Price reform and inflation in Soviet-type economies

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The term price has two meanings, as stressed by Wicksteed. (1933, p. 28). In the ordinary sense, it means the exchange ratio of two commodities on a market, and, in the wider sense, "the terms on which alternatives are offered." It is only prices in the generalized sense that are indispensible for an effective solution of the resource allocation problem (Lange, 1938, p. 60). Such choice indicators can be obtained without a market in the institutional sense. Three sets of data are required for a determinable solution of the resource allocation problem: (1) a preference function which guides choice and which may reflect planners', consumers', or interaction of both, preferences, (2) knowledge of the terms at which the alternatives are offered, and (3) the production function. If the data under 1 and 3 are given, 2 can be determined. There are, of course, other signals than prices for transmitting information about scarcities. Scarcity prices are not necessarily efficient prices and should not always and under all circumstances be used as guides for resource allocation.

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on physical targets and allocations. The economic question is the relative efficiency of such arrangements.

I

In the traditional Soviet-type economy (STE) prices are more or less arbirarily set; they are rigid for prolonged time spans; price formation is divorced from plan construction; prices tend to be inconsistent with other instruments of plan execution; domestic prices are dissociated from world market prices; and producers' prices are insulated from consumers' prices – the dual price system. When the logic of physical planning is carried to an extreme, prices should be neutral and producers insensitive to them. As the system developed, producers' prices became more than merely weights to aggregate heterogenous output and the planner vacillated between circumventing "wrong" prices by a more direct detailed determination of output, and attempting to neutralize sensitive prices or to strengthen their effect by stressing this or that desideratum. Naturally, the planner wants production to be elastic to some prices and inelastic to others and this is a source of many inconsistencies. Executants will make whatever decisions they can on the basis of existing prices (and will try to influence new prices to their own advantage). It is irrational to ask executants to care or know of the opportunity cost to the economy of underpriced or not entirely accounted for inputs – just as it is to appeal to the consumer to be parsimonuous in his consumption of subsidized goods. One of the most expedient measures of reducing the distorting impact of prices is to narrow down the periphery's sphere of decision-making.

In the economist's world of free and unimpeded mechanism of the world market, the forces of competition should equate the country's internal and world market relative price structures. In principle, domestic prices should reflect the proportions and scarcity relations on the world market. In the traditional STEs domestic prices do not correspond to world market price ratios and producers' (industrial wholesale) prices are separated from consumers' (retail) prices. To the extent that production decisions are influenced by official actual prices (as contrasted with shadow or black-market prices and physical allocations and commands) this obfuscates economic calculation and distorts comparative costs and benefits of indirect production. For prices on Western markets, as imperfect as they are, reflect more or less marginal opportunity costs for the country's effective export and import substitution, and tend to stimulate diffusion of world technical progress. The dissociation of domestic prices from those prevailing on Western markets provides certain benefits, including almost complete shielding

from imported cost inflation. But the costs are high in terms of static and dynamic efficiency. Thus, most STE reform blueprints provided for internal prices to be brought into some correspondence with relative prices on Western markets; but, with the notable exception of Yugoslavia, only a limited attempt was made to align domestic with world market prices. The half-measure reforms preserved largely the split between internal and external price patterns. Even in Hungary – where the reform was relatively most advanced – the attempt to establish a realistic concordance between domestic and foreign trade prices was only partly successful.

The STE price system provides an opportunity of insulating changes in some prices from others; of having different prices for one product depending on the sphere of circulation; of using different standards in price formation; and, in general, of manipulating the "budget constraint" on industrial management, income distribution, real purchasing power of household, and the size of the economic surplus to be extracted (capital accumulation). For example, retail prices of consumer goods can be insulated from changes in their factory prices or vice-versa. Production decisions do not have to be justified by the test of realization at market prices, and the producer is not subjected to the "discipline of the market." However, in practice the total insulation has not been carried out. But the application of divergent principles of price formation for producers' and consumers' prices has involved widely differentiated sales taxes and subsidies.

II

The dual price system is characterized not only by a divergent and separately moving price level of producer and consumer goods, with the bulk of surplus collected in the form of vastly differentiated turnover tax in consumers' prices, but also by different principles of price formation (Feiwel, 1965, p. 57–64). The prices of producer goods are, as a rule, computed on the basis of the average attributable branch production costs (with the notorious failure to account adequately for costs of capital employed, rent, depreciation and obsolescence, meagre returns for entrepreneurship and various skills) plus a small "profit" markup on costs to impose a budget constraint, but not to empty the system of incentives. In setting consumers' prices an attempt is made to find the level and relative structure of prices that equates demand with available supply for each commodity ("neoclassical prices"). But prices are strongly conditioned by political and distributional considerations, restricting the use of the pricing mechanism. Thus, in practice, the relative prices of consumer goods frequently seem to be nowhere near their microeconomic equilibria in (partial) markets. With prices

below equilibria, there is excess demand, buyers compete among themselves for the sellers' favors, and black-market profiteers appear. The budget collects a whopping share in the form of turnover tax – the difference between the average production costs plus an insignificant "profit" markup (the factory price) and the price at which the product is sold to the domestic trade organ. Upon sale of the product, the bank automatically extracts from the industrial enterprise the turnover tax which is transferred to the state budget. Thus the firm's revenue is generated ex-turnover tax.

Such a system tends to indicate spurious relative contributions of various sectors, branches, and activities to national production; it distorts distributive shares; it understates the share of resources channelled to capital formation; and it obfuscates efficiency calculus. In fact, the national income accounts understate the share of branches producing producer goods and overstate that of light and food industry branches. Similarly the share of accumulation in national income is understated and that of consumption is overstated. Instead of promoting technical progress, the artificially low prices of producer goods further waste of materials and capital goods.

The dual price system gives rise to considerable subsidies which, for reasons of planning and financial expediency, tend to be concentrated at the early stages of the production process (e.g. mining) and on fewer items in basic industries. But such prices of basic inputs artificially lower production costs (hence prices) at the successive processing stages. One of the principal aims of price revisions has been to reduce subsidies (which, with rigid prices, grew due to wage increases outpacing nonuniform productivity gains in various activities, deteriorating geological conditions, and rising marginal costs). With deficits or low profit rates, current operation of the producer goods branches was subsidized and development was wholly financed by the budget which redistributed funds for capital formation.

The nature of costs, prices, and profit is a cardinal question. If the price is a derivative of costs, its constituents are cost elements which themselves are not independent variables. The cost of a given commodity cannot be said to be price determining since the constituent cost elements are determined by prices. Planners allocate inputs and then set prices. Effective prices cannot be set unless inputs were beforehand allocated efficiently to various uses.

The central planner (c.p.) can determine administratively what constitutes a cost element and assign appropriate values. But to determine at what economic, as distinct from accounting, cost the production of a good is secured one needs to take into account implicit (opportunity) costs. But the state budget carries

some of the costs of inputs and relative price stability is ensured primarily through redistribution of funds and subsidizing of priority activities, with failure to account fully for costs of inputs employed. Thus prices calculated on the basis of average (and sometimes individual) costs do not give proper weight to marginal opportunity costs of all inputs. Even those costs that are explicitly accounted for are based on more or less arbitrary prices of inputs. In many cases the cost basis is considered merely a "point of departure" for price determination. Many deviations from costs are allowed to take into account the relative technical "use values", to enchance or curtail usage in view of relative shortages or surpluses, or to alleviate balance of payments, etc. This raises the question of what the rules really are and to what extent prices are arbitrary.

Backwardness is perpetuated by the practice of setting price of new products on the basis of planned production costs plus a meagre profit markup. These prices remain unchanged for years. The longer the same product is produced at a growing rate, the greater the cost reduction and the higher the profit. Under the traditional system the enterprise is thus vitally interested in continuing production of obsolete, and therefore highly profitable, products for as long as it possibly can, and in not adopting – or delaying the adoption of – new, and therefore less profitable, products. In addition, because factory prices of new goods are determined on the basis of their planned production costs (and in some cases also in accordance with some norms specifying the weight and size of products), even if enterprises adopted new products, they are not interested in subsequently improving their quality and reducing their planned production costs. Their interest dictates exactly the opposite: The adoption of new products with inferior technical parameters and lower quality (because they are easier and faster to produce) and submission of highest possible cost estimates. By its very nature the factory price is designed to cover planned production costs, irrespective of real "use values" of the products, which should be roughly reflected in the retail price. These are some of the determinants of the techincal retardation of certain branches, and of the continuous production of obsolete, ineffective, and expensive producer and consumer goods.

III

The system is never completely protected and sufficiently isolated from changing conditions in a dynamic world. With rigid prices, distortions manifest themselves with increasing intensity and removal of some of them becomes unavoidable. Periodic, one-shot, price revisions are required, *inter alia,* to mitigate the general and cumulative price distortions which initially appeared to be only

faulty particular microeconomic cases. If for no other reasons, fiscal expediency and control require strict limits on the periphery's liquidity (the budget constraint) and elimination of subsidies (or at least their concentration on fewer activities). In turn, financial rearrangements require modified prices. The increased stress on the self-supporting economic unit requires increased markups. But such an enlargement of enterprise liquidity makes it less susceptible to control. Still there is a world of difference between the periodic price revisions, which mainly aim at removing the subventions in the sphere of producer goods production and at bringing producers' prices closer to costs, and the kind of price reform required to support an effective economic reform.

Price reform is a part of an overall economic reform and should be consistent with it. Just as it would be counterproductive to widen the scope of decisions at production levels without scarcity prices; provision of such prices without devolution of at least short-run production decisions would not be enough. A shift away from crude quantiative indices necessarily leads to greater reliance on prices as tools of economic calculation. In this respect the issue of congruence between tools of economic calculation at the center and the periphery assumes growing importance. By fixing or manipulating prices, the c.p. can influence the periphery's decisions. The issue is to make price-setting more consistent with plan construction and with the other instruments of plan execution (such as performance criteria, incentives, etc.), and also to allow for more flexibility to reflect changing environment and desiderata.

This raises the question of alternative methods of generating prices. Scarcity (equilibrium) prices do not necessarily have to be formed on the market in its institutional sense. Such prices may be set up by a Lange-type CPB which performs the function of the market, or by the interaction of electric wires (obtained as the dual solution of a mathematical programming problem (Feiwel, 1972). Not every scarcity price is necessarily an efficient price, for it might not account, for example, for externalities, social costs, market failures, etc., which could be taken into account, however imperfectly, in an optimal plan and in a Lange-type or genuine market by means of taxes, subsidies, etc.

The touchstones of a price reform are: abolition of the dual price system; the extent to which producers' prices reflect scarcity; and the correspondence of domestic prices to the price structure on world markets. But prices which more readily reflect dynamic production conditions cannot be equated with efficiency, nor can the administrative locus of price-fixing be necessarily equated with arbitrariness. The question is not only of the principles underlying periodic price realignments, but of procedures for price mobility. The problem of the traditional

system is not so much initially fallacious prices, but absence of a mechanism of adjustment towards equilibrium.

If prices are to be parameters for the periphery, each actor should be powerless to affect perceptibly the outcome. The c.p. fears that decentralization would strengthen the subunits' opportunities to manipulate prices. The planning process involves bargaining between participants, and the outcome depends on the relative power of the parties and on access to reliable information. Increased horizontal relations can only subject the seller to the "discipline of the market" if the economy is not overheated. The negotiated price depends on the relative power of negotiators. This depends on the state of disequilibrium, industrial structure, reciprocal choice of trading partners, etc. Often contractual parties merely fill out details in assignments predetermined by superiors. This sort of "adaptation to the specific conditions on the spot" is very restrictive, because, rather than satisfying each other, the actors are interested in "satisfying" their superiors.

The Hungarian reformers were fully aware that a sweeping price reform was necessary and the area received priority treatment. The blueprint provided for gradual transformation of centrally set prices into controlled market prices, whose first step was the introduction of the four-tier price construct (1-centrally fixed, 2-maximum, 3-upper and lower limits, and 4-free prices). During implementation the share of goods for which flexible prices were allowed was disappointing, and "free" price-setting was shackled by many restrictions. Under conditions of a seller's market which persisted for many goods, prices reached immediately and remained at the upper limit, so that they were *de facto* indistinguishable from centrally fixed. With the overwhelming bulk of prices in the rigid or nearly rigid category, the movement of free prices was distorting. To maintain many of the fixed prices, a number of activities had to be heavily subsidized and tax reductions were allowed. In fact, during the post-reform period the amount of subsidies rose and tax rates were manipulated for reasons of financial expediency. The dual price system was not abolished and there was little success in linking domestic to world market prices. Consumers' prices continued to be separated from producers' prices by a cumbersome network of highly differentiated (but reduced in number) turnover taxes and subsidies. Much was said about the conflict between price stability and requisites of efficiency. But in practice the system continued to uphold stability. At the outset the state guaranteed maintenance of retail prices of basic necessities and stipulated that the real income of the majority of the population cannot be lowered. The scope for introducing the necessary changes was severely circumscribed.

Thus improvement in relative structure of consumers' prices *"has not come about"*, and in many cases new distortions were introducted (Friss, 1969; Gado, 1972).

In all STEs there is a detectable shift in the interpretation of cost elements, in the methodology of cost determination, and in the techniques of calculation. In practice the methodological innovations tend to be limited. The introduction of the capital charge – whether treated as a cost element or deducted from profit – is far more important than the ideological and doctrinal connotations. In general the charge does not reflect opportunity cost of capital at the margin and discriminatory rates tend to be used. On efficiency grounds, the capital charge (in excess of recovery cost of the investment) should be equal to (uniform) marginal efficiency of investment in all uses throughout the system (Bergson, 1964, pp. 250–74). And to the extent that the charge is underrated, the resulting profit cannot serve as a yardstick for judging comparative efficiency, for extra capital-using producers will show higher profit. Despite inconsistencies and arbitrariness, there is a noticeable attempt to introduce a measure of determinism in the base to which the profit markup is related – a shift from the traditional markup on average costs. There is also an attempt to set more realistic depreciation rates (more allowance for obsolescence) and to revaluate the capital stock. Various rental charges are made in more or less disguised form. One can stress either the new elements and direction of change or the timidity and inconsistency of departures from the old.

In an open system efficiency can be gauged by exposing enterprises to international competition and by measuring profitability in terms of prices that more or less reflect conditions in the world market. The creation of a strong link between domestic and world market prices has a long literature in STEs (Pryor, 1963, p. 24). World market prices were allowed to penetrate domestic price structure at varied rates in different countries, and substantial differences could be observed (Pryor, 1973). Despite the increasing "consideration" of world market prices in the process of price determination and revision, there is considerable inconsistency in linking domestic to foreign trade prices. The 1965 reform and subsequent measures in Yugoslavia had a greater impact on the domestic set of prices than in any other East European country. Domestic prices of goods that were (potentially) subject to foreign trade were administratively fixed on the basis of foreign exchange prices, converted at a uniform and reasonably realistic exchange rate. This resulted in a significant change in the relative price structure (Bajt, 1967).

Despite some progress, the Hungarian reformers did not succeed in their

limited attempt at establishing a realistic congruence between domestic and foreign trade prices (Gado, 1972, Csikos-Nagy, 1973).

In STEs prices of producer goods perform very limited allocative functions and the bulk of allocations is centrally made. Reforms attempted to strengthen the allocative (informational) function of prices, but their success was limited. Broadly speaking the reforms attempted to modify direct centralism (traditional STE) into indirect centralism, but not into market socialism (Lange-type). Consistency requires that a reform either provide effective prices or the system will swing back to direct centralism. To the extent that producers' price are below clearing levels, excess demand pressures will be exerted and physical allocation will necessarily remain and flourish. The dissipation of resources will be prevented by direct allocation to priority uses. Depending on the pay-off, the producer may seek to avoid production of underpriced scarce products and binding assignments *in natura* will proliferate. Thus partial decentralization, without appropriate price reform leads to creeping and cumulative recentralization.

On welfare grounds a system where consumers can spend their income freely is preferable to one without freedom of consumers' choice. Production should be guided by consumer demand (as revealed in demand prices), which in a modified version would mean that production be sensitive to consumer sovereignty, while key decisions on the structure of consumption are made at the center. Even the milder version is largely missed in direct centralism. Despite the exhortations to bring production more in line with consumer demand and some progress, the consumer still has little influence on what is produced. There are serious obstacles in adapting production to demand even in spheres that do not encroach on the c.p.'s prerogatives. To be sure, the c.p. is not always interested in overruling consumers' preferences, if for no other reason than that should the same "value" of consumption be produced with smaller resources, the savings could be used to advance his own objectives. Essentially the system still lacks any specific set of rules that would make production more responsive to market conditions. Such a mechanism should not only ensure that changes in demand *invariably* lead to changes in production, but also that the producer be interested in aggressive innovation and that he should influence demand by providing the market with better products. In order for the market to influence the pattern of production, producers' prices should be brought into proportion with consumers' prices. The turnover tax should become a uniform rate on retail prices, so that producers' price ratios approximate consumers' price ratios, and tax collection is shifted closer to final sale. Here also there are serious practical

difficulties. Even where more daring reforms were introduced (e.g., Hungary) traditional turnover tax continued to prevail partly due to the restricted scope of alterations allowed in the level and pattern of consumers' price.

The managers (as sellers) prefer a state of seller's market, for a hungry buyer is less choosy and troublesome. Shortages force the consumers to find a solution and adapt himself to the system. As supply of consumer goods increases quantitatively, the buyer becomes more choosy. Overstocking forces the planner to use "downward price flexibility" as a device to get rid of unwanted goods. But upward price adjustments to choke off excess demand for some goods are unpopular. Interestingly, the Hungarian experience showed that the process of learning to adapt to the signals of the market was inordinately protracted and drastic price changes, rather than marginal variations, were required to elicit the desired response. Since such large price changes are often prohibitive, the workability and elasticity of the mechanism tends to be overrated by market-oriented economists (Kornai, 1971 passim; cf. Portes, 1970, p. 312).

In a larger perspective, the workability of the market in STEs has to be viewed under conditions of an overheated economy. The market works best under conditions of slack. The market method is not only ineffective when massive redirection of resources is required (as in a war economy), but it is also not forceful enough under conditions of strain, and to accomplish large-scale unusual adjustments, without undue time-lags and costs of waiting. Assume, for example, that serious shortages of rolled steel have arisen. What could be expected from an increase in prices? The prices of capital goods and of some consumers' durables (e.g. automobiles) would have to be increased. If investment funds are not increased, the higher prices of capital goods would reduce the physical volume of investment, but it would not be easy to predict to what extent such a reduction in investment would influence the curtailment of demand for rolled steel. The situation would be similar in consumer durables. Price increases would reduce demand, but again it would be difficult to predict to what extent and after what lapse of time. In order to equilibrate demand with the reduced supply of rolled steel, prices would have to be raised so that the reduction of demand from these two sources would be sufficient. This can only be achieved by trial and error. Moreover, should there be no considerable reduction in demand of the producer whose output is particularly "steel-intensive" (e.g., railroad cars or automobiles), the general reduction of investment and consumption would have to be very high. Such equilibrium would only be achieved with a time-lag during which the use of steel would exceed supply, and stocks would be depleted. It has been suggested that a much simpler and more expedient proce-

dure would be to limit investment, taking into account general priorities and "steel-intensity", and also to restrict production of durables. In case of the latter, prices would also be increased to the level where demand is more or less equilibrated with supply. As a result the distribution of steel among the various branches would be reduced and the production plans would be modified. Even with this method an increase in prices of rolled steel would be indicated if the shortages were of a recurring nature (Kalecki, 1964, pp. 17–19).

IV

If the ultimate aim of economic activity were to outlaw inflation (as recorded in conventional statistics), the inflation-prone Western economy should institute tight price-wage controls, isolate domestic from world market prices, and impose comprehensive foreign trade and exchange controls. But the rise in the overall price level is hardly a measure of aggregate economic loss, nor is a stable price level a measure of aggregate economic gain.

In STEs inflationary forces are generated by the industrialization rush and affected by working arrangements. Accelerated industrialization drives are usually associated with growing disparity between a rapidly expanding wage fund and sluggish supply of consumer goods. While investment leads to enhanced purchasing power, it also means cuts in the production of consumer goods. The latter can be procured by imports, but increased investment strains the balance of payments by generating greater requirements for imports of producer goods. In the end, not only industrial consumer goods cannot be imported, but imports of raw materials for consumers goods production are also constrained, while some consumer goods are being exported to pay for the imports.

Usually an increase in the rate of investment is accompanied by a growth of employment in the investment (investment-supporting activity) sector. Even without a change in wage rates this would produce a rise in the total wage fund in this sector. The average wage rate in this sector is usually above that in the economy as a whole, so that even without a rise of overall wage rates, the reallocation of labor from lower to higher than average wage sectors boosts the wage fund. Intensified industrialization is usually supported by material inducements to speed up the process of transformation and by using the allocative function of wages (premiums) to lure labor to priority activities. An overheated economy, with interruptions of inter-enterprise flows, poor quality of material inputs, and unreliable industrial services, is conducive to waste of labor and overtime. To attract and keep skilled labor various semi-legal monetary inducements are offered.

The tendency to increase employment is not sufficiently counteracted by command and monetary restrictions on the enterprise liquidity. During the course of plan implementation the workers benefit from "excessive" purchasing power, as compared to the diminished production of consumer goods. Pressures to exceed the wage fund are created both in the producer and consumer goods sectors and are intensified by the investment drive. The latter increasingly absorbs resources originally destined for current consumption, resulting in underfulfilment of the plan for consumer goods, and a deficiency of materials and equipment (domestic or imported) for the consumer goods branches. The real test comes not only at the blueprint stage, but when the leaders are confronted with the dilemma of sacrificing part of the resources designated for growth-promoting activities (threats of inroads into the capital formation plans).

In an attempt to mitigate the inflationary pressures that arise as a result of overheating in the economy, the c.p. endeavors to contain the rise in wages and employment. However, in this he is severly constrained by his own mechanism of plan construction and implementation that not only does not oppose households pressures to raise their living standards by means of increasing the number of gainfully employed, but also provides its own pressures for expanding employment, giving rise to the phenomenon of disguised unemployment in industry (Feiwel, 1974).

Despite the important role played by controls of income flows, the c.p. has great difficulties in restraining growth of the wage fund; the ex-post wage fund usually exceeds ex-ante. The spending power is also increased by the private income of peasants and the "private sector" in general – a good part of which is uncontrollable. The illegal or unreported income appears to be of considerable importance, although its size is difficult to ascertain. Such income is also derived from various system-induced economic crimes of more or less serious nature and a widespread network of graft payments.

Economic crimes flourish particularly during periods of intense industrialization. (1) Because the basic task is production plan fulfilment, the problems of costs and quality are of secondary importance; hence, control in these areas is usually neglected. Furthermore, owing to the presence of a seller's market, the buyers are not overly demanding, consequently any misuse of materials that lowers output quality is not revealed at the time of sale. (2) Also owing to the seller's market, the disposal of stolen materials at high prices is facilitated. (3) As a result of the large share of investment in national income real wages are depressed in relation to the economic potential. Whereas the first factors facilitate economic crimes, the third stimulates them. Society tends to regard these crimes

indulgently as a source of supplement to generally low incomes. The situation gives rise to a network of middlemen, dealers in stolen goods, who, together with the growing numbers of others whom practice has inured to theft and who benefit from society's indulgence, tend to perpetuate the crimes. Despite the increasing attention paid to costs and quality and the greater choosiness of trade, economic crimes do not abate in subsequent periods. Instead new forms of crimes arise where the individual dilettante is replaced by a group, much more skilled and better equipped. Such groups may involve employees throughout the entire enterprise or perhaps only those in sensitive positions. Because they involve accounting manipulations, the crimes are committed in an atmosphere that considerably reduces the risks of discovery. On the other hand, development of control does not keep pace with the increase of economic crimes. It is safe to assume, in fact that in some cases the leaders of these groups are sufficiently influencial to oppose successfully the improvement of control. Furthermore, such opposition is supported by those managers who, although unconnected with economic crimes, aim at reporting higher profits (or larger output) by lowering quality (Kalecki, 1964).

Graft payments (in monetary form and in kind) permeate the entire system. They are widespread in industry, involved in the process of bargaining for lower plan targets and larger inputs, in the supply system for timely deliveries of better quality inputs, and in industrial services, transportation, etc. In the consumer sphere graft is prevalent in retail trade (in securing goods in short supply, better grade goods, etc.), in services (including medical care), in obtaining housing (where payments are relatively large), and in securing all sorts of luxuries, such as automobiles, country homes, etc.

From the standpoint of the inflationary problem, it should be noted that some of the unreported income is not only a generator of additional spending power, but in some cases might be salutary by increasing the available flow of goods. However, even if in some cases the speculator performs a useful function, the end result tends to have an adverse distributional effect.

The problem of matching the income flows with supply of goods and services is complicated by the fact that a part of the output of consumer goods cannot be sold at prevailing prices because it is shoddy and of poor quality. Thus for a number of reasons, excess aggregate effective demand tends to prevail, for the increase in purchasing power tends to outpace the increase of available consumer goods. The problem is aggrevated by the prevailing relative price structure and absence of an effective nonprice output adjustment mechanism. The c.p.'s field of maneuver is limited for nominal wages cannot be reduced – indeed,

a certain minimum "normal" increase is expected at certain given intervals. Also price increases – at least for necessities – are politically inadvisable. Whatever the political advantages of price reduction, practiced in some STEs, it must be viewed in the light of the persisting disequilibria on the consumer market. This, together with the lack of success in controlling the size of the wage fund, tends to aggrevate the shortage-prone system. A better way to raise living standards would be to increase wages and to let consumer prices approach equilibria in partial markets.

Inflationary pressures can surface under various guises. The authorities cannot avoid latent price increases which take various forms. Under conditions of excess demand the producers lower the quality or use value of goods so that *de facto* the consumer gets less per unit of expenditure. Real purchasing power declines, for now a larger expenditure is required to get the same utility. Producers tend to modify slightly the product (without commensurately affecting the quality) and the price authorities raise the relative price. At the same time the production of the cheaper product (which is still in demand) is discontinued. This spurious product differentiation is usually not in response to demand, but dictated by the producer's interests and often restricts choice. Thus it is not sufficient to examine the dynamics of overall consumption, but also its composition, for the structure shifts towards more expensive goods. Welfare is reduced when the available options are narrowed down. The consumer is then forced to buy the goods that are available instead of those that he really wants, or he is forced to postpone purchases. Thus arises the problem of forced substitution and savings. Shopping becomes a nightmare and the consumer pays a high price in annoyance, mistreatment, and waste of time. Purchasing power then cannot be equated with shopping power. This also gives rise to all sorts of graft, under-the-counter sales, and purchases from artisans. Inflation is also introduced through various "private" markets (e.g., buying and selling of private homes, antiques, jewelery, etc.) and the black markets (especially in services and repairs), where prices are considerably higher than the official price lists and tend to rise in relation to the increasing shortages on the official market. Consumers, increasingly frustrated by their pursuit of officially lowpriced but unavailable or low quality goods, tend to revert to unofficial markets to procure used goods, to barter new goods, to commission custom-made goods, and to employ all sorts of intermediaries and speculators. The prices actually paid are not reflected in statistics. Although the center tends to take into account only the price changes it effects, the population is not only fully aware of latent inflation, but tends to overrate it (Csikos-Nugy, 1973 pp. 170–175 and Kornai, 1972 pp. 67ff).

Market-type reforms tend to increase the risk of open inflation. One of the problems of using the allocative function of wages (premiums) to spur labor's performance is that in order for it to perform an incentive role the premium has to be sufficiently large, but then it would add to the difficulties in controlling spending power. It is not certain that the extra pay would correspond to increased productivity which would be translated into an increased flow of consumer goods. But this is not an indictment, but rather an argument for effective macro and incomes policies. The poor record of Western economies in containing inflation is not sufficient evidence that the problem cannot be resolved more effectively in a socialist economy with a built-in market mechanism. Those who oppose market type reforms usually point to the inflationary upsurge of prices, substantial unemploment, and a deteriorating balance of payments in post-1965 Yugoslavia. But the argument emphasizes the peculiarities of the decentralized institutional arrangements and underrates mismanagement of macropolicy and structural factors. Also the critics of the Hungarian "new economic mechanism" pointed to the danger of inflation. These fears circumscribed the implementation of the blueprint. In China there is great concern about inflation. On the face, China seems to be more successful than the STEs in controlling inflationary pressures; i.e., overspending on the wage fund. Some of the reasons include a more realistic investment program (at least in the post-Great Leap Forward period); direct allocation of labor; lack of wage bargaining (which takes place informally in STEs); and lack of competition among producers for scarce labor. But again the outcome might be worse than living with moderate inflation (Cf. Wiles, 1977).

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