

ECONOMIC DIRECTIONS

A Publication of Saint Vincent College's Alex G. McKenna Economic Education Series

CENTER FOR ECONOMIC AND POLICY EDUCATION, SAINT VINCENT COLLEGE, LATROBE, PENNSYLVANIA

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(The following is a lecture delivered by Dr. Karen I. Vaughn, Professor of Economics at George Mason University, at Saint Vincent College, Latrobe, Pennsylvania, on February 16, 1994 in the Center for Economics and Policy Education's Alex G. McKenna Economic Education Series.) ▲

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Tonight I am going to talk about some of the reasons for the collapse of communism. As an economist, I will of course concentrate on the economic rather than political reasons. This emphasis is appropriate in any case since the economic

reasons are the more important. I will argue the following points. First, in answer to my question, we have learned one very big and important lesson: central economic planning simply does not work in a big, complex industrial economy. Second, however, I will also argue that few fully appreciate reasons why it doesn't work. This is disturbing not only for intellectual reasons, but for very practical ones. Unless democratic countries know why central planning was such a dismal failure, they are likely to repeat the errors in less spectacular but nevertheless harm-

DID WE LEARN
THE RIGHT
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THE FALL OF
COMMUNISM?

ful ways in dealing with some economic problem or other. Indeed, this is not an idle worry; our own country's industrial policies and health care reform proposals reflect a misunderstanding of what makes markets so reliable in delivering the goods. As a result, we are vulnerable to reinventing central planning by another name.

The dream vs. the reality

For over seventy years, the Soviet Union carried on one of the biggest economic experiments in history: It attempted to substitute the direction of central planners

for the myriad choices of millions of individual economic actors. Marxist ideology held that private property was exploitative and antisocial while public ownership would benefit all people. Soviets believed that markets were inherently unstable and even chaotic; competition was wasteful, and monopolistic power was rampant. "Rationalizing" the system and putting the right people in charge, they believed, would correct all of capitalism's ills such as income inequality, wastes of competition, monopoly exploitation and the production of useless and frivolous products. Moreover, through rational central planning, the Soviet Union would out produce the West and, as Kruschchev once boasted, bury us with their economic abundance.

The outline of the system is well known. Private property in the means of production was abolished and wage labor outlawed. Since individual owners could no longer direct resource use, central planners set production goals and investment levels for state enterprises based on their own perceptions of national priorities. Managers of state enterprises were rewarded to the degree that they fulfilled the planner's goals. Employment was guaranteed to everyone, but salary differentials were suppressed to promote nominal income equality. Furthermore,



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the state took responsibility for education, housing, health care, and all aspects of its citizens' material existence. It also built a formidable military, nurtured the arts, supported world class athletes and on paper, perhaps, seemed to have created the worker's paradise.

With the onset of Glasnost in the 1980s, however, the West came to recognize that the reality was far different from the plan. It became evident that rather than overtaking the West, the communist world was falling farther and farther behind by all measures of economic welfare. The centrally planned economy far from leading to the workers paradise, was leading to economic stagnation and widespread poverty by western standards.

Making things without permission, far from leading to detrimental results, indeed is both a recipe for economic efficiency and a definition of economic freedom!"

Soviet economic performance

The Soviet Union's dismal economic performance staggers the imagination. After an initial period of growth, from the 1970s (and perhaps even from the middle 1950s depending on whose statistics are more convincing), growth in the Soviet Union lagged far behind the west. By 1985, per capita GNP in the Soviet Union was no more than 49% and probably closer to 25% of US GNP.

Not only were living standards measurably far lower in the Soviet Union than had been imagined, but the Soviet citizen also faced great inconveniences in day to day life that can only be imagined in the west -- rationing of consumer goods, ubiquitous queues, crowded living conditions, shoddy goods, and the unavoidable presence of bureaucrats in meeting even the most mundane needs of life. And all this without the promised equality that was once the primary goal of communism. There were innumerable special privileges for Party members and more or less equal poverty for everyone else. By any sensible standard, the great Soviet Experiment has to be declared a failure with no more claim to our attention than as an object lesson in what not to do.

But, it is one thing to agree that the Soviet economy was a disaster and that central planning doesn't work, but it is quite another to understand *why* it didn't work. Why central planning doesn't work is probably the most important lesson we can learn from the Soviet debacle.

Why central planning was a disaster.

While volumes can be written about the reasons for the failure of central planning, in a nutshell, the fundamental cause was this: In the Soviet Union, major economic decisions were disengaged from direct personal responsibility and interest in the outcomes. Many well-known irrationalities of the Soviet system of production were caused by third parties who directed economic activity with little intimate knowledge of the economic processes they were trying to control. Further, since actual production of goods could only take place at the sufferance of the central planners, who were also the sole judges of success or failure, the overriding incentive facing business managers was not so much to produce what would be useful to consumers as it was to look good to the central planners. The production of useful goods and services desired by consumers was only an incidental by-product of this primary activity.

Let's look at some specific difficulties facing economic actors under central planning. Central planners had to set output targets for state enterprises. Yet, even if planners knew what targets to set, it was almost impossible to stipulate in advance every possible dimension of the product desired or to set a policy for every possible contingency faced by firms. The planning board simply could not know enough about the day to day operations of the firm to really plan or control their output. Hence, the directives issued by state planning agencies of necessity had to leave room for discretionary activity on the part of plant managers.

My favorite illustration of consequences of this necessary room for managerial discretion concerns a factory to produce nails. When the production quota for nails was measured in pounds, the factory made a small number of very large and heavy nails. Since that was not what the planners intended, the production quota was then stipulated in terms of units of output. The result was that the firm now produced many, many small and lightweight nails. It is not surprising that the firm chose the easiest way to fulfill the quota rather than trying to produce nails in the proportions that consumers demanded. What perhaps is surprising is that, in either case, it is not clear that the firm was behaving inefficiently. Since consumers were unable to register their demands, there was no way either for planners or



WELCOME — Dr. Karen I. Vaughn, Professor of Economics at George Mason University, (center) was welcomed as the Alex G. McKenna Economic Education Series lecturer by Mrs. Valerie A. Hall (left), Accounts Payable Supervisor at Kennametal Inc., who gave the lecture's introduction, and the Rev. Martin R. Bartel, O.S.B., (right) assistant professor of business administration at Saint Vincent College and a member of the Center for Economic and Policy Education Board of Directors.



STUDENT WELCOME — Welcoming economist Dr. Karen I. Vaughn, (right) to Saint Vincent College were, from left, Ms. Amy L. Jeroski, a junior from West Mifflin, Pennsylvania; Marcus H. Chlystek, a junior from McMurray, Pennsylvania; and Kristen L. Sagath, a junior from Irwin, Pennsylvania. Dr. Vaughn is Professor of Economics at George Mason University.

plant managers to know if producing a few big nails was less efficient than producing a lot of little ones.

The inadequate knowledge of central planners showed up in other ways as well. Planners were too far removed to know much about the details of firm behavior, so they had to rely on the managers of state enterprises to tell them what was possible. But since managers were evaluated according to how well they met production quotas, they would systematically underreport plant capacity to give them the flexibility to earn bonuses for exceeding targets. Indeed, it is well known that rather than being the product of an overall central plan, output targets were the outcome of a bargaining process between planners and managers that went on continuously.

Not only was the information available to planners inadequate, the incentives facing enterprise managers and workers were also perverse. Low worker productivity and high absenteeism was a predictable consequence of guaranteed jobs and inability to reward especially productive workers. Technological backwardness was to be expected in a system where there were few direct personal benefits to successful innovation and real and tangible costs to failure. Finally, even rationing of consumer goods was a policy necessitated by the difficulties in central planning. Even if the planning board could get some balance between production goals and resource supplies, it was impossible to get the mix of consumer goods to reflect what

consumers actually wanted without a price system to tell them how consumers valued one good relative to another. Hence, planners deliberately resorted to rationing (queuing) to allocate consumer goods. The irrationality in this, of course, was that the cost to consumers of time spent on line could not be translated into incentive to produce more.

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by another name."*

Ironically, despite the official hostility to private enterprise, it was well known that the system only worked as long as it did because of the existence of black and gray markets. Black markets in consumer goods helped to supply goods to where they were most in demand. And one of the most interesting gray markets was the existence of the *tolkach* — unofficial traders attached to state enterprises whose major job it was to make informal trades of resource supplies with other firms so that necessary inputs were procured. Much like the Army MASH unit on the popular TV show, each firm had to have its own equivalent of Radar O'Reilly to make sure the inputs matched the needs of the firm to produce output.

As I said, the apparent irrationalities in the Soviet system are all explainable as rational responses to the incentives of central planning in a world where the knowledge required to plan was unavailable. The reason the sum of all these rational actions was so undesirable was that individuals found themselves in a system in which the pursuit of their own goals was not channeled to the service of others. It is as if the Soviets deliberately tried to set Adam Smith on his head.

The Importance of the Price System

If there is an overall lesson in this tragic experience, it is certainly not a new lesson. Indeed, Adam Smith put his finger on it two centuries ago. He explained that in a market economy characterized by private property and contract, the only way people can effectively pursue their own interests is to get the cooperation of others. At least where there are good laws in effect, I can't force you to give me what I want, I have to give you what you want in return. I am encouraged thereby to use my labor and my knowledge to produce things other people want since that is the only way I get from you what I want.

But how do I know what you want well enough to know what to produce for sale? In a complex economy, especially an advanced industrial economy, we do not talk directly to all of our trading partners. Instead, we have indirect indicators of what to produce and how to produce it through market prices. Market prices are the necessary links that inform people of the net consequences of other people's trades

and helps them to calculate the value of their own activities.

Most of us have some understanding of how prices help us to calculate the relative values of goods. We also understand how prices help us to calculate profit and loss and hence give an indication if the wants of others are being served efficiently. Without a price system, a complex economy is impossible, as the Austrian economist Ludwig von Mises argued more than seventy years ago when he criticized central planning even before it got going. What Mises also argued and what needs to be emphasized, however, is that the price system only works because decisions about what to produce and how to produce it are made by property owners who have a direct personal stake in the outcome and who have the best reason to know what to do in the first place.

Knowledge and Incentives in markets

Market prices are only the tip of the iceberg in explaining market economies -- they are the visible manifestation of the many, many activities that lead to efficient use of resources and to economic growth and development in markets. Where people are free to own and dispose of their property, these activities are motivated by personal gain, but they are fueled by a division of knowledge in society that cannot be duplicated by central planners.

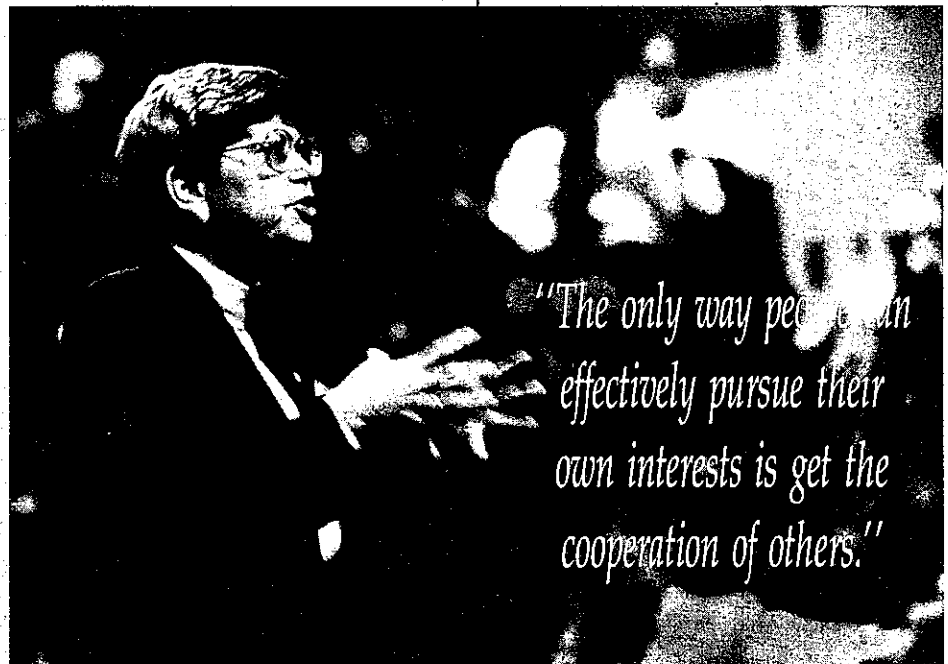
Markets help to link people together who are all different from each other in a variety of ways. Not only do people have different tastes, as economists are fond of saying, they also have different skills, talents, knowledge, expectations and judgment. Each person, in some respects, engages in insider trading by benefitting from some knowledge unavailable to others. It is because people have different kinds of knowledge that there are gains from trade. Another Austrian economist, Friedrich Hayek, helped us to understand the role of knowledge in market economies when he pointed out that the knowledge that aids our economic decision making is often a special kind. Planners focus on the kind of knowledge that can be summarized in statistics; market actors, on the other hand rely on qualitative knowledge of local circumstances -- Hayek called it knowledge of time and place. Where can I locate what I need? Which input is most suitable for my particular business? Who is the most reliable supplier? Which employee is most likely to show up on time and get the job done? One kind of important knowledge may only be the ability to solve problems well; to draw on knowledge you don't know you have until you need it. Certainly, the knowledge that people employ in their market dealings is so detailed and specific to a particular situation that it cannot be

easily communicated to a bureaucracy let alone aggregated into a central plan.

Not only is central planning unable to use all of the existing relevant knowledge in society, it also discourages the production of new knowledge. As Hayek also told us thirty years ago, markets are not simply allocational devices to produce goods to satisfy wants with known resources using available technologies; markets are really at base experimental processes for discovering new wants, resources and technologies. Markets function because people who have a stake in the outcome compete with each other, and competition, in all realms as well as in markets, is a "discovery procedure." The only way a firm manager knows if his costs are minimized, for example, is if a competitor shows him how to produce more cheaply. The way technologies are changed is if

ticism, let me cite two examples from two very different situations. The first is some of the Russian debates over transition to market economy. The second is our own trend toward increasing government regulation of business, and in particular, some of the plans for health care reform currently under debate in this country.

First, consider the Russian difficulties with transition. While most Russian policy makers realize that there is no going back to central planning and that there is no way to avoid increasing the scope for markets in their country, the rhetoric of the debates in the Russian parliament demonstrate that there is little widespread understanding of what markets really are and how they are best established. Two examples come to mind. First is the difficulty Russia has been having in actually developing a law of property and contract.



someone takes a chance and shows others that a larger profit can be made from the innovation. Without the competition of market economies, there is no ability to evaluate the economic efficiency of new skills or techniques, nor is there an incentive to do so.

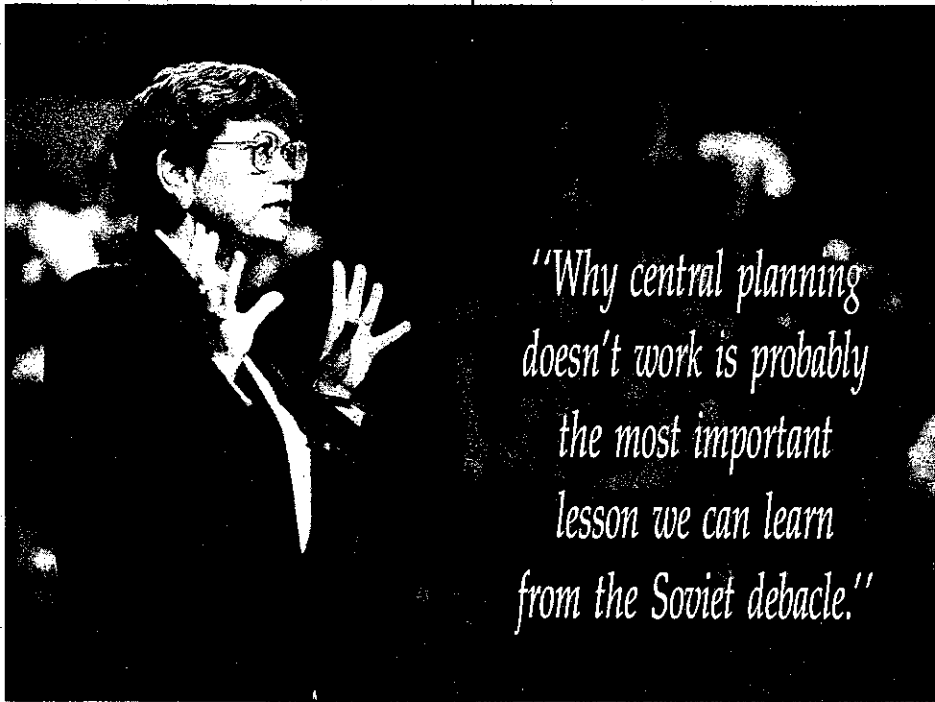
Knowledge and incentives. In a nutshell, these two problems summarize both the weaknesses of central planning and the strength of market economies.

Have the lessons been learned?

I began this talk by suggesting that while the big lesson about the impossibility of central planning seems to have been more or less understood, I had my doubts that the many small lessons about why central planning is a failure have been articulated and absorbed. As evidence for my skep-

Despite the talk about the need for establishing property rights, the Russian parliament can't seem to bring itself to support them unconditionally. Yet property is the fundamental condition for markets to function. Also, Russia, despite the efforts of her most radical reformers, also is reluctant to give up control of prices. Yet, we have seen that for an economy to flourish it is absolutely necessary that people have the right to trade their property with one another at terms that are mutually agreed upon.

I suspect that part of the problem the Russians seem to be having with passing suitable laws of property and contract to bring about the transition to markets is that the wrong metaphor for a market economy is guiding them. The Russian debates keep referring to instituting the market "mechanism." Hence reform



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debate has revolved around which part of the market mechanism to put into place first. Since everything cannot be done at once, what priorities should be followed in reform? Should monetary stability come first? A central banking system? A balanced budget? Should prices be allowed to fluctuate before or after businesses are privatized and by how much? And how far should the market mechanism be permitted to operate without interference. Surely, it should be possible to construct the market mechanism in such a sequence as to minimize the disruption during the transition. Yet, nowhere, and especially in Russia, has the transition been smooth. Indeed, the economic hardships and disruptions are leading to a backlash. And, increasing reports of organized crime seem to suggest in part that government is failing to provide even the minimum necessary conditions for markets to function.

The fact is, a market economy is not a "mechanism" that can be constructed piece by piece according to a preconceived plan. Hayek called a market economy an "order" -- an orderly way in which people go about pursuing their own projects and plans peacefully with one another. Markets are simply what happens when people are free to use their property and trade with each other as they see fit. Mechanisms are the product of engineering and central planning is an exercise in attempted social engineering. But, markets are not constructed by some omniscient engineer, they evolve without an overall conscious plan, but through the many plans of people trying to make a living. Economist Ludwig Lachmann once said the proper analogy for economics was not

engineering so much as gardening. The plants that are the individual manifestations of economic activity grow pretty much according to their own internal logic. Instead of thinking of themselves as engineering a market mechanism, the Soviet parliament would do better to think of themselves as providing the fertile legal soil in which an indigenous market economy can grow.

A similar mistake also flowing from the mechanical analogy and made not only by the Russians but by many in the West who would advise the Russians on the economy, is to think that markets can somehow be installed instantaneously where they didn't exist before, as if the conditions for market activity can be transmitted from one setting to another like moving floppy disks among computers. Yet if we take the gardening analogy seriously, we might recognize that markets are not instituted from without, they evolve from within and develop characteristics that are driven as much by the peculiar histories and cultures of the people who grow them as by the needs for efficient economic dealings.

With the increasing globalization of markets, one might expect there to be more and more similarity among market institutions within various cultures. Monetary institutions like banking, credit and international financial instruments are likely to be very similar in countries that trade with each other. Production techniques are likely not to vary much among trading partners as well. However, for newly emerging market economies, of which Russia would be one, there will be many market institutions that must arise

from the indigenous population. Our understanding of the kinds of knowledge that market economies discover and utilize helps us to see that success does not simply depend on borrowing the technology of how to build an automobile, or set up an account book, for example. That technology is relatively easily transferable. What is perhaps more important and not so easy to transfer from one culture to another is knowledge about how to make deals, how to enter into contracts, how to stipulate the terms, how to set up distributional links -- how to get goods from point A to point B -- and how to deal with unexpected problems. What also must be learned directly rather than imported is the skills of calculation itself; how to count costs and make the appropriate trade-offs that spell profit rather than loss.

Such knowledge and skills necessary to function in markets, make decisions and evaluate alternatives will not develop without the minimum rules of social order, -- the very laws of property and contract that Russia is having such a difficult time developing.

Lessons for western economies

While the former Soviet Union struggles to inch its way toward a market economy -- stumbling much but hopefully learning as it goes, it seems like much of the West is bent on galloping toward its own variant of central planning, and learning nothing from the Soviet experience. While there is not time to go into detail here -- indeed, it could take several talks of this length to make the case -- let me just suggest that our current debate over health care reform in this country argues strongly that our political leaders do not have a clue about what went wrong with central planning.

It is generally acknowledged that much of the current problem with health care cost escalation stems from the widespread use of third party payments that provide no incentive to individuals to make cost effective decisions about the kind of health care they purchase. Additionally, physicians complain about the increasing in-

About the Series

The Alex G. McKenna Economic Education Series is presented by the Center for Economic and Policy Education at Saint Vincent College. These periodic lectures are open to the general public and their purpose is to explore the role of free markets in solving many of the social problems confronting the United States and the world today. Dr. Gary M. Quinlivan, professor of economics at Saint Vincent, directs the series.

The Alex G. McKenna Economic Education Series is made possible by a grant from the Philip M. McKenna Foundation Inc. of Latrobe, Pennsylvania. ▲

trusiveness of insurance companies and Medicare in monitoring physicians' decisions about what kind of health care to provide. Hospital stays for patients are often subject to prescribed limits regardless of the needs of individual cases, choices of prescription medicines are regulated, medical procedures are second guessed and administrative costs mount. All are classic manifestations of the problems associated with divorcing decisions from accountability, of interposing a third party in between the two parties participating in a trade. Yet instead of recognizing that we already have many of the classic problems of bureaucracy and planning from afar in our current health care system, and instead of trying to find genuine market remedies to our perceived problems with health care, we see our president espousing a reform that involves price controls, more bureaucracy, more government involvement and even more remote decisions made by people with the wrong knowledge and the wrong incentives to judge wisely. The health care industry represents about 13% of the US economy, but attempting to centrally plan 13% of an economy is not likely to be any more successful than planning the whole economy.

Substituting bureaucratic decisions for market decisions will always lead to the same kind of problems the Soviets experienced albeit at different magnitudes. We will experience the same consequences of inefficiencies, lack of innovation, attenuation of work effort, general directives that don't reflect the realities of individual situation, reduce scope of judgment for the producer who is on site. The gains will be fleeting and in the long run not even accomplish the kind of equality in provision that health care reform intends.

Conclusion

A critic of capitalism once disparagingly referred to free markets as "making things without permission." I think that critic was exactly right, but he didn't realize that that is the strength of market economies and not a defect. When people are free to make things without permission of others, they are free to exercise their own ingenuity, use their own judgment and stand or fall on the basis of how close their judgment matches those of other trading partners. Making things without permission implies a personal autonomy on the part of the producer to use his own property, but it also means that success will be measured by how well the producer serves others in the bargain.

Consider for a moment what the alternative is to making things without permission -- asking the permission of someone else. First, it is expensive to have to ask permission both in time and in resource costs -- this cost is often referred to as "red tape." Secondly, whose permission might you ask? It would only make sense to ask permission from someone who knows more than you do or who is a better judge of the consequences of your actions than you are. The recent experience with central planning strongly suggests that such a person simply does not exist. There is no one who is a better judge of economic decisions than the people who are part of a voluntary bargain. No third party, no matter how lofty his title or how much expertise he tries to claim, can have the kind of global understanding of how all the parts of a market system fit together that it would take to make the system work effectively for the public good. This goes for all kinds of economic decisions, whether it be the decision to explore for oil, to locate a new business, to design a product or to provide various kinds of health care.

Making things without permission, far from leading to detrimental results, indeed is both a recipe for economic efficiency and a definition of economic freedom. Both work hand in hand; as the saying goes, you can't have one without the other.

Center Announcements

Saint Vincent College's Center for Economic and Policy Education invites you to attend "Lunch with Dr. Lawrence Mead," Visiting Professor of Public Policy at the Kennedy School of Government, Harvard University, at 12 Noon, Wednesday, May 18, 1994 at the Duquesne Club, Pittsburgh, Pennsylvania. His topic will be "The Politics of Welfare Reform." Requested donation is \$22.50 per person. Reservations are required before May 13 and may be made by contacting the Center at 412-537-4597.

Saint Vincent College's Center for Economic and Policy Education will present the third in its Government and Political Education Lecture Series at 7:30 p.m. Tuesday, April 26, 1994 in the Saint Vincent College Science Center Amphitheatre. The speaker will be Dr. Michael J. Malbin, Professor of Political Science at State University of New York at Albany and Director of the Center for Legislative Studies at SUNY's Rockefeller Institute of Government. His topic will be "Undivided Government? Predictions on Clinton's Relations with Congress." Admission is free; no reservations are required.

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