83. The standard growth pattern of Phase 2 is characterized by a certain set of priorities. It is not completely consistent and invariable over time. Nevertheless, there are clearly recognizable features.

- (i) The main growth objective is the maximization of the medium-term growth rate of output (and not the long-term growth rate of consumption). This is a disputed issue; other economists suggest that other objectives are revealed in the choice of high-level planners (e.g., maximization of net capital formation or investment).
- (ii) Priority is given to the so-called "productive" sphere over the "non-productive" sectors. To the latter belongs housing, services, commerce, health, education and infrastructure.

^{1/} Yugoslavia is a special intermediate case, different from the socialist countries which are clearly in Phase 2. It would be wrong to suppose that the socialist sector here is completely unresponsive to price signals. It is questionable, however, as to how strong the response of the Yugoslav enterprise is to price, exchange rate and similar other signals. Without convincing studies clarifying this question, one cannot accept (or reject) unhesitatingly the following straightforward proposition: a more active exchange rate policy is the most important issue. (See Yugoslavia: Adjustment Policies and Development Perspectives, 1983, p. 96.)

^{2/} The linkage between domestic prices on the one hand and export and/or import prices on the other hand is a very important problem, closely related to other issues discussed in the paper. I cannot, however, elaborate on it here.

- (iii) Manufacturing (most importantly, heavy industry) is given priority over all other sectors.
- (iv) There is a strong bias in favor of the large (and often the gigantic) enterprise, as opposed to medium or smaller units, even in areas where the medium or small size would certainly be more efficient.

84. This is not an exhaustive list. Two or three more tendencies could be added. The most common name for this particular growth pattern is "forced growth". I called it "rush" in one of my lectures. For the sake of rapid expansive growth, requirements for balanced and harmonious growth are stubbornly disregarded.

85. From time to time, there are corrections. Some of them are introduced after a careful evaluation of the results as a consequence of a "self-criticism" of policymakers and planners. Sometimes, catastrophes or public protests induce change. The corrections are usually only marginal and provisional. Ultimately, inertia and rigidity prevail. Intertemporal averages over longer periods show that proportions of different sectors, once established, change only extremely slowly.

86. A litmus test of the seriousness of reforms is the examination of the following questions: are they significant and, more importantly, are they long-lasting and permanent readjustments in favor of formerly neglected sectors, such as housing, infrastructure, health and so on? Is production better adjusted to needs, as expressed either through economic signals (high demand prices, the black market, the semi-legal second economy, abnormally long waiting queues, etc.), or through "voice", ^{1/} i.e., complaints, proposals and protests?

87. There were a few interesting hints in different World Bank reports to the peculiarities of the "forced growth" pattern. ^{2/} A more thorough analysis would certainly help both positive understanding and policy formation. This is a field where comparative research can be very instructive, contrasting the growth pattern of the country under examination with the pattern of other socialist countries and non-socialist economies as well. The Bank has a long and highly respected tradition in this area, which could be well utilized here.

^{1/} Albert Hirschman's term in Exit, Voice and Loyalty, Cambridge, Massachusetts, 1970.

^{2/} See, for example, Romania: Economic Memorandum, 1984, p. iii; and People's Democratic Republic of Yemen: Economic Memorandum, 1982, pp. 2-3.

IV (f). About the underlying philosophy

88. Sections IV (a) to IV (e) discussed five common characteristics of the classical command economy. As mentioned earlier, I do not claim that these and only these features are important; a few more could be added. To each proposition put forward in the present paper belongs a new set of questions searching for deeper explanation. I deliberately omitted important issues, such as the analysis of the political system and the role of non-private (state or collective) ownership, which to some extent explain the phenomena discussed here. I think that a serious analysis of these issues would lead us far beyond the scope of economics into the realm of other disciplines such as history, sociology and political science.

89. Even if we remain within the limited scope of the present paper, there is an underlying philosophy in the discussion of the common characteristics of socialist economies. I assume that certain cohesion exists amongst the most important attributes of a specific socio-economic system. They are, in a historical perspective, not only correlated in the statistical sense, but there is also a causal interaction among them.

90. It is widely disputed whether we can find a set of primary explanatory factors distinguishable from a secondary set, which is more or less a consequence of the first one. For example, can the objectives and priorities of the policymakers be derived from the socio-political characteristics of the system, such as ownership, political structure, institutions and so on? Or does the main direction of causality run the other way round: the conscious efforts to achieve certain objectives lead to the creation of an appropriate institutional mechanism? I am inclined to base my research on the first hypothesis, but the problem deserves further investigation. In any case, there is mutual causation and interaction. This proposition goes back to the ideas exposed in Section II: all socialist countries exhibit some important common properties. ^{1/} In other words, they belong to the same "species" of social systems. ^{1/} This is what makes any deeper reform so difficult. No single element can be removed arbitrarily without changing the rest. Or, in a somewhat narrower formulation, there are many (not all) elements which cannot be altered without alterations in many other elements.

91. And here we have arrived at the topics of the next two sections, which will discuss some problems of reform. As indicated in the Introduction, the emphasis will be on the formulation of the questions and not on the detailed elaboration of the answers. I want to assist the outside analyst of a socialist economy to recognize the dilemmas he is likely to face.

^{1/} The proposition that all socialist countries belong to the same "species" does not exclude the possibility that many of their attributes to some extent may appear in other "species" as well. For example, we may find many symptoms of the soft budget constraint syndrome or of investment hunger in developing mixed economies.

V. The first reform dilemma: macro adjustment versus institutional change

92. There have been various serious imbalances in the socialist economies in recent years (partly in common with many non-socialist countries and partly more system specific). Internal shortages, chronic excess demand, repressed or open inflation have appeared in all of them, as well as unemployment in some of them. There were external imbalances as well: trade deficit, balance of payments deficit and excessive foreign debt. Not all socialist countries are tormented by these imbalances to the same extent, but in some of them the situation has become or is on the way to becoming rather critical.

93. What kind of measures should be taken in response to the imbalances? The answer of the reformers is to introduce much more decentralization, more reliance on market forces, more competition, liberalization and deregulation. Some reformers make light-headed promises in the zeal of obtaining more popular support, raising hopes for fast and painless results. The majority of reformers is, rightly, more cautious. They maintain that the reforms will produce some visible improvements in the near future, but many of the beneficial results will show up only after a longer lag, when the new mechanism has been consolidated and the behavior of the economic actors has been adjusted to the new rules of the game.

94. We can witness a very different response to the imbalances as well. This is the reaction of the conservative-orthodox advocates of the Phase 2 socialism, or of some "conditional" reformers who are not against changes, but want to postpone them after the macro difficulties and imbalances are put in order. Many officials do not even think about the dilemmas of reform, but act according to a Pavlovian "conditioned reflex": solve a macro imbalance by centralized activist State intervention. A few examples are:

- (a) drastic cutback of investment by administrative rule; (This was discussed in more detail in Section IV (c), and the references to World Bank papers can be found on p. 21 in the footnote to paragraph 68.)
- (b) administrative restrictions of imports. This can be done formally by applying tighter quotas and granting less import licenses. Or it can be done informally by placing more pressure on the importer, requesting that he "voluntarily" give up his import intentions. Also, import substitution can be relatively easily enforced by central command;
- (c) commands to producer firms and to the foreign trade companies to increase exports, even if the profitability and efficiency of the additional transactions become much lower; (This topic and

the import issue have already been discussed in more detail in Section IV (d).)

- (d) running down the inventories of the producers and of the commercial sectors. This temporarily results in import substitutions and/or domestic production, but increases the probability of shortages, bottlenecks and the spillover effects of such disturbances, causing further shortages and bottlenecks at some other points; and
- (e) the enforcement of austerity programs by drastic increases of some centrally-fixed consumer prices and only partially compensated for by nominal income increases, thus ultimately causing an acceleration in inflation.

95. The more energetic the central intervention (and, as a precondition, the tougher and more disciplined the bureaucratic hierarchy), the faster and more spectacular the results. The fact that there are serious difficulties and imbalances has an ambiguous effect on the reform process. On the one hand, it strengthens the position of the reformers in disputes. They can argue that one cannot go further with the present mechanism and that far-reaching modifications are needed. If everything were fine, who would be interested in changing the old rules and old institutions? On the other hand (and this aspect is the more decisive one), serious imbalances create an unfavorable economic environment for reform. Let us go over the same sequence of issues again:

- (a) Liberalization of market forces would immediately reveal a great many structural disproportions. It is true that the price adjustments can ensure short-term equilibrium on the market, but later on the price and profit signals should be followed by the adjustment of capacities. The composition of supply which dominated demand on the chronic seller's market should finally come closer to the composition of demand. Structural adjustment, however, requires rather large sums of investment - and this at a time when investment has been cut because of macro imbalances.
- (b) A strong competition between imported and domestically produced goods is very much needed to wake up the inert producers used to the relaxed condition of a seller's market. In small countries, in many sectors or subsectors, no parallel domestic production of the imported goods can be afforded because this would lead to the abandonment of economies of scale. Hence, imports must serve as the real or the potential competitor. But, again, it is not easy to demand

full import liberalization when the country is suffering from deficits in external balances.

- (c) The effects of more enterprise initiative, less bureaucratic restrictions and the stimulating impact of the shift towards a domestic buyer's market will show with the better quality, more reliable delivery, more innovation, finer adjustment to demand and, as a final consequence, in more successful exports - but in some cases only after some delay. The trouble is that more exports to markets paying in convertible currency are needed right now.
- (d) The shift in the allocation of macro output (more to pay the external deficit, less for domestic investment and consumption) is inevitably accompanied by some inflation. Inflation, however, weakens the reliability of price signals and undermines financial discipline in the sensitive "educational" transition period, when the actors just start to learn responsiveness to prices.
- (e) Austerity programs are perhaps inevitable. The well-trained economist, who has no prejudices against reform, understands that the cut into the standard of living today is the fault of the prereform Phase 2 system, aggravated by the deterioration of external conditions (and by the poor response to the deterioration). But the man on the street will not follow this true but complicated reasoning. Many people think in terms of synchronized causality: if there is a reform currently underway and if the standard of living is falling, the fall, therefore, is caused by the reform. Populist opponents of reform extensively use such arguments.

96. Perhaps there does exist a narrow strait between the Scylla of an economic crisis caused by macro imbalances and the Charybdis of the defeat of the reform. Caution, wisdom and good luck can help find the narrow strait. In any case, the outside analyst and advisor must consider very carefully his position before intervening in the process when searching for a solution. There are no readily available rules of thumb equally applicable everywhere and at all times. The same advice, which may be acceptable and can be implemented in a non-socialist Asian, African or Latin American developing country, can cause more harm than good in the delicate transition period from Phases 2 to 3 to 4 in a socialist country.

97. Reading the World Bank reports, I got the impression of a somewhat ambivalent or, if I may say so, schizophrenic attitude. ^{1/} As works of micro economists trained in the tradition of Adam Smith, the papers

reflected an approval of the reform ideas: more decentralization, deregulation, liberalization and more reliance on market forces. As works of macro economists and perhaps also of bankers, the same writings approved the drastic macro measures, which are strongly connected with centralization (or perhaps recentralization).

98. There is a genuine conflict between different ultimate values. I do not think that this conflict can be resolved (or evaded) in a perfectly value-free and ideologically neutral "technocratic" manner. The Introduction underlined that it is not my job to evaluate the World Bank's actual policy vis-a-vis socialist economies. As a researcher - and also as a citizen of a socialist country - I am unambiguously on the side of the reform process, because only this can bring these economies closer to a long-term solution. Drastic central interventions may cure acute troubles, but may only postpone the treatment of chronic problems.

VI. The second reform dilemma:
partial or overall, one-stroke or successive reform

99. A focal point of disputes is the speed and the scope of reform. In each country where reform is under discussion, a large variety of views is expressed, from the very cautious to the middle of the road to the radical.

100. Digressing slightly, I have a few words about experiments. I share the scepticism of those who do not trust laboratory experiments in this area, e.g., the introduction of a new planning and incentive scheme for some selected enterprises, while the rest of the firms work under unchanged conditions. The result cannot be conclusive. If it is a success, it may be because experimental firms received "green light", preferential treatment. If it is a failure, perhaps it was because they were operating in an alien environment. Any suggestion of such laboratory experiments should be treated with suspicion: they will only serve to defer genuine changes.

101. The whole reform process is an experimentation in vivo. No one can be sure of the outcome. Nothing is final as repeated revisions are required. The latecomers are fortunate enough in that they can make use of the positive and negative experiences of the pioneers: the Yugoslav and the Hungarian economies. The cost of experimentation was or is still being paid by the population of these two countries - the lessons are available free of charge for the others. That is a much more reliable source of information than the artificial in vitro experiments.

102. Turning back to the original issue of speed and scope, I would not search for a simple summary answer. I suggest the introduction of classification and the subdivision of the issues into three classes.

1/ See, for example, the papers on Romania and the earlier reports on China.

103. The first problem of the first class is ownership. In the classical Phase 2, several forms of ownership exist side by side; in the reform process, many more appear. The dominant sector in Phase 2 (or at least the dominant sector in the production of non-agricultural goods and services) is the sector of State-owned and centrally-controlled firms. An outstanding component of reform is the increasing contribution of other, non State-owned units to the total output. I am using a collective term with a negative definition (non State-owned) as I wish to put a large variety of forms under this heading:

- (a) activity based on private ownership, which is the main source of family income. For example, private craftsmen, merchants, freelance professionals, private farmers belong to this category. It may or may not be associated with the employment of non-family members;
- (b) activity based on private ownership, but only as a secondary source of family income. The first source remains employment in a State-owned firm, governmental agency or any other form of non-private ownership such as forms (c), (d) and (e) below. Examples of these forms are work on the private household plot which complements collective or cooperative agriculture, repair or construction activity as a second job in in a "do-it-yourself" fashion for self-consumption, freelance professional service as a supplementary activity, etc.;
- (c) activities based on different variants of cooperative ownership;
- (d) activities based on different forms of collective ownership, excluding the central governmental ownership. The owner could be a local community, a non-profit institution (e.g., a university), an association, etc. This category and the classical case of centrally-controlled state ownership are distinguished by the locus of discretionary power: whether it is the center or some lower-level organization which appoints or fires the manager and checks the operation of the economic unit;
- (e) labor-managed firm, as practised in Yugoslavia. (The official Yugoslav terminology prefers to call it "social sector.") It is related to forms (c) and (d), but is not identical with them; and
- (f) combinations of non-private and private ownership. There are many feasible arrangements. An

example is the different tenancy and rental contracts between units based on non-private ownership and an individual or a group of individuals partly using privately owned assets. Nowadays, the vast majority of Chinese agriculture belongs to this category. Such combined forms also can be applied in manufacturing, in the retail trade, in service, etc.

104. In most countries, the contribution to forms (a) - (f) to total output can increase only gradually. The shift may accelerate or decelerate in different periods, but it must certainly be a consecutive process. This is a genuine experimentation in vivo taking place in a wide variety of forms. A historical natural selection is needed: let the viable forms survive and the unviable ones cease. It is better to apply neither artificial support, nor artificial suppression, but let the different forms compete with each other. It will then resolve itself to a point where the social and political limits of a peaceful coexistence are naturally established between public and private ownership.

105. In the second class, the State-owned sector proper, there is one change which can be introduced relatively easily, without too many preconditions. Surprisingly, perhaps, this is the simple abolition of mandatory short-term output targets and input quotas for the firm. There is no need to be overly cautious - the compulsory indicators can be abolished at one stroke. To reassure those who are in favor of maintaining a strong central control, one might point out that the short-term output targets and input quotas are effective but rather crude, instruments for that purpose. The center can get rid of them and still keep tight control by relying on other, usually less crude instruments: fiscal and monetary policy, price and wage control, redistributive measures and formal and informal regulatory interventions.

106. Drastic abolition can be accomplished even in the case of a firm that has not yet become a genuinely market-oriented unit, subject to competition and strong profit incentives and for whom the price and wage structures are still distorted, budget constraints still soft and so on. This is not to say that, under such circumstances, allocation efficiency will improve very much. But once the most unnecessary bureaucratic restrictions are removed, there will be quite significant improvement in firms' initiative and in their adjustment to demand. Their decisions will be based more on consensus and not only on rigid discipline. These are gains without any corresponding real loss. The Yugoslav and Hungarian cases present ample evidence that, after the abolition of short-term central instruction, the economy does not collapse; on the contrary, it will run somewhat more smoothly.

107. The third group of measures centers around a deeper reform of the State-owned sector, deeper than the simple termination of short-term commands. How can an enterprise be transformed into a truly market-oriented economic unit, but at the same time maintain State ownership? This seems to be an extremely complex problem. There is no part of the whole institu-

tional and organizational framework and no aspect of economic policy unaffected by such a deep change. It is unreal to hope for a one-stroke solution.

108. There is, however, a collection of measures which inevitably must be linked together as a "minimum package". Here are a few components of the package. Sections IV (a) - IV (f) have already provided some arguments as to why these measures must be linked together:

- (a) autonomy and full responsibility of the firm;
- (b) hard budget constraint: radical abolition of subsidies, uniform tax rules with only a very few exceptions, appropriate legal procedures for bankruptcy and takeover and strict enforcement of the law in case of persistent deficit;
- (c) deregulation of prices (perhaps a few exceptions can be granted temporarily);
- (d) the determination of correct interest rates and exchange rates;
- (e) import liberalization; domestic and import competitive pressure on the producers;
- (f) significant profit retention in the profitable firm; and
- (g) establishment of appropriate financial institutions for efficient voluntary reallocation of savings accumulated by profitable firms.

109. This is not an exhaustive list; a few more items may be added and some others already included in the package could be reformulated. My list serves more as an illustration of the idea of a "minimum package" than as a concrete proposition. This is all the more so as the compilation of such a package must depend on the specific momentary situation of the country in which the collection of measures will be applied. In each country, very careful selection of what should belong to the "minimum package" and what can be left for later successive steps would be needed.