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Some Properties of the Eastern European Growth Pattern

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Summary. – Sections 2 and 3 of this paper treat the extensive growth period of Eastern socialist economies, in which reserve labour is still ample. It discusses five properties of the growth pattern of that period, which are the following: (i) expansion-drive and insatiable investment-hunger; (ii) rapid increase of employment, up to the total absorption of labour reserves; (iii) disharmonic sectoral proportions; (iv) foreign trade subject to expansion-drive; and, finally (v) chronic shortage.

Section 4 of this paper discusses the intensive period in which the growth rate slows down considerably in comparison with the earlier rate.

1. INTRODUCTION

My aim in this paper is to give a descriptive and positive analysis of Eastern European growth: what has happened there and what is going on right now. I do not discuss the question of what ought to be done in the future. It is not my aim to arrive in this article at a normative, prescriptive theory.

My way of thinking is based on observation of historical facts, but it contains some generalizations as well, and it will be on a fairly abstract level. So all I try to present is the general growth pattern in Eastern Europe, disregarding differences among the Eastern European countries. Since I have limited space, there will only be a few ideas in a nutshell.[1]

I will divide the history of the systems into two periods. One is called, in the terminology of Eastern Europe, the *extensive period*. I call it also the *'rush'* period. The other one is usually called the *intensive period* and an alternative name could be the *'slow-down'* after the 'rush' period.

The 'rush' period will be discussed in the Section 2 of this paper, and the 'slow-down' period will be treated briefly at the end.

I will focus on the smaller of the Eastern European countries,[2] so I exclude from this brief discussion the growth pattern of the Soviet Union, which is similar but has some special characteristics as well. For the smaller Eastern European countries the extensive period started in the second half of the 1940s and ended in about the mid-1970s. So it is an era of about 25 years, long enough to be called a historical period. It was characterized by a fairly high growth rate, about 5–8% per annum. It was not perfectly steady, but almost, and there were no long recessions or stagnations during these 25 years. Without aiming at completeness I will single out *five characteristic properties* of this period.

2. FIVE PROPERTIES OF THE PERIOD

(a) *Expansion-drive and investment-hunger*

We have to start our analysis with investment. To explain the determination of investment it must be mentioned that an overwhelming part of output is produced by socialized organizations. The larger part of these organizations are state-owned enterprises. We have also large co-operatives and finally there are different non-profit institutions, such as universities, hospitals and so on. The nationalized enterprises, the co-operatives and the non-profit institutions will be called collectively the public sector. Compared with the public sector, the private sector is only minor.[3] It produces only a small fraction of total output: about 5%, varying among the countries.

One of the most important characteristics of public organizations is a *persistent expansion-drive*. There is a permanent desire to grow. Strongly linked to that we have an *insatiable* *investment-hunger*. It is really like hunger; you satisfy yourself for a couple of hours and then hunger returns. There are different motivations for this expansion-drive and investment-hunger.

The first motivation, a very simple one, is self-identification with the organization. People in charge of an organization feel that it is important and, since the services of this organization are needed, it should grow. This applies not only to firms, but to non-profit institutions and co-operatives as well.

The second motivation is prestige. A larger organization brings more prestige, and also more power. Perhaps in some organizations and institutions there are financial advantages attached to the size: growing brings a greater bonus or salary, but, let me emphasize, this is not extremely important. One can find expansion-drive and investment-hunger with managers who do not have the slightest financial interest in growth; nevertheless they are very eager to grow. This eagerness to grow is not system-specific. It occurs in every social system, and therefore, it does not need too much explanation. Where explanation is necessary is the following question: is there any self-restraint which will moderate, or put some constraint on the expansion-drive? In a private enterprise such moderating considerations are: fear of losses and of failure, caution and, together with them, risk-aversion. In other words, investment is a risky undertaking and failure can lead to bankruptcy, or to the dissolution of the firm. The uncertainty of expectations puts a restraint on the expansion-drive. What distinguishes the Eastern European system from the behaviour of private entrepreneurs concerning investment is that this self-restraint is missing. The 'animal spirits' never relax; they are permanently there. There is not the slightest fear for losses, there is practically no financial failure, no bankruptcy, and a paternalistic state bails out almost automatically all firms which get into trouble. There are different ways to do that: subsidies, soft credits, postponement of repayments, tax-exemptions and so on. This paternalistic relationship between state and firm, or state and non-profit institution is the main explanation of insatiable investment-hunger; there is no need for fear, no need for self-restraint because, if you get into trouble, you will be helped out. Under such circumstances the investor is not cost-responsive, and not price-responsive, either on the input side, or on the output side. He is convinced that expansion can go on at any cost.

This is the most important point to understand. Government policy can only add to it or substract from it. If the government tries to push economic progress very actively, it can intensify the expansion-drive. But even if the government decides to be more moderate by putting some restraint on expansion-drive, there will be a tremendous pressure from below on the government. All firms, all directors, even all ministers will be pushing the government to allow more and more investment.

There are constraints, of course, but they are not self-restraints of the entrepreneur. The first and most important constraint is a simple one: the physical limitation of resources. Of course, the capacity of the economy is finite and one cannot go up to infinite investment. Physical bottlenecks restrain investment activities. Second, there are political tolerance limits. If investment goes too far, it is at the price of the standards of living and, if people are very much dissatisfied, they have several ways to voice their discontent and protests. This puts some limits on excessive investment. Third, investment is usually connected with heavy importing and there are limits to foreign debts (we will come back to the issue of foreign trade later).

To sum up: there are physical bottlenecks, tolerance limits of living standards, and tolerance limits on foreign debts. But up to these ceilings, expansion-drive will go on as far as possible.[4]

Let me stop here for a minute and draw your attention to the following. I have not raised a *policy* issue, I have not asked the question whether it is good or bad for an economy to have such an expansion-drive. It is simply an empirical observation that such investment-hunger does exist. It is an immanent *behavioural regularity* of the system at all levels of policy-making, from the top to the bottom; from the central planners to the managers in the firm. Even if the policy-makers strive to be more moderate, the behavioural regularity of the system will generate expansion-drive.

(b) *Rapid increase of employment*

The second property of the Eastern European growth pattern is related to employment. Let us begin with the choice of techniques. We start again with an empirical observation: the choice of techniques is not usually based on cost-calculations. This follows from what was mentioned earlier: the investor is not really cost-responsive. In his choice he does not consider marginal rates of substitution, transformation curves, or the optimal combination of different factors. Instead, two mutually contradictory tendencies prevail.

One is the appeal of the most up-to-date technology, most strongly felt by the engineer. He prefers modern to obsolete techniques. So, if the choice depends on him, he will always order the most up-to-date technology. A great number of policy-makers and planners share this preference for modern technology.

There is an opposing tendency: all policy-makers and managers are permanently aware of the scarcity of capital. They learn about it not from prices or interest rates, but from quantity signals. In all bargaining processes, when they claim investment resources from the higher authorities, it is quite clear to them that investment funds are scarce. At the same time, in the extensive period they have easy access to labour. Therefore, they are pushed by the one-sided quantity signals to look for capital-saving and labour-intensive technologies.

Since these are two mutually contradictory effects, as a final outcome we get a blend of techniques: some very modern plants surrounded by a great number of other plants equipped with non-modern, intermediate or obsolete techniques. One can find such mixtures even within the same enterprise: one shop is modern, others are obsolete. The final blend will be a kind of intermediate technology.

Now let us consider what we have understood so far. We have expansion-drive and a high investment rate. We have an intermediate, not very capital-saving, rather labour-intensive choice of techniques. In addition, we have a low scrapping rate, due also to expansion-drive: if you strive for large quantity, you simply do not want to throw out machinery which can still be used. This leads necessarily to a *high growth rate of employment*. This is the second property of the Eastern European growth pattern: rapid growth of employment which goes up to the stage where full employment is achieved.

There will be differences as to which Eastern European country arrives at full employment at which point of historical time. In some countries it will go faster and in some others slower. But it is not only full employment in the Western European sense, that is, elimination of open unemployment. It absorbs any kind of latent underemployment. The secular growth of the activity rate is a more characteristic measure of the process than are customary unemployment data. Not only people who are already on the labour market will be absorbed, but people who are not there as yet will be drawn into the productive activities by offers of employment. The very rapid expansion of the public sector creates labour demand. Labour demand creates labour supply in these countries. So what we finally get are very high activity rates; significantly higher than in most of the Western European countries, to say nothing of the developing countries. Small farmers, peasants and housewives are absorbed by the ever increasing public sector. This leads to very deep social changes. It is a long and irreversible historical process that attracts people into the operation of the formal sector. They are drawn out of the informal sector, or out of the activities they did before.

The final result is a situation which is characterized by *chronic labour shortage*. The end of the extensive period has arrived, when instead of having latent unemployment, we get chronic labour shortage.

Full employment is a great historical success, one of the most important achievements of this growth pattern. One cannot say that this is simply the result of a wise employment policy. It is rooted much deeper. It is the consequence of the behavioural regularities of the system. If you have expansion-drive, investment-hunger, and quantity signals reporting the scarcity of capital and the abundance of labour, and if you have the usual European type of demographic circumstances, that is, no demographic explosion but a very slow increase or even a stationary demographic situation, you must get, as a consequence, the absorption of the labour reserves.

(c) *Disharmonious sectoral proportions*

The sectoral proportions of the economy show a large variance over countries. We must be aware that in all sectors we have expansion-drive and investment-hunger. But not all sectors carry the same weight when they approach the superior authorities. Some have more prestige, or have more powerful ways of expression. Of course, the centre may also have preferences.

Let me mention three typical priorities, which we can observe in Eastern Europe. The first is the priority of manufacturing over agriculture. The second one is the priority of the production of goods over services. The last is the priority of the production of tradeables over non-tradeables. These priorities are to a certain extent overlapping.

The different central priorities, and the pressure exerted on the central planners by the different sectors are conflicting. This leads to a *disharmonious sectoral structure*, which I regard as the third characteristic property of the Eastern European growth pattern.

Beside favourite sectors you find neglected sectors. There is always a backlog of postponed targets. These targets are usually urgent now, or even overdue, but they are postponed because you must give the resources to the preferred sectors.

Of course, the degree of disharmony will depend on the wisdom of the planners. According to my experience, one should regard planners as ordinary human beings and not as any kind of rational supermen who are past all ordinary features. They are subject to pressures, that is, to something called 'lobbying' in Western terminology. We have a chemical lobby, we have energy lobbies, we have agriculture lobbies; some are more convincing than others. The decision of the planners will depend not simply on careful calculations but also on this lobbying, and on the relative power of the different sectors as well.

There is another human property of planners which must be taken into consideration. This one has an important explanatory power if you look at the neglected sectors. If the general success indicator is growth, a planner will be inclined to favour sectors in which the contribution to growth is more direct. This leads to valuation problems, problems of pricing and subsidizing. The neglected sectors are usually the subsidized sectors with underpriced outputs. So, investment in an underpriced sector gives the impression that it is less efficient than investment in an overpriced sector. Therefore, there is a permanent temptation to give priority to sectors which are overpriced.[5]

There is also a conditioned reflex of planners in making allocative decisions. You can call it 'to put out the fire'; to put investment into places where you have got into trouble. This leads to a kind of vicious circle: at first you postpone because you need the resources in other places, then this postponement leads to a 'fire', that is a minor catastrophe; then you put the resources there, but in doing so, you will have fire soon at the next place. It is like a man permanently in debt, and asking for new credits all the time to pay his debts. A country has not only monetary debts, but also 'debts' to the population: targets overdue because you did not have the resources; you have waited till a catastrophe has appeared, then you put the resources there, postponing again something else.

Of course, planners try to be more balanced and harmonious in their planning, but there are strong forces which distort a balanced allocation again and again.

(d) *Foreign trade subject to expansion-drive*

The fourth characteristic feature is related to foreign trade. The countries in Eastern Europe are all small, open economies. Foreign trade is not based on profitability or efficiency calculations. The really important consideration is this: foreign trade is mainly a vehicle of expansion-drive.

On the import side, the Eastern European countries like to import highly developed technology because that is one way of accelerating growth. If needed, they import also energy, raw materials and food. One may observe very high import elasticities strongly coupled to the fast expansion of the system.

The role of the export side is simply to cover the costs of the imports. It is usually accompanied by rather large trade deficits financed by significant amounts of credits up to the ceilings which have already been mentioned. There are tolerance limits of indebtedness, both on the side of the creditors and of the debtors.

As expansion goes on, efficiency of foreign trade is not increasing, it may be even decreasing. It is not really based on considering comparative advantages. The dominant criterion is: how far can we go in supporting expansion through foreign trade; as long as it helps, we shall go on doing it. So, the fourth property is: *foreign trade subjected to expansion-drive*.

(e) *Chronic shortage*

All these processes are accompanied by *chronic shortages*. This is the fifth property of the Eastern European growth pattern. There are shortages in consumer goods and in many producer goods like energy, materials and semi-finished goods. Chronic shortage does not mean that you are always short of everything at every moment. It is a stochastic phenomenon: today you are short of this, tomorrow you are short of other things; at one place you are short of that and at another place you are short of something else.

To explain shortage, one has to explain the demand-side and not the supply-side. Household demand is finite in our system, because wages and salaries put a constraint on household demand. The demand of public administration is also subjected to fiscal constraints. What runs out of control all the time, is the firms' demand: both for current inputs and for investment resources. This part of total demand is almost unlimited.

If someone looks at the Eastern European system from the outside, he may get the impression that everything is accounted in money, that firms have regular financial balance sheets, that they have to report their incomes and their expenditures. So it seems that firms have budget constraints. But this is a kind of illusion; in practice money is passive in the public sector. Money supply to this sector is always adjusted to demand generated by the physical activities of the firm. Every firm is quite aware that the most important thing is to *start* the investment project. Once the project is started it will be finished. If the project exceeds the original budget by, for instance, 50%, it will still be finished. In the end, the state will pay the bill. So the firm does not really have a budget constraint. This phenomenon can be called a 'soft' budget constraint.

The 'soft' budget constraint will set into motion something that can be called the 'suction process'; the firms draw resources out of the economy as much as possible. So you may restrict consumers by restricting their money incomes, but as long as you do not restrict the firms, you will permanently reproduce the general shortage situation. Foreign trade adds to this situation: what cannot be pumped out directly by the public firm can be pumped out for the purpose of exports, which will lead to further shortage phenomena. There is a strong interaction between expansion-drive and shortages. Expansion-drive strengthens shortage and shortage strengthens expansion-drive. If we have shortages, buyers urge the seller to give them more. This leads to the expansion of production up to the physical bottlenecks. This is always a good reason for asking for investment resources. There is no pessimism in expectations concerning future sales; we have a sellers' market. This is one side of a vicious circle, when shortage amplifies expansion-drive. The other side is the pumping out of resources by expansion-drive, and thereby amplifying shortages. So these are two mutually interacting and reinforcing phenomena.

3. SOME GENERAL REMARKS

There is a philosophy underlying the present description. *Growth patterns are basically determined by the behavioural regularities of the participants.* It depends on the institutional framework, the ownership and power structure, and the political and social organization. What we call policy in the narrow sense can lead to some variations. It can weaken or intensify some tendencies. But it does not play a dominant role. There is a certain degree of freedom, but not very much. *The basic growth pattern will be determined by the 'nature' of the system, and not by the policy of the governments.*

This philosophy can be applied, of course, to other systems as well. When talking about Western Europe we could say that unemployment and inflation are caused by the 'nature' of the system and not by government policy. Government policy can explain why the inflation rate is 6% here and 15% there, or why the unemployment rate is 4% here and 9% there, but the fact that inflation and unemployment exist has a deeper reason in the nature of the system.

A second general remark will be also in order. You cannot single out some 'nice' properties of a system, avoiding other properties that you do not like. The 'nature' of the system leads to fast growth in the extensive period. It also leads to full employment, even to labour shortage. This goes together with shortages and with some disharmonies. These are *joint* products, belonging to the same system. The main task of economic science is to understand the 'nature' of systems, and not simply to look for policy options. If you understand the 'nature' of systems, then you can think about alternative policies. Policy-makers can do much but only within the framework of the 'nature' of the system.

4. 'SLOW-DOWN' FOLLOWING 'RUSH'

Only a few things can be said about the second, that is, the intensive, period. It is too early to make very wide generalizations, since it is a very recent development. It is certain that Eastern European growth is slowing down. In the last few years the 5–8% growth rate went down to about 2–3%. It is not simply the downward phase of a cyclical movement around an unchanged trend, but it seems that the trend is decelerating. There are several views on this. I will consider three main explanatory factors for the 'slow-down'.

One factor is that latent unemployment is absorbed. We entered a period of labour shortage. This is a dramatic change. Previously we could make investment with fairly labour-intensive, capital-saving techniques, but now labour-saving techniques must be applied. This makes expansion much more expensive. The system is supply-constrained in goods *and* labour, while previously it was only constrained in goods. This is the first and most important explanation of the 'slow-down'.

A second explanation is the phenomenon of postponement mentioned earlier. This cannot go on forever. The neglected sectors must be developed sooner or later. They are usually very capital-intensive, like road transport, housing, the health sector and so on. There are increasing pressures from the population to put in order these neglected areas. They absorb large amounts of capital and they are not very impressive if you look at their contributions to aggregate GDP.

The third problem is the deterioration of the external conditions. Most of the Eastern European countries suffer also from the consequences of the oil shock. Energy prices have risen. Sometimes there have been unfortunate changes in their terms of trade. The recession of the capitalist countries causes difficulties to the exports of the Eastern European countries directed to the capitalist economies.

There are Eastern European economists and policy-makers who blame the deterioration of the external conditions for the deceleration. This is not a sufficient explanation. One canot blame the oil problem for everything. If your country is in trouble, you fist have to look for internal causes. Internal problems can be aggravated by external conditions. But the external conditions are usually not at the root of the trouble.

The analysis of the response to this 'slowdown' is not yet worked out. There has not been enough time for it as yet. There are *first reactions* to the new situation, but you cannot call them deep-rooted *regularities*. There are certain tendencies, however. On the one hand, one may observe a rigid answer: simply continue to apply the old rules to the new situation. However, some old regularities which worked in the extensive period will not necessarily work in the intensive period. But, nevertheless, they are applied. This leads to conflicts and contradictions in society. On the other hand, there is an upsurge of reforms.[6] It is too early to predict which one of these tendencies will prevail. This may also vary from country to country.

It was possible for me to provide a summary description of the extensive period, because there have been 25–30 years for observation. But one cannot give a similar systematic description of the intensive period. One or two decades must elapse before a more systematic analysis of the growth pattern in the intensive period can be elaborated.

NOTES

1. The issues discussed in this paper are too broad, and the space too narrow, to allow specific documentation and references. The problems are explained in detail in two recent works of the author: *Economics of Shortage* (Amsterdam: North-Holland, 1980), and *Growth, Shortage and Efficiency* (Oxford: Blackwells, forthcoming). The former deals primarily with the micro-economic theory of the socialist economy, and the latter presents a macro-dynamic mathematical growth model. The reader may find the necessary references in these two books.

2. The analysis does not cover Yugoslavia, whose economic mechanism essentially differs from that of the other Eastern European socialist countries.

3. In this respect Poland is an exception, for a considerable part of Polish agriculture belongs to the private sector.

4. Expansion-drive hits from time to time the upper limits enumerated, which will then set off cyclical movements. For the investment cycles of socialist countries see the following studies: T. Bauer, 'Investment cycles in planned economies', *Acta Oeconomica*, Vol. 21 (1978), pp. 243–260; A. K. Soós, 'Causes of investment fluctuations', *Eastern European Economics*, Vol. 14, No. 2 (1975–1976), pp. 25–36; M. Lackó, 'Cumulating and easing of tensions', *Acta Oeconomica*, Vol. 24, No. 3–4 (1980); O. Kyn and W. Schrettle (eds), *On the Stability of Contemporary Systems* (Göthingen: Vandenhoeck-Ruprecht, 1979).

5. See Zs. Dániel, 'The reflection of economic growth: experimental computations to revise synthetic value indicators of output', *Acta Oeconomica*, Vol. 15 (1976), pp. 135–155.

6. A number of important and topical ideas concerned with the Hungarian reform are raised by the aricle of R. Nyers and M. Tardos, 'What economic development policy should we adopt', *Acta Oeconomica*, Vol. 22 (1979), pp. 11–31.