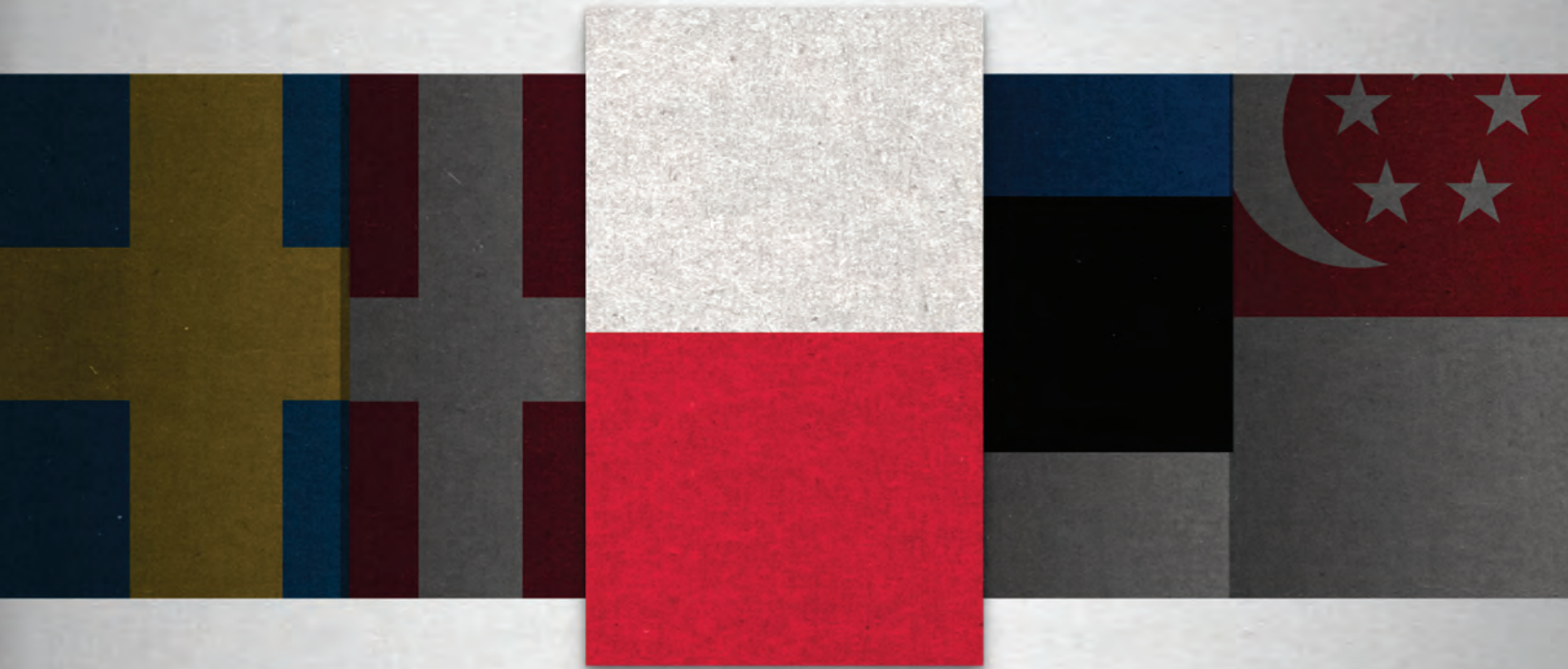


**PRE-RELEASE**  
CHAPTERS 1-3

# **THE ROAD TO SOCIALISM AND BACK**

An Economic History of Poland, 1939–2019

Peter J. Boettke, Konstantin Zhukov, Matthew Mitchell



REALITIES OF

# **SOCIALISM**



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### **Dedications**

The authors jointly dedicate this book to Anna Walentynowicz, whose sense of justice helped spark a revolution that toppled an empire, and whose death made her one of the last victims of the Katyn massacre.

Peter J. Boettke dedicates this book to Matthew, Stephen and Liz and the hope that their generation and beyond will escape the errors of the socialist past and instead enjoy the peace and prosperity produced by the creative power of a free civilization.

Konstantin Zhukov dedicates this book to Anna and Richard, for inspiring his intellectual curiosity and pursuit of knowledge.

Matthew Mitchell dedicates this book to Megan for her constant love and support.

# CONTENTS

Introduction: The Polish Experiment	1
1 The Political Economy of Socialism	3
2 Socialism in Poland	15
3 Poland's Transition from Socialism to the Market System	53
4 Assessing the Transition	
5 The New Polish Economy	
6 Contemporary Economic and Regulatory Policy in Poland	
7 Publicly Provided Resources Before and After the Transition	
8 Conclusion	
Appendix: Contemporary Fiscal Policy	
References	

Publishing information

About the Authors

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## THE POLISH EXPERIMENT

For four decades during the latter half of the 20<sup>th</sup> century, Poland and its people were the subjects of a grand socio-economic experiment. Under the watchful eye of its Soviet masters, the Polish United Workers' Party transformed the mixed economy of this nation of 35 million into a centrally planned, socialist state (albeit one with an irrepressible black market). Then, in the closing decade of the 20<sup>th</sup> century, under the leadership of Polish minister of finance Leszek Balcerowicz, the nation was transformed back into a mixed economy.

In this book, we document the results of this experiment. We show that there was a wide chasm between the lofty goals of socialist ideology and the realities of socialism as the Polish people experienced them. We also show that while the transition back from a socialist to a mixed economy was not without its own pain, it did unleash the extraordinary productive power of the Polish people, allowing their standard of living to rise at more than twice the rate of growth that prevailed during the socialist era. The experiences of the Poles, like those of so many behind the Iron Curtain, demonstrate the value of economic freedom, the immiserating consequences of its denial, and the often painful process of regaining lost freedoms.

The road to socialism and back also teaches us something about the intellectual development of economic thinking. As we will see, the debate surrounding economic calculation in a socialist economy highlighted not only a fundamental flaw in socialist planning, but also a critical feature that allows markets to work. Markets work because they permit economic decision-makers to engage in rational economic calculation. This calculation depends on the constellation of relative prices and the accounting of profits and losses that emerge from the free choices of individuals trading property rights. It allows us to sort out the economically viable projects from the technologically feasible ones. Without such a price system, these calculations are impossible, and this sorting does not occur. Resources are systematically wasted and inefficiencies in production and exchange abound.

In the middle of the 20<sup>th</sup> century, many economic theorists were blind to the basic but crucial point that the price system depends on the property rights arrangements within which it operates. The appreciation of this fact led to the emergence of property rights economics, the fields of law and economics, public choice economics, and the entrepreneurial theory of the competitive market process. It is those theories that were able to

shed light on the failing socialist economies of the 1980s and their collapse between 1989 and 1992. Moreover, these ideas formed the theoretical underpinning of the transition from socialism to an economy grounded in private property and freedom of contract protected by the rule of law.

But it is one thing to state this basic formula and quite another to implement it and sustain it against the political pressures of a new class of interest groups. As memories fade and as the number of living witnesses to the socialist experiment dwindle, the temptation to jump back on the road to socialism grows stronger.

Here is the plan for the book. In chapter 1 we discuss the political economy of socialism. We focus on the three great challenges of socialist planning—the control problem, the knowledge problem, and the incentive problem—and describe how these challenges give rise to what we call the pathologies of privilege. In chapter 2 we discuss the socialist era in Poland, describing how the communist government took control and attempted to centrally plan the Polish economy. We describe the features of the socialist economy—from the elimination of private property and central planning to soft budget constraints, rampant shortages, favouritism, and black markets. We also discuss the different approaches taken by successive socialist administrations (though our discussion is only loosely chronological). The chapter ends with the economic and political crisis that emerged in the early 1980s. In chapter 3 we discuss the transition from socialism to a mixed economy. We address the so-called Washington Consensus and shock-therapy as well as the main components of Leszek Balcerowicz's transition plan. In chapter 4 we assess the transition. We discuss both the good—hyperinflation was tamed, shortages disappeared, growth resumed, and living standards rose—and the bad—unemployment soared and remained high for decades. In chapter 5 we discuss the changed landscape of the new, mixed, Polish economy. In chapter 6 we describe contemporary economic and regulatory policy in Poland. And in chapter 7 we discuss three services that are typically provided in both socialist and mixed regimes—social safety nets, health care, and education—contrasting their provision under the socialist and mixed-economy regimes. In chapter 8 we offer concluding remarks.



## THE POLITICAL ECONOMY OF SOCIALISM

In a socialist regime, the state owns and operates the means of production. The main goals of socialism are the ultimate eradication of want from human experience, and material and social equality between individuals.<sup>1</sup> In Marx's view, this new order is supposed to come about through natural historical processes, whereby the capitalistic stage of society is replaced by the socialistic stage and, eventually, the communist stage in which the state withers away.<sup>2</sup> Lenin, however, believed that capitalist forces would suppress revolutionary notions and that a revolutionary vanguard needed to seize power by force and establish a dictatorship of the proletariat.

Private property would eventually become a relic of the past and all individuals would be able to obtain desired goods and services at will. Central planners, who would be capable of correctly estimating the needs of the population and effectively providing for these needs through the appropriate mechanisms, would provide these goods and services (Conway, 1987).

This, at least, was the goal. In this chapter, we briefly sketch the challenges that socialist planners face in attempting to realize this goal. These are the control problem, the knowledge problem, and the incentive problem. Together, these challenges give rise to what we call the pathologies of privilege.

The sad irony is that the society of a socialist state bears a striking resemblance to Marx's indictment of capitalism. Though he thought it was capable of "massive" and "colossal productive forces" Marx believed that capitalism would ultimately lead to stagnation, inequity, materialist obsession, worker alienation, environmental degradation, political suppression, crisis, and revolt.<sup>3</sup> As we will show, this is exactly what materialized in socialist Poland (Clark and Wildavsky, 1991).

### The control problem

First consider the control problem. Above all, central planning requires control. To state the obvious, every human is different. We each have our own interests, abilities, and plans. In a market economy, people are free to make their own plans, fitting them in with the plans of others through a process of mutual adjustment. But in a centrally planned economy, the planner who wishes to reallocate capital or labour must override the individual plans of the people. In Adam Smith's famous metaphor, the central planner

seems to imagine that he can arrange the different members of a great society with as much ease as the hand arranges the different pieces upon a chess-board. He does not consider that the pieces upon the chess-board have no other principle of motion besides that which the hand impresses upon them; but that, in the great chess-board of human society, every single piece has a principle of motion of its own, altogether different from that which the legislature might chuse to impress upon it. (Smith, 1759: VI.II.42)

In impressing their own plans upon individuals, planners must exercise a great deal of control. They must override what Smith identified as the natural, human “propensity to truck, barter, and exchange” (Smith, 1776: I.II). They must override individuals’ plans to work, shop, invest, and exchange with whomever they want on whatever terms they want. And to do this, they must apply force or the threat of force.

Once leaders obtain this power, moreover, they are liable to abuse it. The Russian revolutionary Mikhail Bakunin warned in 1873 that

from whatever point of view we look at this question, it always comes down to the same dismal result: government of the vast majority of the people by a privileged minority. But this minority, the Marxists say, will consist of workers. Yes, perhaps of *former* workers, who, as soon as they become rulers or representatives of the people will cease to be workers and will begin to look upon the whole workers’ world from the heights of the state. They will no longer represent the people but themselves and their own pretensions to govern the people. Anyone who doubts this is not at all familiar with human nature. (Bakunin, 1873/1990: 178)

Socialist thinkers were unphased by these concerns because they believed that socialism would remake human nature. The New Socialist Man (sometimes called the New Soviet Man) was to be intelligent, healthy, muscular, selfless, and supremely dedicated to the cause. The New Socialist Woman was to be an upright communist citizen, loyal to the state, her job, and her family (Clements, 1994).

The advocates for economic freedom, by contrast, were much less utopian. For them, the system of free enterprise serves human wants and desires, even if humans are deeply flawed. As Friedrich Hayek put it, Smith and his contemporaries had advocated for a

system under which bad men can do least harm. It is a social system which does not depend for its functioning on our finding good men for running it, or on all men becoming better than they now are, but which makes use of men in all their given variety and complexity, sometimes good and sometimes bad, sometimes intelligent and more often stupid. (Hayek, 1948: 11-12)

Because free enterprise operates without any central command structure, it need not have perfect men and women at the helm. And because the system is an open-access order, as

North, Wallis, and Weingast (2009) have put it, free enterprise is not as susceptible to sincere errors or human imperfections as is the command economy. If a private entrepreneur fails to see an opportunity or misjudges consumers' wants, another rival can jump into the market and profit by correcting this oversight. But if a central planner errs, there is no check or balance to his mistakes.

And if power corrupts, as Lord Acton warned, then he may be liable to make quite a few mistakes (Acton, 1887). Worse still, the apparatus of control may tend to *attract* the worst elements of society. Here, again, Adam Smith was prescient, warning that the statesman who attempted to plan peoples' lives would "assume an authority which could safely be trusted, not only to no single person, but to no council or senate whatever, and which would nowhere be so dangerous as in the hands of a man who had folly and presumption enough to fancy himself fit to exercise it" (Smith, 1776: IV.II).

Hayek would also pick up on this point, arguing that in a centrally planned state, the worst would tend to rise to the top of the hierarchy. One reason, he suggested, was that "It seems to be almost a law of human nature that it is easier for people to agree on a negative program—on the hatred of an enemy, on the envy of those better off—than on any positive task" (Hayek, 1944: 153). As we will see, Smith, Bakunin, and Hayek's concerns were all realized in socialist Poland.

In summary, the control problem suggests that socialism and totalitarianism go hand-in-hand. To exercise this much control over the behaviour of humans, the state must erect a vast apparatus of coercion. Once it has done so, the apparatus will attract the worst elements of society, especially those who are willing to seek and maintain power through demagoguery. Thus, it is no accident that socialist states routinely employ secret police, a network of informants, forced labour camps, the threat of extradition, and mass murder (Paczkowski, 1999). These measures did not go so far in Poland as they did in other socialist countries. But as we will see, even the comparatively "mild" variety of totalitarian socialism was terrifying.

### **The knowledge problem**

If the control problem requires planners to rearrange the members of society like so many chess pieces, the knowledge problem suggests that planners will not know where to put the pieces. Though Donald Lavoie coined the term in 1985, the knowledge problem was first raised by the Austrian economist Ludwig von Mises in 1920 and elaborated on by fellow Austrian Friedrich Hayek in 1945 (Mises 1920/2015; Hayek 1945; Lavoie 1985).<sup>4</sup> As Mises and Hayek explained, useful economic knowledge often concerns what might seem to be trivial or mundane, such as consumers' subjective preferences or workers' alternative job opportunities. This knowledge is highly dispersed; it is found in the subjective, often contradictory beliefs of countless market participants.

This is not just a matter of communicating *existing* information up and down the chain of command—though that, too, can be a problem in a bureaucracy.<sup>5</sup> For example, if the

task were simply to communicate that “a mining truck has broken down in Silesia” this could be done. The Polish socialist economist Oskar Lange (mis)interpreted the problem this way and thought it could be solved by computers (Lange, 1967).

But the type of knowledge involved in the knowledge problem is often tacit and contingent and cannot be communicated, even if one were instructed to do so. Think, for example, of the tacit knowledge involved in negotiating with a particular vendor, or the impossible-to-recount strategies one has adopted to manage a complex workflow. This sort of knowledge is only gained through trial and error.

Importantly, *some economic knowledge can only be known when a decision-maker is faced with a decision*. For example, it is impossible to know whether customers will prefer a more durable but more expensive fabric to a flimsier and cheaper alternative until they are given the opportunity to choose. Even the apparently simple example of the broken-down truck is not so simple. Only when an actual customer is faced with the actual choice of paying for repairs will we know whether, in the customer’s mind, the repairs are worth the expense.

In a market economy, Mises and Hayek argued, prices elicit this dispersed knowledge, turning it into signals to which others may react. To take Hayek’s example, if consumers come to place more value on tin, or if producers find it more difficult to make tin, then the price of the metal will rise. This signals to consumers that they should economize on its use and encourages entrepreneurs to explore alternative ways to satisfy consumer desires. In Hayek’s words, this allows people to “fit their plans in with those of others” without any central coordination or coercion (Hayek, 1945: 521).

But for this process to work, prices must emerge from the free choices of individuals exchanging rights over private property. Moreover, entrepreneurs must be allowed to try out new ideas, to experiment with novel products, production techniques, prices, and management strategies. As Hayek would later put it, competition serves as a “discovery procedure” (Hayek, 2002).

In this way, exchange helps sort between the merely technologically feasible and the economically valuable. For example, it may be technologically feasible to build houses with platinum instead of brick. But the only way to know whether it is economically valuable to do so is if a customer out-bids others for the scarce raw material (Boettke and Storr, 1985/2015). In this sense, competition is not an end-state in which price equals marginal cost, as the textbook competitive model tells us, but a *process* of entrepreneurial discovery (Mitchell and Boettke, 2017: 36).

Because central planners set prices by diktat and because their plans do not countenance the “chaos” of market experimentation, they are unable to make use of this knowledge. They are blind, guessing at the marginal value that consumers place on goods as well as the marginal opportunity cost of producers. This is the essence of the knowledge problem. And according to Mises and Hayek, it makes central planning extremely difficult, perhaps even impossible.

The knowledge problem tends to grow more severe over time. At first, planners can copy the prices that emerged under the free choices of individuals before the imposition of central planning. But as preferences, technologies, and opportunities evolve, these prices will diverge more and more from the current subjective realities of market participants. The knowledge problem is especially acute when it comes to brand new knowledge produced by entrepreneurial discovery, for in this case, there was no previous price.

The knowledge problem also becomes more severe as the *type* of growth changes. After the conflagration of World War II and the Soviet looting of productive property, the capital stock of Eastern Europe was decimated, so the main task for many countries in the communist bloc was to rebuild their capital stock. As Nobel Laureate Robert Solow explained, this type of growth—which has since come to be known as “catch-up growth”—can be quite rapid (Solow, 1956). Note that since the previous capital stock was known, planners did not face a significant knowledge problem during the catch-up phase of growth. Once these nations had rebuilt, however, new growth was not simply a matter of adding more machines.<sup>6</sup> At this point, new growth had to be driven by new ideas—or at least by copying new ideas from other countries. This type of “cutting-edge growth” is not so easy to achieve. And since it requires brand new arrangements of capital, it presents a significant knowledge problem.

### The incentive problem

The control problem and the knowledge problems are compounded by the incentive problem. Simply put, most decision-makers in a socialist system are not given an incentive to serve the general interest. In fact, many decision-makers can improve their positions by *undermining* the general interest.

First, consider the interests of the leader. The late public choice economist Mancur Olson provocatively suggested that when powerful and secure dictators first come to power, they have an incentive to maximize society’s wealth. This is because dictators have what he termed an “encompassing” interest in the productivity of the societies they oversee (Olson 1982; 1993). Writing in 1991 as the socialist systems in Eastern Europe were falling apart, Olson and Peter Murrell described the encompassing interest of the socialist dictator:

Consider Stalin. At least to an approximation, he controlled the Soviet Union just as the owner of a firm in a market economy controls his firm. He had, as it were, a property right in his society that democratic politicians did not have in any of the societies of the West. Just as the owner of a firm has an incentive to make the firm as valuable and productive as possible, so Stalin had an incentive to make the domain he owned as productive and wealthy as he could. (Murrell and Olson, 1991: 253)

Even if an autocrat’s “sumptuary styles should be exceptionally grand,” they continue, “the resources needed to provide for their personal consumption are bound to be small in relation to the output of a nation; it is the leaders’ interest in power, prestige, and

international influence that is important” (Murrell and Olson, 1991: 254). This doesn’t necessarily mean that the leader has an incentive to maximize the *welfare* of the average worker, only the *growth rate* of society at large, since it is upon the latter that his own welfare depends: “The consumption of ordinary citizens need be no higher than the leader determines is necessary to ensure a healthy and productive workforce” (Murrell and Olson, 1991: 255).

In related work, Olson (1993) likened a secure and powerful dictator to a “stationary bandit” that predares on his society. Because a secure leader plans on sticking around for a while, he has an incentive to maximize the wealth of the society upon which he feeds. The story is quite different, however, for an insecure leader whose tenure is less assured. An insecure dictator, he reasoned, is like a “roving bandit.” He too predares on society but because he doesn’t know how long his own tenure will last, he is less concerned with the long-run health and stability of the society on which he feeds. “Whenever an autocrat expects a brief tenure,” Olson explains, “it pays him to confiscate those assets whose tax yield over his tenure is less than their total value. This incentive plus the inherent uncertainty of succession in dictatorships imply that autocracies will rarely have good economic performance for more than a generation” (Olson, 1993: 567).

Next, consider the incentives of subordinates. Socialist societies, of course, are supposed to ensure equality. But central planning tends to create stratification. One reason is that central planning requires bureaucracy and bureaucracies everywhere tend to become hierarchical over time. To ease the managerial and informational demands of supervision, bureau chiefs delegate authority to other managers and they, in turn, further delegate, creating a pyramid-shaped organizational structure (Mises, 1944/2007; Tullock, 1965). Managers soon learn that they can increase the perquisites of their positions if they can contrive to increase the size of the operations they oversee (Niskanen, 1971; 1975).

As corporate workers in market economies can attest, private firms are susceptible to bureaucratization too. But in a competitive market, entrepreneurs can challenge firms that have become overly bureaucratic. Even the threat of such a challenge can discipline firms to keep costs low, customers happy, and internal bureaucracies in check (Baumol, 1982). And if it doesn’t, then old behemoths will be replaced by newcomers. This sort of churn, when it is permitted, tends to check monopoly power and enhance productivity.<sup>7</sup> There is no such check in a socialist planned economy.

Entrepreneurship is one casualty. Though central planners in socialist societies may want to encourage their managers to be entrepreneurial, the system’s incentives stand in the way. As Schumpeter explained, the role of the entrepreneur is to “reform or revolutionize the pattern of production” (Schumpeter, 1912: 132). So almost by definition, innovation is a departure from the norm, a challenge to the “plan.”<sup>8</sup> The socialist manager who departs from the plan, however, risks missing his planning targets and therefore his bonus. Even if he were willing to take this risk, he would gain no personal share in the reward if his innovation worked. As a result, there is very little innovation in planned economies (Smith, 1983: 57).

There is also very little creative destruction, and this means that these economies tend to be dominated by inefficient, hulking, bureaucratic state-owned firms. And even if a secure dictator's incentives are encompassing, the incentives of those who lead these behemoths are certainly not. Their incentive to accurately transmit information up the chain of command is especially perverse:

Each subordinate's chances of promotion or bonuses are lowered if a superior learns of his mistakes, his shirking, and his other forms of on-the-job consumption. There is accordingly an incentive not to transmit, or even actively to conceal, information about any shortcomings that can be successfully hidden. There is also an incentive to overstate the difficulties faced and to understate potential production. The incentives to distort information operate and cumulate at every level of a hierarchy, so they increase nonlinearly with the size of the bureaucracy and are bound to be exceptionally serious in a centrally planned economy. (Murrell and Olson, 1991: 255-56)

By forcing bureaus to compete with one another, the central authority may be able to overcome some of these problems, especially when the regime is new, or “after a purge, cultural revolution, or other total shake-up of society” (Murrell and Olson, 1991: 257). But over time, groups of individuals up and down the chain of command overcome the collective action problems that stand in the way of working together and find it easier to collude with one another.<sup>9</sup> This can happen at the upper level of the bureaucracy, where managers withhold or distort information to press for more power and resources for themselves. And it can happen at the individual work-group level where workers collectively shirk (Murrell and Olson, 1991: 260).

According to this theory, the process eventually undermines the chief ideological aims of socialism—social and economic equality and the elimination of want. In the end, an entrenched aristocracy of bureaucrats extract society's wealth and misallocate resources, leading to stagnation and collapse.

Eventually, the devolutionary process that our theory predicts reaches the point where the dictatorship of the General Secretary and even of the Politburo largely disappears. The higher ranking subordinates gain so much power that they become the constituents of the General Secretary and the Politburo and, ultimately, the people who determine who becomes General Secretary and who enters the Politburo. The last stage of communism is not the stateless and classless society that Marx forecast, but rule by a rather large aristocracy of upper level bureaucrats. When this stage is reached, the encompassing interest of the dictatorial leader that has been the motivating force for growth and productivity in the traditional Soviet-type society disappears. The class of officials to whom power has devolved is then too large to engage in productive collective action. When this stage is reached, no one owns the society, and no one has an incentive to make it work. So economic performance

deteriorates even further. In time, the system must collapse or be fundamentally transformed. (Murrell and Olson, 1991: 260)

### The pathologies of privilege

As upper level bureaucrats gain power, a whole new set of problems known as the “pathologies of privilege,” arise (Mitchell, 2012). These pathologies are a set of social and economic problems that occur when some members of society are privileged over others. Of course, socialism is supposed to eliminate privilege and the official wages for the various jobs reflected this goal. Managers earned higher wages than the workers they oversaw, but the differences were not as great as in the West.<sup>10</sup> As one study found, “inequality of official money incomes does not itself constitute a primary dimension of social inequality” (Asselain, 1987: 21). Instead, the main source of inequality arose from unequal access to scarce goods. As Clark and Wildavsky put it, “The locus of privilege [in a socialist political economy] is scarcity” (Clark and Wildavsky, 1991: 163).

Theoretically, by making it difficult for socialist managers to set prices correctly, the knowledge problem could have made surpluses just as common as shortages, irrespective of the good in question. Instead, there was a consistent pattern: socialist systems tended to experience surpluses of raw materials and shortages of consumer products. As the Hungarian economist János Kornai put it, “shortage and slack appear simultaneously in the same workshop” (Kornai, 1980: 35).

Political economy explains why. Concentrated interests find it easier to organize for political action than do diffuse interests (Olson, 1965; Lowi, 1969). And compared with the makers of consumer goods, the producers of raw materials were more concentrated and therefore better at lobbying the central authorities to ensure that the overarching plan demanded their materials.<sup>11</sup> Meanwhile, central planners and the managers that lobbied them engineered shortages of consumer goods (Levy, 1990; Shleifer and Vishny, 1992). Shleifer and Vishny explain why:

These bureaucrats intentionally plan shortages in order to invite bribes from rationed consumers. If markets cleared, firms in an industry could earn profits, but most of these profits would accrue to the state treasury, not to the managers or the ministries. The key feature of socialism is that the decision makers who determine the prices and output of firms do not, to a first approximation, keep any of the profits. In contrast, when there is a shortage of a good, potential customers try to obtain it by offering bribes and favors to the bureaucrats in the ministry (and to the managers of firms). (Shleifer and Vishny, 1992: 238)

In an important contribution to economic theory, Gordon Tullock argued that when individuals can use the political process to obtain privileges such as transfers or above-normal profits, they have an incentive to expend scarce resources *seeking* these privileges (Tullock, 1967). In many cases, these efforts are themselves wasteful. Individuals, firms, and



“ministerial lobbies” (as they were known in socialist Poland) will waste time, money, and effort ingratiating themselves to higher authorities. For example, they may hire these authorities’ friends or family members, or alter their business models to curry favour with decision-makers, even if these alterations create no value for consumers (Mitchell, 2019). Because the above-normal profits of privileged monopolists are called “rent,” these wasteful efforts have become known as “rent seeking.”<sup>12</sup>

Tullock showed that this waste grows as the privilege-seeking “market” grows more competitive and as favoured interests get better at seeking favour (Tullock, 1980). Ultimately, this leads to a perverse allocation of talent as society’s best minds dream up new ways to obtain privilege rather than new ways to create value for consumers (Baumol, 1990; Murphy, Shleifer, and Vishny, 1991). Moreover, the wasteful competition for privilege can take place at multiple levels. Firms and ministerial lobbies will waste resources competing over perquisites and above-normal profits, while party officials and bureaucrats will waste resources competing over the right to *dispense* these privileges (Buchanan, 1980).

In an important extension of Tullock’s concept, Fred McChesney developed the notion of “rent extraction” (McChesney, 1987; 1997). In this case, the problem is not favour but disfavour. If those in power are able to selectively punish certain members of society—say, by threatening their livelihoods—then the threatened interests will waste time, money, and effort trying to avoid being subject to predation. Given the control problem and the large apparatus of coercion in socialist societies, rent extraction could be rife.

Ironically, it is sometimes possible to avoid the waste associated with rent seeking and rent extraction when it is impossible to contest favour or disfavour (Mitchell, 2019). For example, Polish First Secretary Edward Gierak was infamous for favouring his home-region of Silesia with investments (Clark and Wildavsky, 1991: 120), but this probably didn’t generate much rent-seeking waste if officials from other regions assumed that their entreaties were unlikely to win his favour. In this sense, government-granted privilege traps citizens between the Scylla of contestable favour, which maximizes rent-seeking waste, and the Charybdis of uncontestable favour, which maximizes inequity.<sup>13</sup>

In another irony, Tullock (1975) showed that favoured interests typically don’t earn above-normal profits (rent) over the long run. As he put it, “there are only transitional gains to be made when the government establishes special privileges for a group of people” (Tullock, 1975: 671). Those who were initially privileged may benefit handsomely. But after that, newcomers must often pay a price to access some sort of asset or station that entitles them to the privilege. For example, if one needs to be a member of the party in order to obtain certain privileges, then eventually aspirants will bid up the price of joining the party or rising in its ranks. Of course, this “price” may not be a monetary price. And it may not be legal. It may be paid in favours or gifts or special attention given to party leaders. Net of this price, the privilege may not be especially valuable (and its value is further reduced by the fact that rent-seeking societies are poor societies (Murphy, Shleifer, and Vishny, 1993).) Whatever price is paid, however, it is often a sunk cost and cannot be recovered. This means that if a privilege is then taken away—say because of a transition

to free enterprise—then those who “paid their dues” to rise to the top of the party will have no way to recover their sunk costs. As we will see, this was an especially important factor during Poland’s transition away from socialism.

Now that we have sketched the contours of socialist political economy, we are ready to see how socialism actually played out in Poland.

## Notes

- 1 The terms “communism” and “socialism” have a complicated and technical history. Many of the regimes of the 20th century that described themselves as communist countries were still in their socialist stage. That is, they were thought to be transitioning from the previous capitalist economy to the full communist system. However, by the traditional definitions, none ever achieved the final stage of full communism in which the state withered away. So, we will refer throughout to these regimes as socialist economies, reserving the words “communist” and “communism” for the parties or for the international alliances (such as the communist bloc).
- 2 It was Karl Marx who developed this notion of the stages of history. In his view, societies naturally progress through six stages: primitive communism, slave society, feudalism, capitalism, socialism, and global stateless communism.
- 3 Marx and Engels waxed poetic about the productive power of capitalism, writing: “The bourgeoisie, during its rule of scarce one hundred years, has created more massive and more colossal productive forces than have all preceding generations together. Subjection of Nature’s forces to man, machinery, application of chemistry to industry and agriculture, steam-navigation, railways, electric telegraphs, clearing of whole continents for cultivation, canalisation of rivers, whole populations conjured out of the ground – what earlier century had even a presentiment that such productive forces slumbered in the lap of social labour?” (Marx and Engels, 1848).
- 4 For a comprehensive review of this debate, see Lavoie (2015) and Boettke (2000).
- 5 Gordon Tullock called this phenomenon “whispering down the lane” asserting that “the amount of error (“noise” in communications-theory terminology) would increase exponentially with the increase in the number of persons in the transmission chain and with the complexity of the message transmitted” (Tullock, 1965: 148)
- 6 Once it has rebuilt, a nation’s capital stock is close to its “steady state” level. At the steady state, old capital depreciates at the same rate that new capital is formed.
- 7 Though economically freer societies permit significantly more churn than did planned economies, they often privilege certain producers. Researchers find that societies that permit more churn among their top firms tend to grow faster (Fogel, Morck, and Yeung, 2008; Mitchell, 2012).
- 8 Clark and Wildavsky call this “the autonomy-command contradiction.” As they put it, “The command, ‘Be innovative!’ is like the commands ‘Be autonomous,’ ‘Think for yourself,’ or ‘Question commands.’ Part of being innovative is thinking differently, going outside or beyond what is ordered. In demanding that an individual follow the command to innovate, one is in essence commanding that he question commands. Not an easy task” (Clark and Wildavsky, 1991: 284).
- 9 One collective action problem is the temptation to free ride. It stands in the way of collusion. But over time, individuals with the same interests find ways to overcome the temptation to free ride and this can lead to the proliferation of special-interest pleading. This problem is not unique to centrally planned societies. In fact, Olson first developed his theory to explain sclerotic growth in advanced Western societies, attributing it to the rise of distributional coalitions that, over time, find it easier to collude with one another to obtain government protection from competition and other privileges (Olson, 1982). As his later work demonstrates, however, Olson came to believe that these problems were more serious in centrally planned socialist societies.

- 10 “The earned income of a factory director is barely three times that of a female dairy worker, a miner is better paid than a chief medical officer and a lawyer is well below a train driver” (Asselain, 1987: 33)
- 11 As we will see, without the signals of market-determined prices, profit, and loss, planners fell back on naïve targets such as weight counts.
- 12 The term “rent seeking” was coined by Anne Krueger who, unaware of Tullock’s original work, independently developed the concept. The economists’ peculiar use of the term “rent” as the above-normal profit of an exclusive producer dates back to Ricardo (Krueger, 1974; Ricardo, 1817: 33-44)
- 13 In 1972, the Polish Council of State created a new set of privileges with both uncontestable and contestable features. Among the uncontestable favours, the grandchildren of party leaders were awarded special rights to inherit property and have access to certain positions. This was grossly unfair but unlikely to generate wasteful rent-seeking since those who didn’t meet the criteria could do little about it. At the same time, the premier was given the power to extend these privileges to any individual of his choice. If we assume that he was open to the entreaties (and bribes) of any and all, then this form of privilege was an expensive open invitation to seek rent.



## SOCIALISM IN POLAND

### Poland succumbs to Soviet control

In September 1939, in accordance with the Molotov-Ribbentrop Pact, Germany invaded Poland from the West while the Soviets invaded Poland from the East (see figure 2.1). Within a month, the occupiers were in control, dividing the nation down the middle and annexing the occupied territories to their respective empires. Both occupations were brutal. In the West, the Germans summarily executed tens of thousands of Poles in Hitler's first attempt at ethnic cleansing (Rossino, 2003). In the East, in what became known as the Katyn Massacre, the Soviets killed 14,587 prisoners of war, burying them in mass graves in the Katyn forest (Paczkowski, 1999: 369). In total, about 30,000 Poles were shot by the Soviets during the occupation; between 330,000 and 340,000 were deported, sent to work in Soviet factories or mines; 90,000 to 100,000 died in deportation camps (Paczkowski, 1999: 372). Unfortunately, the Poles were no strangers to foreign occupation, having previously been invaded and partitioned by tsarist Russia, Austria, and Prussia. As Staniszkis (1979: 185) put it, "In the Polish tradition, the state was always an 'enemy' state."

In 1941, the Germans double-crossed their erstwhile allies, invading the Soviet Union and ending the non-aggression pact between the two nations. For the next three years, the Germans controlled the entirety of Poland, prosecuting a reign of terror against the local population, targeting Polish Jews, Romani, and other ethnic groups for mass murder and subjugation.

Figure 2.1: A Timeline of the Communist Takeover



Poland was devastated by World War II. Over 6 million Poles lost their lives. Thirty-eight percent of Poland's pre-war assets were destroyed. Sixty percent of all establishments, 38 percent of all rail lines, 20 percent of all arms, 43 percent of all cultural assets, and 55 percent of all medical facilities were lost (Brzeziński, 1967: 9). In the summer of 1944, as the Soviets prepared to reinvade, the Polish resistance Home Army organized the Warsaw Uprising. It was the largest counteroffensive of any European resistance movement during the war. The Soviets refused to grant RAF planes permission to use Russian airfields, leaving the Polish freedom fighters to fend for themselves against the Germans. More than 200,000 Poles lost their lives in this one episode. As British historian F.B. Singleton put it, the catastrophe "removed from the scene the only important non-Communist resistance movement in Eastern Europe and ensured that the future government of Poland would be made in the image of its Soviet patron" (Singleton, 1965: 96).

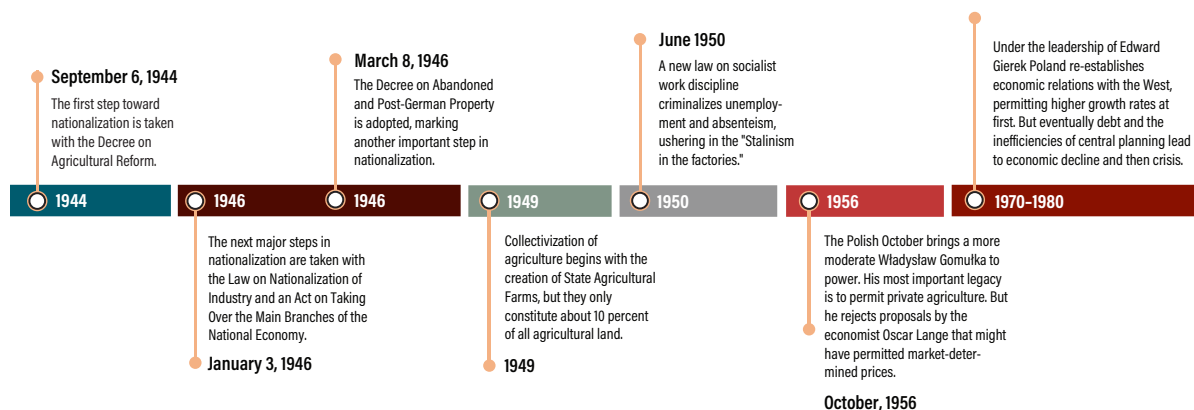
When the Soviets finally reinvaded in the summer of 1944, they established control through the communist Polish Committee of National Liberation. Stalin assured his Western allies that a post-war Poland would retain its sovereignty and that the nation's fate would be decided by free and fair elections. Nevertheless, once they established control over the country, the Soviets held fraudulent elections and established a one-party socialist regime run by the Polish United Workers' Party, merging the party with the formerly independent Socialist Party in 1948 (Hunter, 1986: 302). Bolesław Bierut, who considered himself a student of Stalinism, became the leader of Poland for the first decade of communist rule (Jerzy, 2014). To ensure control over the country, Constantine Rokossovsky, a Polish-born Soviet marshal, was appointed commander-in-chief of the Polish army and minister of defense in 1949. All high military positions in Poland were awarded to Russian officers, ensuring near-complete dominance by the Soviets.

Under this arrangement, Polish interests—like those of other communist bloc nations—were often sacrificed for the greater international communist cause. So when the United States offered aid to help rebuild Poland, Stalin insisted that Poland reject the offer, fearing it would lead to greater Western influence (Clark and Wildavsky, 1991: 51). In fact, the Soviets established something like the Marshall Plan in reverse. Marer estimates "the value of the unrequited flow of resources from Eastern Europe to the Soviet Union during the first postwar decade to be roughly \$14 billion, or of the same order of magnitude as the aid the United States gave to Western Europe under the Marshall Plan" (Marer, 1974; 1984: 156). Polish factories were dismantled and shipped to the USSR under the theory that the Soviets were entitled to them since the Germans had used them during the war. In total, the Soviets estimated that they took about \$500 million worth of industrial equipment from the Poles, which is less than they took from East Germany, Hungary, or Romania (Clark and Wildavsky, 1991: 91).

## The elimination of private property

“The theory of the communists may be summed up in a single sentence,” declared Marx and Engels in the *Communist Manifesto*: “Abolition of private property” (1848/1969: 22). Even before the establishment of the Polish People’s Republic in 1952, the Soviets began to expropriate productive private property (Kozminski, 1997). The process took several years and included both direct and indirect nationalization (see Figure 2.2).

Figure 2.2: A Timeline of Nationalization and Central Planning



Indirect nationalization generally took the form of confiscatory taxes on property reaching as high as 85 percent of income. Over time this forced property owners to renounce their property for the benefit of the state (Stec, 2001). Direct nationalization began in 1944 with a series of laws passed under the auspices of the Soviet-backed Polish Committee of National Liberation, stipulating confiscation of German property on Polish territory. In time, additional laws nationalized most economic activity in Poland. The most important acts enabling nationalization were the Decree on Agricultural Reform of September 6, 1944; the Law on Nationalization of Industry and an Act on Taking Over the Main Branches of the National Economy, both passed on January 3, 1946; and the Decree on Abandoned and Post-German Property of March 8, 1946 (Stec, 2001; Bazylar and Gostynski, 2018; Hunter, 1986).

Some acts only confiscated property of the former Third Reich and German citizens on newly acquired territories and Polish land. Confiscated property included factories, mines, banks, pharmacies, and other commercial enterprises. But by the authority of the Decree on Abandoned and Post-German Property it included both moveable and immovable property of Germans. Expropriated owners were not compensated (Stec, 2001).

Other acts targeted the Polish citizens themselves, confiscating their property regardless of religion or ethnicity. By order of the Law on Nationalization of Industry of January 1946, private firms employing more than 50 people in one shift were nationalized, as were firms of any size in strategic industries like telecommunications, transport, energy,

and mining. Other legislation expropriated the property of private enterprises like banks, pharmacies, ships, and even went so far as to nationalize the property of all religious and charitable establishments (Stec, 2001). And though expropriated asset owners were supposed to receive compensation, in reality owners received none (Bazyler and Gostynski, 2018; Stec, 2001: 293).

The nationalization of property in Warsaw in 1945 is illustrative. There, according to the Decree on Use and Ownership of Immovable Property in Warsaw of October 26, 1945, all immovable property within the city was expropriated. And although a former property owner could attempt to acquire a perpetual lease in formerly owned buildings, this was essentially impossible to attain (Bazyler and Gostynski, 2018; Stec, 2001).

Nationalization of private property was also extended to the agricultural sector, although over time, the regime eased restrictions on ownership of private agricultural plots. The agricultural industry was governed according to the Decree on Agricultural Reform of 1944 and accompanying decrees like the nationalization of forests (Stec, 2001). Per regulations, large farms over 100 hectares, and in some instances even smaller agricultural plots were to be nationalized, along with adjacent farm buildings, tools, machinery, and cattle. Once nationalized, the plots were redistributed to smaller farms at a nominal fee, while expropriated farmers received no compensation (Bazyler and Gostynski, 2018; Stec, 2001).

The process of nationalization in the late 1940s thus set the framework of property relationships in Poland until the collapse of the regime. For the next four and a half decades, Poles could not exchange fixed productive property such as factories or shops. Nor could they enter into contracts concerning their use or exclude others from using these assets. Private property rights over movable assets such as cars or mechanical tools were also limited by regulations that hampered a person's ability to profit from or exchange these resources. These non-fixed assets were allocated by the central bureaucracy. In short, they had none of the standard rights of private ownership to productive property.

Indeed, ownership over commercial assets gradually withered away as additional laws passed in the late 1940s further constrained private businesses by constructing a maze of bureaucratic rules, such as license requirements and arbitrary fines and taxes (Montias, 1974). Thus, the property rights regime left few options, outside of illicit markets, for potential entrepreneurs to employ capital in productive ways. As we will discuss below, state monopolization of trade and production of goods and services further weakened entrepreneurial incentives.

There were exceptions, however. Small private enterprises were tolerated in crafts, retailing, and small industry (Kozminski, 1997). And the government eventually abandoned its plans to collectivize agriculture. But as we illustrate later, private employment in non-agricultural sectors was quite low.

Because of these changes, the most common types of firms during the socialist regime were state-owned firms, firms owned by regional authorities, and cooperatives (Kornai, 1992). State-owned firms were fully controlled by the bureaucracy. Bureaucrats set the



prices of goods, hired managers, determined the supply chain, and exercised other control rights over these firms. And since state-owned firms are, by definition, owned by the state, they could not be sold or leased out. Because profits and losses in these firms accrued to central authorities there was little incentive to either maximize value creation or minimize resource consumption. Firms owned by regional authorities differed from state-owned firms only in their responsibility to regional bureaucracies, although in the end, the ultimate arbiter of decision-making was still the central government bureaucratic apparatus.

Cooperatives, the third type of firm, were mostly found in agriculture in the form of state-owned farms. Members of cooperatives generally could not decide to leave the cooperative, employ permanent labour outside the cooperative, or join a different cooperative on a voluntary basis (Kornai, 1992). Moreover, cooperative leadership could not independently decide how to use revenue in excess of expenses (if there was any), how to employ the cooperative's means of production, or even whether to purchase new agricultural tools.

Importantly, however, cooperatives operated alongside private agriculture. The Polish Workers' Party attempted to collectivize agriculture in 1949, creating State Agricultural Farms as part of the Three Year Plan of National Reconstruction. But these collective farms only constituted about 10 percent of all agricultural land, and Polish farmers were fiercely resistant to further nationalization (Zawadzki, 1956). This resistance grew in the mid-1950s just as a post-Stalinist Soviet Union was relinquishing some control over Poland. As we will see below, important changes in 1956 ensured that agriculture would remain mostly private.

Though they tolerated small private enterprises (employing 50 or fewer persons), the socialists were largely successful in eliminating private ventures outside of agriculture (Kozminski, 1997). For instance, Montias (1974: 54) cites data by Berman and Minc which shows that private retail shops decreased from 78 percent of all shops in 1946 to just 15 percent in 1950, while private wholesale trade was essentially eliminated. A similar scenario played out in industry and handicrafts, where private output decreased from 21 percent in 1946 to just 6 percent in 1950. Clark and Wildavsky report that, in total, the state sector produced 91.2 percent of all goods and services by 1946 (1991: 97).

Kornai (1992: 84) shows that the trend continued for the next several decades. He reports that private nonagricultural employment was 11.6 percent of total nonagricultural employment in 1949, and between 1950 and 1980, this share more than halved and hovered at around 4 percent. Finally, according to Fallenbuchl (1982: 32) total private employment in the national economy steadily decreased from 53 percent in 1950 to around 29 percent in 1983.

### **The push for breakneck industrialization**

Though Marx worried that capitalism led to commodification, he was no anti-materialist.<sup>1</sup> His famous promise to supply “each according to his needs” (1875/1970) presupposed that the socialist economy would be *able to meet* these needs. Indeed, Marx and Engels

were confident that socialism would offer “such an abundance of goods” that it would be “able to satisfy the needs of all its members” (1848/1969: 51). And quite a few socialists (and some non-socialists) believed this. Khrushchev’s assertion that “we will bury you,” for example, was not a militaristic threat; it was an (ultimately incorrect) empirical claim that socialism would out-produce capitalism.<sup>2</sup>

This is one reason why Marx held that socialism needed to follow capitalism. The socialist society, Marx thought, could build on the impressive record of productivity that capitalism had unleashed. As Clark and Wildavsky put it, “Marx’s thought is not about efficiency, for that was supposed to have been taken care of by capitalism” (Clark and Wildavsky, 1991: 335). For the socialist planners tasked with realizing Marx’s promise, outproducing the capitalists was a tall order. It was especially difficult given that socialism did not arise in advanced capitalist societies as Marx had predicted, but had instead been instituted in relatively unindustrialized nations like the USSR and Poland. Planners devised several strategies to out-produce the capitalists.

One key, they thought, was to encourage what the Polish-born London School of Economics professor Stanisław Gomulka called a “culture of growth” in which “strong material incentives dominate; relatively large income inequalities are maintained, ideals of competition, promotion, success, power and economic efficiency are cultivated” (Gomulka, 1986: 16-17). Clark and Wildavsky argue that, in practice, this meant “officials in the central apparatus of communist regimes do not behave like real capitalists, but rather like the capitalists portrayed by Marx and neo-Marxists” (Wildavsky, 1991: 10-11).

Especially in the first years of power, this culture of growth stressed breakneck industrialization and investment. Planners believed that, left to their own devices, workers would consume too much of their incomes. By restraining consumption, they believed a planned economy could encourage the appropriate level of savings and investment. Today’s sacrifices would yield tomorrow’s plenty. And, indeed, socialist states saved and invested about 30 percent of national output compared with just 10 percent in the United States (Clark and Wildavsky, 1991: 104, 274).<sup>3</sup>

As Kornai explains, socialist political economy reinforced the ideological imperative to invest: “In a socialist economy there is no firm or nonprofit institution that does not want to invest. There is no saturation. *Investment hunger* is permanent” (Kornai, 1980: 191-92). This hunger arose for several reasons. First, as mentioned above, input industries tended to possess outsized political power which meant that their products were well-represented in the plan. Second, managers found it handy to have an excess of inputs in case a shortage might arise. Third, managers were able to obtain higher salaries, more perquisites, and bigger bribes if they had more resources at their disposal. And finally, managers could always sell excess raw materials on the black market. As we discuss below, the state accommodated investment hunger, leading to what Kornai called soft budget constraints. Moreover, investment hunger was self-perpetuating since planners tended to give more resources to larger enterprises and were more likely to funnel resources to projects that were already underway (Clark and Wildavsky, 1991: 272-76).

Not only did socialist planners believe that workers in a market economy would not save and invest enough on their own, but they also believed that enterprises in a market economy would not invest in the right ways. These enterprises, planners thought, would direct too much capital to frivolous consumption goods and not enough to heavy industry.

As a result, socialist planners in Poland and elsewhere prioritized heavy industry, channeling society's resources to coal, iron, utilities, and other producer's goods. Without market-determined signals of prices, profit, and loss, planners often focused on what Poles called "the producer's economy" or "production for production sake" (Clark and Wildavsky, 1991: 190, 260). And lacking any better metric, planners rewarded managers for sheer weight. As Clark and Wildavsky put it:

Polish planning can be summarized in two words: Weight counts. During the heyday of Stalinism in the first half of the 1950s, this was often quite true: The production target of an enterprise would be assigned in terms of tonnage of output, and firms would produce X thousand kilotons of nails. (Clark and Wildavsky, 1991: 8)

Over time, planners added other metrics.<sup>4</sup> But weight remained an important gauge of production. By 1985, the emphasis on weight was so evident that even Soviet leaders like Mikhail Gorbachev were complaining that their economies used twice as much metal, 23 percent more fuel, and 30 percent more raw materials for each unit of output (Dobbs, 1989).

As we will see below, in the producer's economy the consumer's desires were ignored. As Kornai explains, in socialist economies "in many cases the producer does not manufacture what he *should*, but what he *can*, that is, what he is able to produce from the combination of available inputs" (quoted in Clark and Wildavsky, 1991: 159).

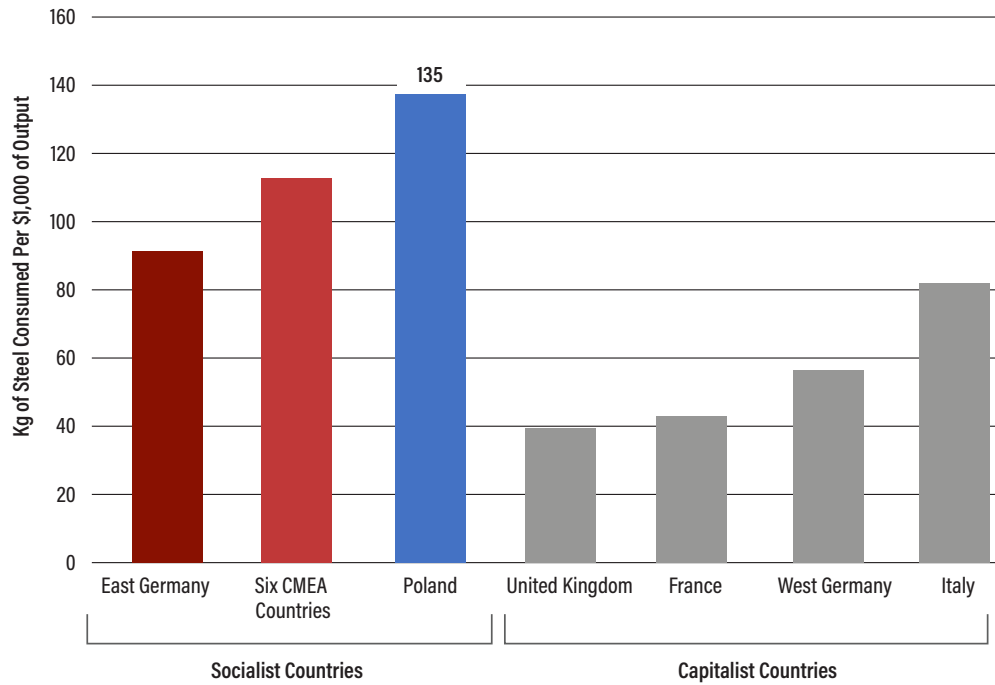
### Exploitation of natural resources

Given the emphasis on production for production's sake, planners paid little attention to natural resource stewardship. Stanisław Gomulka explains that in socialist economies the push to industrialize:

relied on a merciless exploitation (some would say short-sighted plundering) of the countries' natural resources of land, water, and minerals, and processing these resources in a rather wasteful way to produce poor quality products using methods of production which appeared to be what had been significantly more capital- and labour-intensive than need be. (Gomulka, 1986: 103)

Figure 2.3 illustrates the result. It shows steel consumption per \$1,000 of output in socialist and capitalist countries in 1980. While the typical capitalist country used a little over 50 kg of steel to produce \$1,000 in output, Poland used 135 kg.

Figure 2.3: Steel Consumption Per Output, 1980

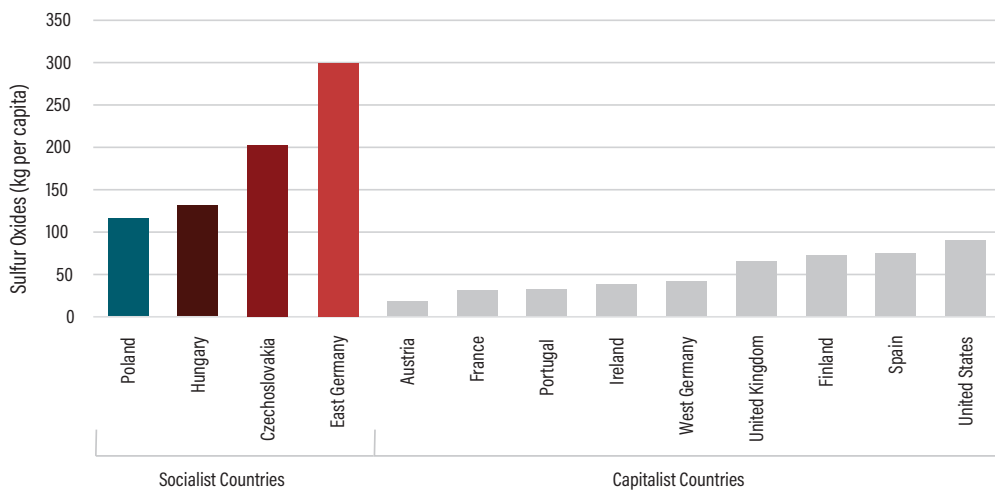


Note: The six Council for Mutual Economic Assistance (CMEA) countries are Bulgaria, Czechoslovakia, East Germany, Hungary, Poland, and the Soviet Union.

Source: Kornai, 1992: 294, table 12.4.

The socialist record of pollution was notorious and industrial pollution in Poland was especially bad. A 1991 article in the *Washington Post* described Warsaw’s tap water this way: “It spurts yellowish-brown from the tap, laced with heavy metals, coalmine salts and organic carcinogens. It stains the sink, tastes soapy and smells like a wet sock that has been fished out of a heavily chlorinated swimming pool” (Harden, 1991). The same article reported that Warsaw tap water had double the World Health Organization’s

Figure 2.4: Air Pollution in Selected Countries, 1985



Source: Kornai, 1992: 179, table 9.4.

limits on chloroform concentration; a quarter of Poland's big industrial plants had either no waste-water treatment or used treatment devices with insufficient capacity; 57 percent of the Vistula river was classified as unfit for any purpose and the average concentration of mercury was nine times greater than the Polish norm for safe drinking water (Harden, 1991).

Figure 2.4 shows the degree of air pollution, as measured by sulfur oxides per capita in socialist and capitalist countries in 1985. As we will see below, socialist countries had relatively few cars per capita, so these numbers indicate an especially high level of pollution per unit of output.

### Exploitation of human resources

Ironically, the push to industrialize also meant that the Polish United Workers' Party ignored worker welfare. Marx had famously pilloried the capitalist's "soul," writing that:

As capitalist, he is only capital personified. His soul is the soul of capital. But capital has one single life impulse, the tendency to create value and surplus-value, to make its constant factor, the means of production, absorb the greatest possible amount of surplus-labour. Capital is dead labour, that, vampire-like, only lives by sucking living labour, and lives the more, the more labour it sucks. (Marx, 1867/1976: 342)

The administration of Bolesław Bierut—who controlled Poland as president and later as president *and* party leader from 1947 until his death in 1956—made its own attempts to absorb surplus labour.<sup>5</sup> Thus:

One of the first acts of the communist government was to increase the work week from forty to forty-six hours. New directives gave management sweeping powers in the workplace—in particular, harsh punitive measures aimed at those who shirked work. The Labor Discipline Act of 1950 codified the imposition of disciplinary action, a wage cut, and/or transfer to a lower-paid job for an unjustified one-day absence. State-defined "social parasites" were subject to administrative assignment to two years' compulsory labor anywhere the state thought necessary. Management was freed of interference not just from unions but from labor courts, which were abolished in 1950 and replaced by management-controlled review boards. (Ost, 1996: 33)

As the historian Padraic Kenney put it, the 1950 law on work discipline "marks the official beginning of the open battle with worker crime and the dawn of Stalinism in the factories" (Kenney, 2012: 206). Though drunkenness and leaving the workplace during the day were also addressed, the focus of the law was absenteeism.

Just as production targets focused on weight, employment targets focused on hours. In other words, planners attempted to maximize labour inputs, not labour outputs. The law "virtually ignored workers' behavior during work" (Kenney, 2012: 206). This meant that

many were employed without doing much work. A worker who missed four days of work in a year could be subject to criminal prosecution. The standard punishment was 10 to 15 percent of pay for one or two months. “In just seven months in 1950, 42,443 workers were convicted under the law; this represented 21 percent of *all* convictions in Poland that year” (Kenney, 2012: 206). Though the socialists could boast that there was very little unemployment in socialist Poland, this is mostly because unemployment was illegal.

### Urbanization

The push to industrialize altered the Polish landscape. Poland experienced a massive wave of urbanization as Poles increasingly moved away from their rural homelands to cities. By the end of the 1960s, for the first time in the history of Poland, more than one-half of the population was living in urban areas, illustrating the new significance of urban workers in the economy. During the next decade the trend only strengthened, with the industrial sector employing 40 percent of the workforce and the agricultural sector employing 30 percent of the workers (Koryś, 2018: 288).

Urbanization was partly encouraged by the agricultural reforms. In an effort to win the sympathies of the peasants and small landowners, the regime collectivized all estates over 100 hectares and parceled them out to farmers with either smaller plots or to those without land altogether. No compensation was given to those farmers whose land was seized. Authorities faced severe backlash from agricultural groups and the rural population. This backlash was strengthened by the support of the Catholic Church. Collectivization helped accelerate the decline in agricultural production, and this, in turn, put at risk the state’s ability to maintain enough industrial production in the cities. As a result, the government eased the pressure on the rural population and allowed both collective and private farms to co-exist. This made agriculture one of the few bastions in which private enterprise was permitted, although, as noted below, private farms remained at a disadvantage due to the lack of access to capital markets and due to the allocation of state funds to collectives.

### The Polish October

The Man of Steel, Joseph Stalin, suffered a stroke on March 1, 1953, and died four days later. Once he had eliminated and sidelined his rivals, Nikita Khrushchev became the new leader of the Soviet Union and began to pursue a softer approach to governing.<sup>6</sup> This new approach was famously signaled by Khrushchev’s “Secret Speech” of February 25, 1956, in which he exhaustively recounted and denounced Stalin’s crimes.<sup>7</sup> The speech had an immediate impact in Poland where the Stalinist leader, Bolesław Bierut, read it on March 12 and died of a heart attack (Gaddis, 2006: 131).

At the same time, public anger with socialist leadership was beginning to boil over. Shortages were endemic to the Polish socialist economy.<sup>8</sup> And these shortages often lead to violent protests and regime change. Angry over stagnant living standards, continued Soviet dominance, and persistent shortages of food and other necessities, rioters took to the streets of Poland in the spring and summer of 1956. These protests would prove to

be the most important resistance to the communist regime up until the Solidarity protests of 1981 (Machcewicz, 1999).

Initially, the Polish government responded with violence. Several dozen protesters and innocent bystanders—including at least one child—were massacred by government authorities when 100,000 protesters gathered in June in Poznań. But as one historian put it, the communist government’s violent reaction soon “turned to nervous sensitivity about the real state of public opinion, which the censored media so strenuously concealed” (Machcewicz, 1999).

Bierut’s death had weakened the hardline communist faction in Poland and in what came to be known as the Polish October or Polish Thaw, the Soviets permitted Władysław Gomułka, a once-jailed leader of the moderate faction of the Party, to take control of the country in October of 1956. Though a committed communist and central planner, Gomułka permitted some liberalization. For example, he repealed the draconian labour discipline laws that Bierut had adopted, though employment remained mandatory for all able-bodied persons 18 years or older (Ost, 1996: 33; Inglot, 2008: 153).

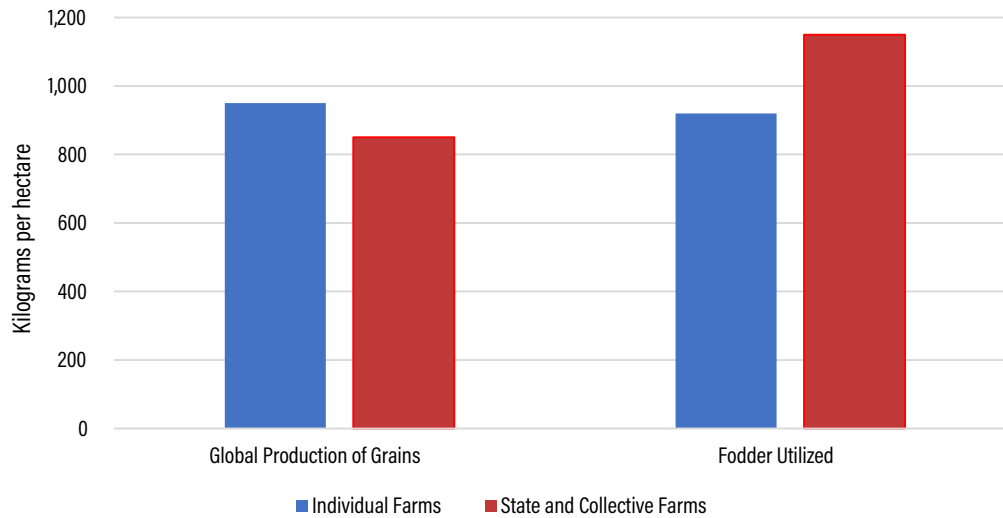
And importantly, he allowed private agriculture a place in the socialist order (Kemp-Welch, 2006). Kozminski (1997: 95) estimates that near the end of the socialist regime, over 85 percent of agricultural land was private. In 1980 16.6 percent of GNP was produced by the private sector, and 11.1 percent of it by private agriculture. On the eve of Poland’s transition in the late 1980s, private activity produced about 19 percent of GNP, with agriculture accounting for half of it (Kozminski, 1997: 95). Thanks to Gomułka and the Polish October, private agriculture would play a much more significant role in Poland than in any other nation in the communist bloc.

The decision to allow private farms did not signal the abandonment of the idea of nationalized agriculture. It was a pragmatic response to low agricultural outputs at the time. And it allowed the country to avoid the devastating famines that seem to be so common in socialist regimes (Zycher, 2016). Even in this case of relative liberalization in which markets for agricultural produce were permitted, private farms were constrained along multiple dimensions. Prices were set administratively, and the state was the main buyer of produce. Furthermore, farmers had to meet mandatory sales quotas, while the bureaucracy rationed inputs used in the production of agricultural produce (Kochanowicz, 2015).

All firms require access to credit markets in order to hedge against risks and to bridge the gap between the time when an investment is made and profits are earned. This is especially true in the seasonal and risky enterprise of farming. In Poland, however, private farmers’ access to credit was limited due to prohibitions on private financial institutions and due to the fact that state credit was channeled to favoured collective farms.

Other policies explicitly aimed to stymie the growth of private farming. As one scholar put it, “the Polish bureaucracy tried to limit the expansion of small-scale [private] farming as much as possible. Land turnover was very restricted right up to the early 1980s, and so were purchases of means of production and sale of produce. Consequently the ‘private’

Figure 2.5: Individual vs. State and Collective Farm Productivity in Poland in 1980



Source: Hirszowicz, 1986: 78.

Polish farms remained backward and poor” (Mizsei, 1992: 286). So private farms generally conducted their work on small and scattered fields, resulting in mostly subsistence farming with outdated technologies.

Still, as Figure 2.5 shows, despite their disadvantages, private farms managed to obtain higher yields with fewer inputs than their state and collective counterparts

As we will soon see, however, Gomulka was less interested in reforming the process of central planning.

### The central planning process

The Polish economic system revolved around the communist Polish United Workers’ Party which set policies and goals for the entire country (Pajestka, 1964). The Planning Commission formulated the plans, although other bureaucratic agencies such as the Council of Ministers, the Economic Committee, and the Economic Council also took part in the process (Montias, 1974).

Plans were developed in several major steps. First, the Planning Commission issued directives for plan articulation. These entailed the formation of a preliminary yet comprehensive plan for the economy, including decisions on the allocation of the most important resources (Montias, 1974; Pajestka, 1964). During the plan articulation phase, the Planning Commission estimated the desired output in terms of the aggregate volume of goods to be manufactured throughout the plan’s timeline by the main sectors of the economy (heavy industry, agriculture, chemicals, automotive, etc.). The plan also included an outline of how the goods were to be used and the appropriate distribution of raw inputs and semi-finished materials across industries. The plan incorporated assessments of the



necessary labour hours and wages to be paid for different kinds of work. Aiming to imitate the market process, the agency added investment targets, and goals for innovations, new technologies, and the use of the new inventions (Kornai, 1992).

It was an immensely complex task to determine the production patterns and strategies for millions of items by thousands of different firms throughout the economy. At the second stage, the Planning Commission had to disaggregate the production plans to direct the entities below in the hierarchical top-down bureaucratic structure. Thus, there was a breakdown of the production quotas to the responsible ministries, with each ministry further delegating the assigned figures to the agencies, factories, and farms they oversaw. Ultimately the production quotas reached the firms' superiors, who then sent their feedback and suggestions back to the upper agencies (Kornai, 1992). Based on this feedback on the original plan, the commission then amended the National Economic Plan, which upon approval by the Council of Ministers was promulgated and used to draw the final details for the associated agencies and ministries (Montias, 1974; Pajestka, 1964).

Consistent with the economic theories discussed in the previous chapter, the state had to erect a vast apparatus of suppression to deal with the control problem inherent to central planning. They created a secret service, the "Bezpieka," that employed 34,000 people by 1952 (Paczkowski, 1999: 381). The Bezpieka, in turn, relied on a network of 26,000 informants, turning Pole against Pole (Paczkowski, 1999: 381). In 1945, the government established the Special Commission for the Fight against Economic Abuses and Sabotage (Paczkowski, 1999: 381-82). It had a wide remit, enforcing production quotas and policing "hooliganism." But it also prosecuted Poles for speculation and black marketing. Between 1945 and 1952, 84,200 Poles were sent to forced-labour camps for these "crimes" (Paczkowski, 1999: 382). By 1952, the country had 49,500 political prisoners (Paczkowski, 1999: 382).

While the control problem loomed large in the early years of Polish central planning, neither the incentive problem nor the knowledge problem was especially noticeable at first. Following the devastation of World War II, early central planners focused on rebuilding the nation's capital stock. And as the Solow growth model predicted, this catch-up growth was quite rapid. Though the Polish economists have been criticized for their statistical methods and though official growth figures were likely exaggerated, historians generally believe that the Polish economy grew rapidly at the end of the 1940s and early 1950s (Hunter, 1986: 301; Erlich, 1959: 95).

However, in time, both the knowledge and incentive problems began to undermine the system's productivity and stability. Because prices, profit, and loss did not emerge from the free choices of market participants, central planners had no way of knowing what workers thought about different employment options or how consumers thought about different purchasing options. Without this information, the central plan was nothing more than guesswork.

These knowledge problems were made worse by the fact that information generally moved in a top-down direction. While subordinate entities could send amendments and suggestions to their superiors and could also coordinate with other agencies through horizontal interaction, the disaggregation of the economic plan was in essence a command rather than a request for suggestions. This was, in many ways, inevitable because superiors had the authority to make life-altering decisions for their inferiors and so inferiors were understandably reluctant to question decisions that came from the top (Mises, 1944/2007; Tullock, 1965).

It is also important to note the kind of information that planners used in the process of creating and disseminating production plans. In the absence of a market-based price system that distributes knowledge to market participants and hence allows them to coordinate their actions, central planners had to rely on the accumulation of massive and unmanageable amounts of data that agencies and firms had collected. The planners' data included targets for long-term plans, current performance statistics, and summary balances of the national economy. It also included preliminary forecasts of growth in national income, consumption, investments in fixed capital, and inventories for the future year (Montias, 1974; Pajestka, 1964). They had to pay particular attention to the structure of investments and labour supply in order to attempt to make plans consistent over time.

In the wake of the Polish October, there may have been an opportunity to mitigate some of the knowledge problem, but it was squandered. The official notes of the 7th Plenary Session of the Polish United Workers' Party in July of 1956 included the following admission:

In the course of the implementation of the Six Year Plan, an excessive centralization of the planning and administration has taken place, as well as an excessive growth of the state apparatus... and the bureaucratization of the methods of leadership. These phenomena have hampered the initiative of the masses... have caused waste and have retarded technical progress and economic expansion in general. (Hunter, 1986: 303)

One might have expected the moderate Władysław Gomułka to address some of the problems when he came to power that October. And the prospects for change were especially bright after the Polish economist Oscar Lange became the head of the newly created State Economic Council. Lange was a thoroughgoing socialist. But he had read Mises and took his critiques seriously. Lange believed that the knowledge problem could be overcome by incorporating market pricing tools within the socialist framework. He even went so far as to proclaim that Professor von Mises deserved a marble statute in the halls of the future Central Planning Board (Hayek, 1945: 529).

The State Economic Council, under Lange's leadership, recommended that the economic structure be decentralized, permitting factories and enterprises to make decisions regarding investment and new production. They also recommended that private enterprise be permitted in retail trade, handicrafts, services, and small-scale production. Though Lange's

ideas were adopted in Hungary (where they permitted higher levels of economic growth), they were thoroughly rejected by the Gomułka regime in Lange's native Poland.<sup>10</sup>

Hence, at the height of the socialist regime in the 1950s, '60s, and '70s, the main instruments for the coordination of economic activity in Poland were government plans informed by statistics that did not necessarily reflect the subjective preferences of the Polish people. Prices for producer and consumer goods produced by state firms (that is, a vast majority of goods) were set centrally by the planning authorities.

### **Biased prices and the shortage economy**

In setting prices for producer goods the planning authorities relied on three main principles (Kornai, 1992: 149-55). First, prices were supposed to reflect socially necessary costs of production. In practice, this meant that the firm was supposed to earn a normal profit after it made other payments to the budget.<sup>11</sup> For ideological reasons, firms were not allowed to count the cost of using land or capital and they were required to rely on average instead of marginal costs. This often meant that prices were not high enough to cover actual marginal costs and firms often lost money and needed to rely on the state for assistance (see the section below on soft budget constraints).

The second principle called for using prices to encourage specific production processes. For example, if planners wanted firms to use a certain agricultural input, its prices would be set artificially low. But since the public firms could almost always receive more funds from the state, they were not responsive to these signals.

Finally, the third principle of price-setting called for stable prices. The requirement of stable prices had nothing to do with economics and was desirable purely for political reasons. The planners were afraid that inflation would erode consumers' purchasing power and lead to political demonstrations and demands for change (Montias, 1974: 151). As a result, the planners strived to leave prices unchanged for long periods of time. The final principle clearly contradicted the first two because it prevented prices from adjusting to changed costs and technologies.

These mutually contradictory goals ensured that prices failed to convey useful knowledge. As Kornai explained:

One function of price in market coordination is to convey information in a concise form on the relative scarcity of resources and products. No such information is conveyed by the prices here described. In fact, they impart almost no useful information at all, as it is almost all lost in the conflict between the disparate pricing principles. In other words, the relative prices emerging under the classical [socialist] system are arbitrary and irrational. (Kornai, 1992: 151-52)

Though unstated, an important function of centrally-determined producer prices in Poland was to "create the weighting system needed for arriving at the aggregate volume

indicators” (Kornai, 1992: 152). Hence prices became accounting tools for the generation and maintenance of the centrally-developed plan. They were not, as in a market economy, genuine signals of how consumers and producers hoped to realize their *own* plans based on their own preferences. Nor did prices create the sorts of incentives that they do in a market economy. They did not encourage workers or firms to direct their efforts in ways that create value for consumers or to economize the use of resources, including human resources (Piatkowski, 2018).

The Planning Commission fixed prices for most raw materials, investment goods, semi-fabricated goods, export articles, industries’ by-products, transportation, water, gas, and other services. In those instances where the Planning Commission did not set producer prices, this price-setting authority was delegated to regional ministries and organizations. The guiding principles for consumer goods pricing included all of the above principles, but also incorporated two additional principles. First, the planners set consumer prices to direct consumer preferences in accordance with what planners thought was best for the people. This manifested the regime’s paternalistic nature and disregard for the subjective wishes of the people. Second, prices were set to encourage income redistribution. Thus, officials set higher prices and/or imposed higher taxes on luxury goods.

The Planning Commission’s counterpart in the consumer market was the State Planning Commission. It set all retail prices for consumer goods, including procurement prices for compulsory deliveries of food, medication, and other goods (Montias, 1974). Piatkowski captured the result of such a system well:

Prices largely lost their relation to the inherent value or costs of production. Distorted prices led to [a] large misallocation of resources into low-return heavy industry rather than high-return consumption-oriented industry. They also blunted incentives for technological progress by keeping the potential rents from innovation low. Centrally set prices also removed information inherent in market-based prices about the changing patterns of demand and ensured that the structure of production was increasingly removed from demand. (Piatkowski, 2018: 87-88)

As we discussed in the previous chapter, the knowledge problem predicts that planners will not be able to set prices correctly. And as we have just seen, this challenge was compounded by price-setting principles that often conflicted with one another. By themselves, these problems suggest that prices might be too high or too low and that there might be surpluses or shortages. The incentive problem predicts, however, that consumer prices are more likely to be set too low than too high. This is because if prices are below the market-clearing equilibrium, shortages will emerge and these shortages allow local bureaucrats to obtain bribes from rationed customers (Levy, 1990; Shleifer and Vishny, 1991). Central authorities were happy to accommodate these local bureaucrats because they perceived high prices to be politically unpopular and because they were happy to purchase the cooperation of local authorities. As a result, socialist economies were shortage economies (Kornai, 1980). This meant that the typical Pole (though, as we will see,

not the elite) often went without basic consumer goods, had to wait weeks and even years to obtain certain items, and grew accustomed to paying bribes or pilfering from their apartments or places of employment.<sup>12</sup>

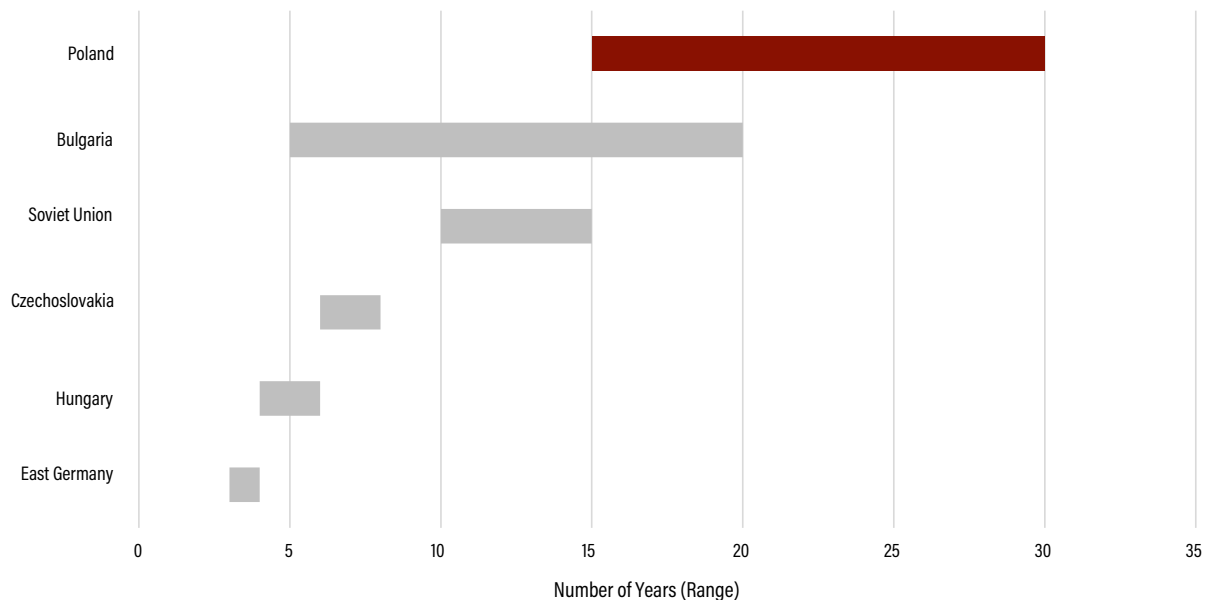
Figure 2.6 shows the range of wait times for housing in socialist countries in the 1980s. Poles waited between 15 and 30 years to obtain housing. And when they finally did, it was often poor quality. Clark and Wildavsky describe a large housing complex outside of Gdańsk in the late 1970s:

All of the several hundred units in the complex were occupied by one family or more, even though more than half of the flats did not have hot water, and many did not have running water or electricity. None of the flats had telephones. In fact, the only phone within a half mile was a pay phone outside the complex that had not worked for years. (Clark and Wildavsky, 1991: 144-45)]

Figure 2.7 shows the number of people waiting for telephone service for every 100 subscribers. Not only were there more people on waiting lists in socialist countries than in capitalist countries (in most capitalist countries there was no wait at all), but the trends were moving in opposite directions. In the early 1970s, for every 100 telephone subscribers in Poland, there were another 34 people waiting for service. By the 1980s, there were 57 Poles waiting for service for every 100 subscribers.

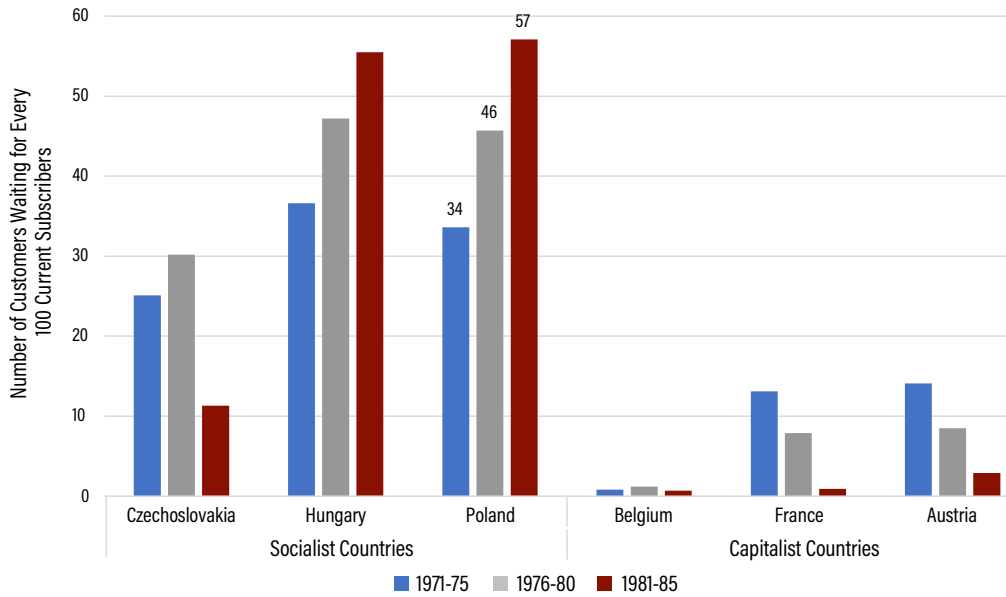
Figure 2.8 shows the number of main telephone lines per 100 people in socialist and capitalist countries in 1986. Poland had only 7 main lines per 100 inhabitants while capitalist countries averaged about 24 lines per 100 inhabitants.

**Figure 2.6: Waiting for Housing in the 1980s**



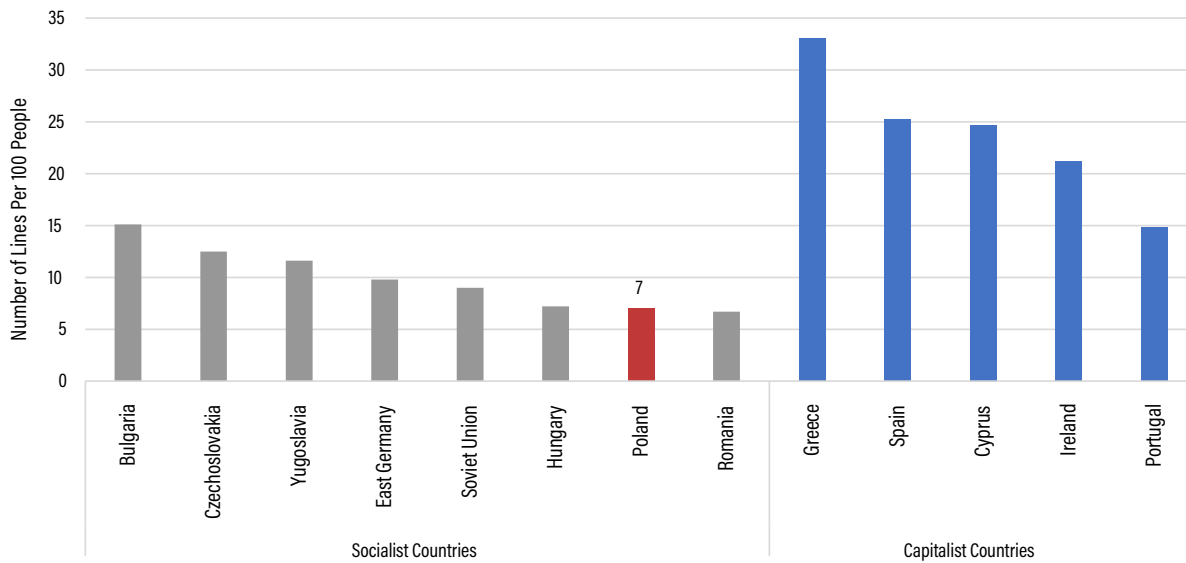
Source: Kornai, 1992: 234, table 11.2.

Figure 2.7: Number of Customers Waiting for Telephone Service



Source: Kornai, 1992: 235, table 11.3.

Figure 2.8: Main Telephone Lines Per 100 Inhabitants, 1986

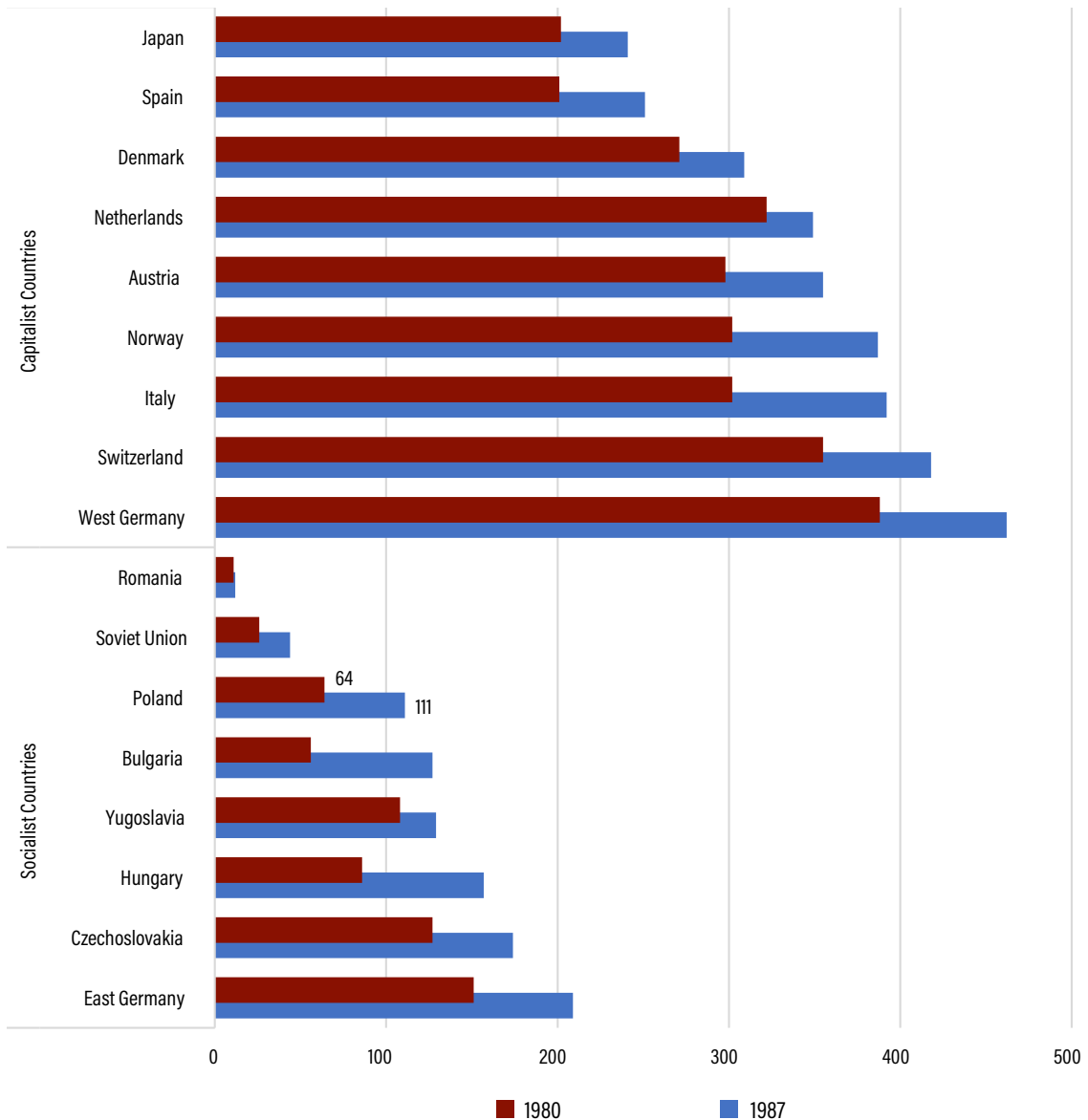


Source: Kornai, 1992: 304, table 13.2

Figure 2.9 shows a similar pattern with cars. In 1980 there were just 64 cars for every 1,000 Poles while in the typical capitalist country there were nearly 300 cars for every 1,000 people. By 1987 there were 111 cars for every 1,000 Poles, while in the typical capitalist country there were more than 350 cars per 1,000 people.

Unsurprisingly, certain cultural norms emerged to deal with the shortage economy. Pregnant women, for example, were often given priority in food queues. Clark and Wildavsky recount the emergent phenomenon of queuing committees. Rather than wait in line for

Figure 2.9: Number of Cars Per 1,000 People, 1980 and 1987



Source: Kornai, 1992: 305, table 13.3.

weeks on end for a refrigerator, customers would spontaneously organize committees and take turns waiting in line for one another. Twice a day (at, say, 10 a.m. and 9 p.m.) anyone who wanted a refrigerator had to show up. If a person wasn't there when his or her name was called out, the name would be struck from the list. In between these times, a smaller set of customers would stand guard, waiting in line for 3 hours a night, every third night. This smaller contingent needed to have at least 18 men or so to prevent thugs from jumping the queue. Occasionally, such a coup would occur, however. "Those who have not spent three hours every third night on refrigerator duty may have trouble empathizing" (Clark and Wildavsky, 1991: 142-43). This sort of waste is precisely what Tullock had in mind when he described the social cost of rent seeking.

Ironically, the shortage economy encouraged the commodification that Marx and his followers decried. For example, consumers hoarded items that were in short supply and speculated in items that might be. When the zloty lost value, items that were in short supply such as vodka, chocolate, or ham, were used as currency. As one Pole sardonically put it in the 1980s:

I'm into toothpaste futures. I take the view that in the whole history of the world there has never been a recorded case of a nation rioting over a lack of toothpaste. Accordingly, toothpaste must have a low priority in the office of the planning ministry. So I tell everyone that comes to see me from the West "bring me nothing else but toothpaste." With toothpaste I live like a king. It has proved to be a much more solid and reliable currency than the Polish zloty! (Clark and Wildavsky, 1991: 135)

### **Incomplete capital markets**

Ideally, economies develop through capital markets that turn savings into useful investment, labour markets that encourage the productive division of labour and the acquisition of useful skills, management systems that efficiently organize economic activity, and entrepreneurship that drives change. But under central planning, without the signals and incentives of a market-generated price system each of these engines of economic development is significantly handicapped.

Consider private capital markets, which were essentially non-existent in Poland, as the planning authority was responsible for directing investments into specific projects and industries with the aid of nationalized banks that facilitated the dispersal of financial resources (Montias, 1974). The investments in a specific year were determined by the long-term plan and current projections of growth. These investments were generally directed at the capital goods industry and heavy industries, especially steel, chemistry, and coal, at the expense of the consumers' desires (Piatkowski, 2013). The few, predominantly agricultural, private firms that did exist were deprived of financial resources available to state firms, thereby constraining private firms' abilities to compete with state companies. As the reform-era minister of finance, Leszek Balcerowicz, put it decades later, "the range of financial assets available to enterprises and individuals was extremely limited, as a market-type financial system could not have coexisted with central planning" (Balcerowicz, 2002: 29).

### **Incomplete division of labour**

In a similar vein, central planning did a poor job of orchestrating the efficient division of labour. The authorities could not exert direct control over the allocation of labour in specific industries, except in cases where technically trained specialists were assigned to particular projects. But the state used indirect means such as wages, regulation of purchasing power, and other material benefits that gave workers the incentive to take on certain jobs (Montias, 1974). For instance, it was widely known that cities with strategic



(often military) facilities received a wider variety of better-quality consumer goods, hence creating competition among workers for jobs in these locations.

For ideological reasons, pay gaps were not allowed to be significant. For instance, according to one report, “the earned income of a factory director is barely three times that of a female dairy worker, a miner is better paid than a chief medical officer and a lawyer is well below a train driver” (Asselain, 1987: 33). While these relatively narrow ranges scratched the ideological itch for equality, they offered workers little incentive to acquire expensive training or skills.

And since factories so often found that they couldn’t obtain the right parts, or parts that were in working order, they often had to resort to making these themselves. As Clark and Wildavsky explain, “A basic reason behind the inefficiencies of command economies is that so many factories are forced into making things that are supposed to be supplied to them. The advantages of specialization are lost along with many other things” (Clark and Wildavsky, 1991: 157).

### **Negotiating with ministerial lobbies**

Since the planning authorities determined firms’ production processes, the incentive structure encouraged intensive bargaining between the bureaucratic entities, further undermining the efficient use of productive resources and making it difficult to satisfy consumer demands. Given the allotted inputs, firms were expected to produce their assigned output targets, and faced the possibility of punishment if they failed.

The socialist system encouraged managers to report lower than actual output capacity. This allowed them to receive a lower production target and to request higher-than-necessary quantities of inputs which they could then sell on the black market. This strategy reduced the risk that managers would fall short of the plan, allowing them to avoid punishment and increasing their chances of receiving a bonus (Kornai, 1992). It was a common tactic. As one scholar has put it, the one rule that operates no matter what is: “the lower the targets of the plan... the more means for its realization are available” (Hunter, 1986: 301).

As the knowledge problem became more pronounced over time, so too did the incentive problem. And these problems, in turn, exacerbated the pathologies of privilege. Consider Brada and Montias’s 1984 study of the Polish leadership’s attempt to encourage specialization in the late 1960s. In March of 1968, Gomułka delivered the keynote address at the Central Committee’s meeting, telling the attendees that “smaller countries, even the more developed among them, must specialize their production” (Brada and Montias, 1984: 386). Planners were ordered to draw up a list of export industries in which Poland should specialize. This kicked off an intense scramble among privileged industries, bargaining with one another and with the planners to make the list. When the final list of “specialized” exporters was published, it included 17 industries, together representing 60 percent of all output in the Ministry of Heavy Industry and 65 percent of all output

of the Ministry of Machine Building (Brada and Montias, 1984: 388-89). Consistent with Olson's thesis, as time went on, ministerial lobbies found it easier to overcome their collective action problems and grew better at seeking privileges.

Władysław Gomułka, like Bierut before him, was forced from power when economic unrest turned to protest, and protest turned to deadly confrontation with the Polish army.<sup>13</sup> (A young electrician named Lech Wałęsa witnessed the army fire on striking workers at the Gdańsk shipyard in 1970 and it no doubt left an impression (Gaddis, 2006: 255)). Gomułka left office in December 1970, replaced by Edward Gierek.

Gierek also had to bargain with the ministerial lobbies. He was especially solicitous toward the military industrial complex with its well-known links to Moscow (Brada and Montias, 1984: 391-92). As Brada and Montias summarize their research:

Even a casual analysis of this experience should put to rest the notion that, in such planned economies, "whatever the center wants it gets." What actually happens is the outcome of a complex bureaucratic process in which lower organs exert nonnegligible counterpower. (Brada and Montias, 1984: 417)

The leaders, meanwhile, grew less secure as one regime after another was toppled by protest and civil unrest. Thus, the leaders increasingly behaved as roving bandits instead of stationary bandits. That is, their incentive to maximize society's long-term growth rate grew weaker as their grip on power grew less secure (Olson, 1993). In order to maintain power, leaders offered more and more privileges to party and managerial elite, cultivating what Ginny Choi and Virgil Storr (2019) have called a "culture of rent seeking," which we will discuss at length below. As one scholar has put it, "it is well known that the market does not yield to the pressures of group interests like central command planning did" (Kolodko, 1989: 65).

As Murrell and Olson's theory predicted, these concessions to special interests carried an economic cost. In their own empirical analysis, Murrell and Olson point to the fact that centrally planned economies achieved high levels of catch-up growth in the early postwar period but that their performance deteriorated over time compared to that of market economies (Murrell and Olson 1991, 239). In a more precise test of the hypothesis, Roger Faith and Nancy Short find that increasing bureaucratic tenure in Czechoslovakia and Hungary had an adverse effect on technical efficiency (Faith and Short, 1995). And in his study of Poland's unfolding economic crisis in the late 1970s and early 1980s, Montias places the blame squarely on special interest lobbies.

The "ministerial lobbies," as they are now called, successfully pressed for more investments and more imports for the enterprises under their direction long after it had become obvious that increases in either would have nefarious consequences for the economy. (Montias, 1982: 12-14)

## Soft budget constraints

Another source of inefficiency was soft budget constraints (Kornai, 1986; Boettke and Candela, 2021; Vahabi, 2021). Under a hard budget constraint, a firm must cover its costs using revenue or capital raised through markets. If it fails to do so, it will go bankrupt. Under a soft budget constraint, however, the firm need not raise revenue or capital to cover its costs because it expects the government to cover its losses. In socialist systems, nearly every firm faced a soft budget constraint.

To better understand the consequences of soft budget constraints, we need to briefly discuss the fundamental idea of resource scarcity. Despite boundless human desires, life on Earth is characterized by limited resources. This means that we are forced to carefully select among alternative ways to use our resources (including our human resources) so that we can gain the most at the least sacrifice.

Over the long run, organizations and projects that fail to use their resources wisely will fail to thrive and may even fail to survive. When an organization faces a hard budget constraint, it confronts this reality. In a market order, firms that employ their resources wisely are rewarded through higher profits, while those that fail to use their resources wisely will incur losses, and in the worst case, will have to liquidate their assets. The assets, of course, do not disappear. Instead, they can then be reallocated to better uses.

Though scarcity and failure are facts of life, socialist planners effectively ignored them. As Kornai put it, “Failure, in the true sense of the word, is impossible” (1980: 194). As a result, firms in socialist Poland did not expect to go bankrupt when their costs exceeded their profits. Instead, their survival depended on the favour of the bureaucratic authorities, who had a different criterion for the entities’ survival: the fulfillment of predetermined output targets (Kornai, 1992). And since the fulfillment of the plan was an essential goal, the state allowed sustained losses on the part of some firms and consistently granted subsidies to keep them afloat. As Clark and Wildavsky put it, “a command economy generates so powerful a nexus of interests around its industrial programs that it is not possible to allow factory complexes to decline, only to feed them with ever greater doses of resources” (Clark and Wildavsky, 1991: 112).

Kornai eloquently captured the phenomenon:

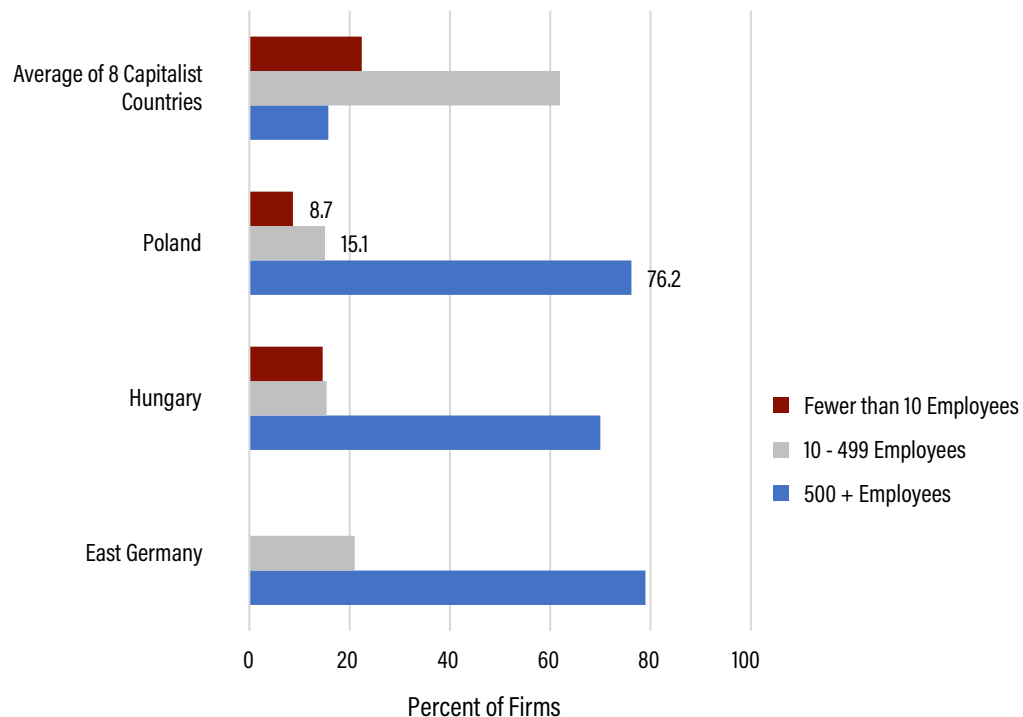
Whether profitable or loss-making, this did not affect an enterprise’s subsequent operation or development. Losses were either covered automatically, or its administratively controlled prices would be adjusted from time to time to its costs. What was demanded above all from existing SOEs [state-owned enterprises] was fulfillment of its production plan. Investment decisions prescribed firstly what capacity was to be created and when production was to begin; expected profitability did not play any essential role. There was of course a cost target, but exceeding it was ignored. What was punished was late completion of the new facility (Kornai, 1986: 35).

When the government extended credit to firms, the Polish Bank typically accommodated it, increasing the money supply and causing inflationary pressure (Crane, 1988: 9). Thus, while official prices tended to be kept below the market-clearing rate, real prices on the black market were pushed higher, giving rise to a phenomenon that some have called “shortageflation” (Kolodko and McMahon, 1987).

The effects of the state-sponsored soft budget constraint on the allocation of resources were predictable. On the one hand, inspired by the output targets and dictates of the bureaucratic apparatus, input demands from firms soared, often beyond the quantities necessary for the actual production. Yet these inputs could have been used more productively in some other ventures, leaving activities that the central planners undervalued starved of capital. On the other hand, because unprofitable firms never had to reckon with their unprofitability, they had little incentive to improve their manufacturing processes. This adversely affected both the quantity and quality of output.

The problem got worse over time as the least profitable industries in Poland received the most financial support and attracted the most workers, siphoning resources away from more profitable enterprises (Feiwel, 1971: 279-81; Crane, 1988). And if the experience of Hungary is any guide, firms with the most political clout (as measured by the size of fixed assets and employee involvement in the party) received the most aid (Winiiecki, 1989). Figure 2.10 illustrates one consequence: Large firms dominated socialist economies. While construction firms with 500 or more employees were only about 16 percent of the

Figure 2.10: Distribution of Construction Firm Sizes in about 1980



Source: Kornai, 1992: 400, table 173.

industry in capitalist economies, they represented over 70 percent of the industry in Poland and other socialist countries.

As we will see, the results of the soft budget constraint were well illustrated during the period of the transition from a socialist to a market-based economy, when many firms with negative value-added production went bankrupt in the absence of state-supplied loans and subsidies. That is, the value of the inputs that these firms used was higher than the value of their outputs, indicating inefficient production. As we will discuss in chapter 5, when they finally faced competitive pressures after reforms in the 1990s, many of these firms went bankrupt.

### Foreign trade and foreign debt

As discussed above, Edward Gierek succeeded Władysław Gomułka in late 1970 following the violent suppression of protests over economic conditions. Gierek believed that Gomułka's regime had been too inward-looking and "self contained" (Hunter, 1986: 305). He and his team wanted to increase both investment and consumption, and they believed the way to do so was to open the economy to foreign trade and to reestablish economic relations with the West (Hunter, 1986; Brada and Montias, 1984). Leveraging his personal relationship with Soviet leader Leonid Brezhnev, Gierek was permitted to reach out to the West, establishing good relations with the leaders of France and Germany and opening trade between Poland and Western countries (Jerzy, 2014: 255-85).

Gierek promised to build a "second Poland," that is, to double the size of the economy. In the early 1970s, Polish exports increased at an average of 10.7 percent per year while imports increased at an average of 15.4 percent per year; most of the increase came from the West (Hunter, 1986: 305). Meanwhile, the Gierek regime built new factories that turned raw imports from the West into finished goods. At first, the strategy seemed to pay off. Real growth exceeded 6 percent per year in the early-to-mid 1970s (Hunter, 1986: 299). The growth fed the ever-present investment hunger, allowing the state to build more factories in Gierek's home region of Silesia. The regime constructed the nation's first modern highway and embarked on an ambitious plan to address the nation's housing shortage by building millions of new apartments (Browns, 1974).

But the growth was not sustainable. Unfortunately, most of the trade deficit was financed through the accumulation of foreign debt which rose from almost nothing in 1970 to \$29.3 billion by the end of the 1970s (Hunter, 1986: 299). The cost of servicing that debt rose from 27 percent of export income in 1974, to 43 percent in 1975, and to 70 percent in 1980 (Clark and Wildavsky, 1991: 117). This unsustainable debt-servicing burden began to crowd out imports of consumer goods as well as imports of semi-finished goods and raw materials. Those factories that had been built to finish imported raw materials found it difficult to stay open (Slay, 1994: 43).

By the late 1970s, the economy was collapsing under the weight of this foreign debt. Economic conditions worsened, food shortages once again reemerged, and the ambitious

housing plan proved a failure (Hunter, 1986: 299). By the end of the decade, the number of housing units per household was lower than it had been at the beginning (Mayo and Stein, 1995). At the same time, the pathologies of privilege grew more evident. As Clark and Wildavsky put it: “A ‘Second Poland’ was built with the money borrowed, it is true, but it was a Second Poland of lavish estates and Swiss bank accounts for the party elite” (1991: 312).

In a familiar cycle, the once-popular Gierek was removed by the Central Committee in September 1980.

### **Black markets**

There is yet one more sense in which the term “Second Poland” could be employed. In light of their inability to deliver “to each according to his needs,” socialist systems inevitably give rise to “parallel” or “second” economies (Katsenelinboigen, 1977; Grossman, 1983; Treml and Alexeev, 1997; Murphy, Shleifer, and Vishny, 1991).

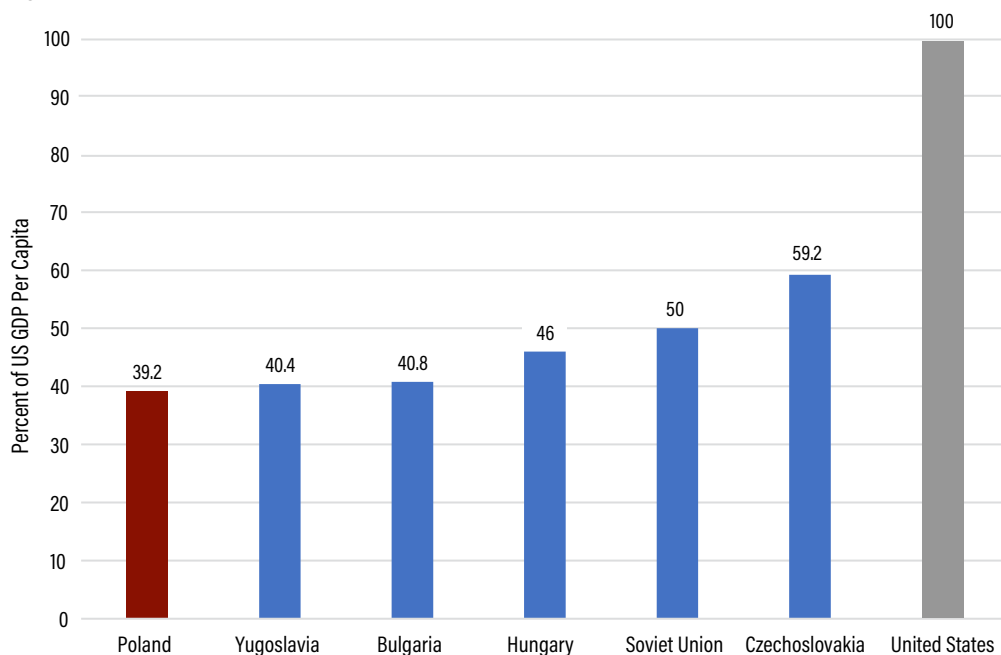
The state adopted an ambivalent, and at times contradictory, approach to the second economy. On the one hand, it attempted to suppress it. As discussed above, the Special Commission for the Fight against Economic Abuses and Sabotage fought back, arresting black marketers (Paczkowski, 1999: 382). On the other hand, it tolerated some degree of “benign plan violation” since it would be impossible to fulfill the plan without going outside of it (Wiles, 1982). The irony, as we have described, is that black markets held the socialist system together since the only way for managers to internalize profit was to sell rationed goods on the black market (Levy, 1990; Shleifer and Vishny, 1991). Though this helped address the control problem by securing the loyalty (or at least quiescence) of local managers, it encouraged a culture of corruption and contributed to disillusionment.

The black market in currency also contributed to this disillusionment. Since the Polish National Bank was willing to monetize the debt, the zloty was seen as worthless. As a result, “Nothing worthwhile, from apartments to cars to travel, [could] be bought without foreign currency. The zloty is devalued not only nominally but as a sign of national autonomy” (Clark and Wildavsky, 1991: 14). As a sign of their contempt for their own currency, Poles came to refer to foreign currency—which kept its value—as “hard currency.”

### **Stagnant living standards**

As the years of socialist rule wore on, the immiserating effects of socialism exposed the glaring inability of the system to achieve its promise of banishing want from the human experience. Simply put, central planning failed to deliver an adequate quality of life. Consider Figure 2.11. It shows per capita production in six socialist countries as a share of US per capita production in 1985. Only in Czechoslovakia was per capita production more than 50 percent of US per capita production. In Poland, per capita production was less than 40 percent of US per capita production.

Figure 2.11: GDP or GNP Per Capita As a Share of US GDP Per Capita, 1985



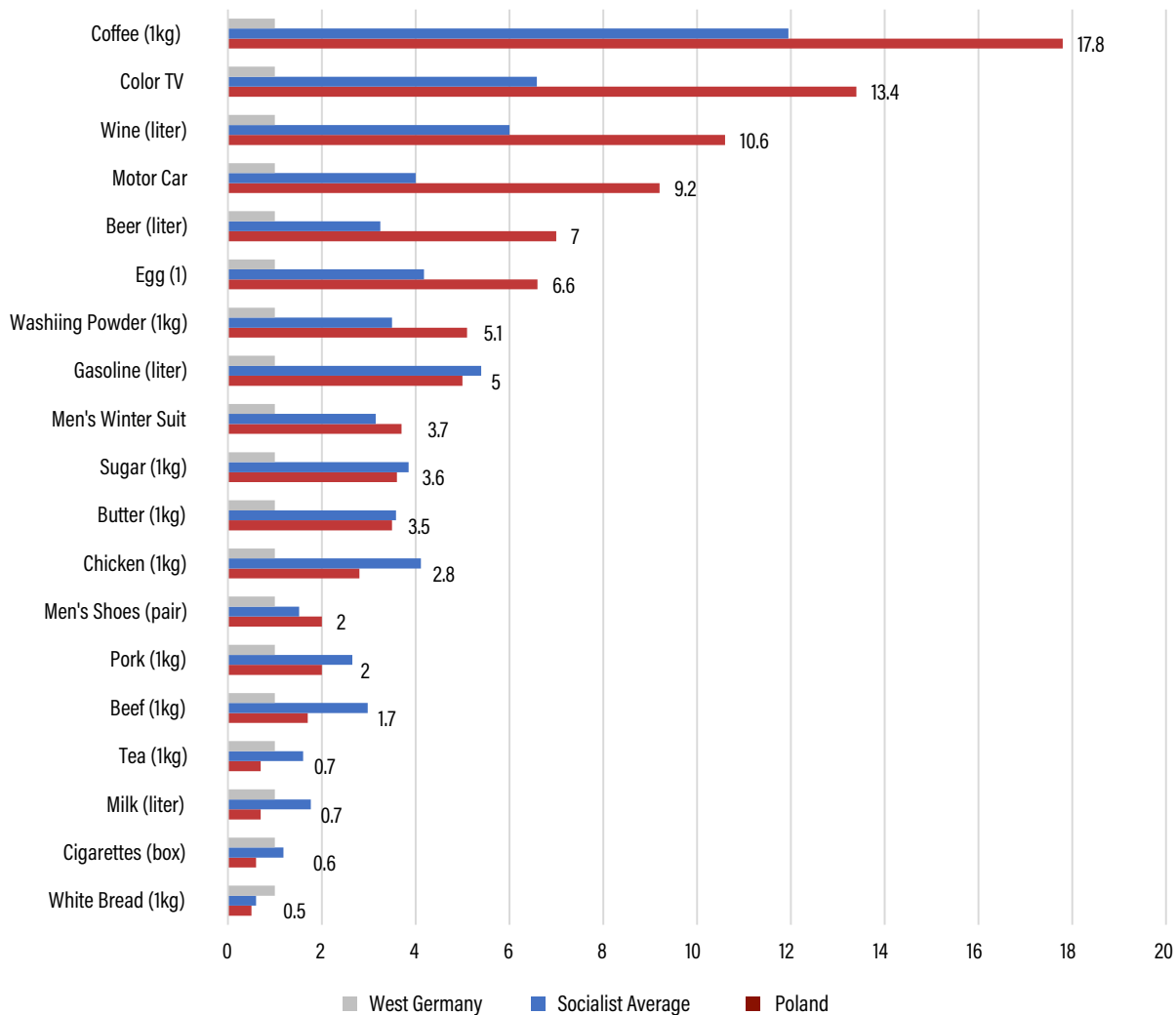
Source: Kornai, 1992: 6, table 1.1.

Life in Poland also reflected the planners' belief that certain consumer items were frivolous and unnecessary. Croatian journalist Slavenka Drakulić poignantly captured this reality when she was asked to give an academic presentation on women in Eastern Europe:

But before I started my speech, I took out one sanitary napkin and one Tampax and, holding them high in the air, I showed them to the audience. "I have just come from Bulgaria," I said, "and believe me, women there don't have either napkins or Tampaxes—they never had them, in fact. Nor do women in Poland, or Czechoslovakia, much less in the Soviet Union or Romania. This I hold as one of the proofs of why communism failed, because in the seventy years of its existence it couldn't fulfil the basic needs of half of the population." (Drakulić, 2016: 120)

Given differences in incomes and prices across countries, one of the best ways to make an apples-to-apples cross-country comparison is to see how long an average worker must work in order to afford certain items. Figure 2.12 shows how long people had to work in Poland and in an average of six socialist countries to afford 19 basic items in 1988. It presents this data relative to West Germany. It shows, for example, that the average Pole had to work nearly 18 times as long as the average West German to make enough money to buy a comparable amount of coffee. Poles had to work 13 times as long as West Germans for TVs, 10 times as long for wine, and 9 times as long for cars. They had to work about twice as long for beef and pork and nearly three times as long for chicken. For the most expensive items, Poles typically had to work longer hours than their socialist comrades in other countries. When it came to four cheaper items, tea, milk, cigarettes, and white bread, however, Poles fared better than their comrades—and

Figure 2.12: Hours of Work Required to Buy 1 Unit of Consumer Goods Relative to West Germany, 1988



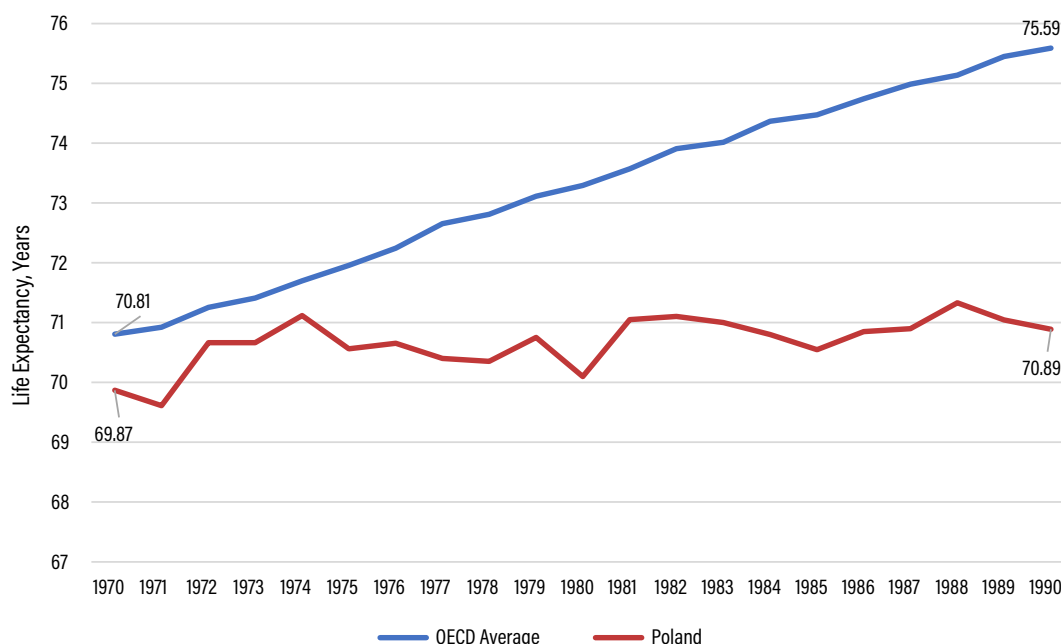
Source: Kornai, 1992: 308-9, table 13.5.

West Germans. Note that compared with West Germany the only item that could be bought for fewer hours of work in the average socialist country was white bread. Even this, however, reflected the strange reality of socialist planning. Bread was cheap because its production was highly subsidized. It was so highly subsidized, in fact, that it was cheaper for farmers to feed their animals bread than it was for them to feed them unprocessed grains (Reaves, 1981).

Perhaps the most striking indication of socialist malaise was stagnant life expectancy. Figure 2.13 shows life expectancy at birth from 1970 through 1990 for Poland and the original OECD nations. Over this time, the average life expectancy of a child born in an OECD nation grew by nearly 5 years while it grew by just 1 year in Poland. In fact, Polish life expectancy declined from 1974 to 1980, and between 1981 and 1989 reached a ceiling of just 71.3 years.



Figure 2.13: Life Expectancy at Birth, Poland vs. OECD Average, 1970-1990



Source: World Bank, 2021.

### The pathology of privilege in Poland

The term “nomenklatura” first originated in Soviet Russia, but it came to be used in all socialist economies. It referred, at first, to a list of positions throughout society that were so important that the party alone retained the right to fill them. In time, it also came to refer to the occupants of these positions. Hence the nomenklatura comprised party and government officials at the helm of the party, the bureaucratic and planning agencies, and the heads of state-controlled enterprises. These were the party’s trusted elite who were entitled to the top positions. In Poland, a nation of 30 million, there were about 70,000 members of the nomenklatura in the 1950s and 130,000 in the 1970s (Clark and Wildavsky, 1991: 214). They were the top one-half of one percent.

And having access to key positions in economic and bureaucratic agencies endowed the group with influence and personal benefits such as access to consumer goods and other services that ordinary workers could not obtain (Tarkowski, 1994). They also had access to luxurious summer resorts, spas, hunting grounds, special medical care, and their own retirement benefits (Bloom, 2013: 20). The elite did not pay taxes; and the party made sure that this fact was classified (Clark and Wildavsky, 1991: 168). These privileges were a way around the officially “flat” pay structure and they helped the regime address the control problem inherent to central planning.

Some of these privileges were extraordinary. Consider Maciej Szczepanski, who oversaw national broadcasting under Gierek. He had 10 luxury residences, a 32-acre sheep farm, a hunting lodge appointed with more than a million dollars’ worth of antiques, a 40-room

mansion in Warsaw, a yacht, a villa in Kenya, and an office with a swimming pool and sauna. Somehow he managed to afford gifts for Gierek that were more than four times his official salary (Clark and Wildavsky, 1991: 168).

The privileged position of the *nomenklatura* contrasted sharply with the socialist aspiration of material and social equality between individuals, sapping the regime of its moral authority. Making matters worse, because the elites were spared from the worst consequences of the system, they became oblivious to these problems and uninterested in addressing them.<sup>14</sup> Author Stewart Steven recounts the story of a mid-level party member who had read a story in *Newsweek* about a food shortage:

Thinking the Western media was slandering Poland again, the official mentioned this incident to a colleague who, surprisingly, remained silent. The next week the colleague took the official aside, saying, “We live like foreigners in our own country. We know less about what’s really going on than a foreigner who flies in, talks to ordinary people, and leaves again.” Shocked at this revelation, the official decided to check up on his own. He invited to dinner a cousin he hadn’t seen for a long time, inquired about the food shortage, and heard the truth. He then recalled that it had been years since he had a conversation of more than a minute or two with a Pole who was not a member of the *nomenklatura*. (Steven, 1982: 94)

### **Alienation, and monstrous moral hybrids**

At the same time, the shortage economy forced non-elites to sacrifice their morals and commodify their relationships. As one observer put it: “one can make a generalization that everybody in Poland who has the chance engages in a good deal of stealing, cheating, and supplementing his or her income by illegal means” (Korbonski, 1978: 102-3). Cheating could take many forms: “goods snatched from workplaces, private services rendered during work hours; private utilization of state machines, tools, or transport, procuring goods ‘under the counter’” (Los, 1987: 34).

One Pole complained: “Why must I so often do things to get a promotion or improve my family’s living standard that run against my conscience? Why and how has it become true that I am a swine? When did I realize it, and when did I stop caring?” (Vale, 1981: 86). Planners, too, worried about the corrosive effects: “What is going to happen to the character of the young generation,” a state planner asked, “if from the very beginning of their working career in the enterprise, they are being taught and morally forced to cheat at the expense of the whole society?” (Zielinski, 1973: 106).

These sentiments are consistent with what Ginny Choi and Virgil Storr call “a culture of rent seeking” (Choi and Storr, 2019). It is a culture that arises when members of a society come to view it as acceptable and necessary to seek privileges and to subvert the rules in their favour. In such cultures, people often feel a sense of guilty pleasure in cheating. The anthropologist Janine Wedel describes a Polish woman who manipulated her connections

to obtain curtains: “[She] feels a kind of revengeful pride—she is happy to manipulate a system that has humiliated her all her life” (Wedel, 1986: 150).

Unfortunately, as Clark and Wildavsky have argued, this sort of manipulation tends to corrupt relationships:

When the need for social or political contacts to accomplish anything—from getting enough steel in order to meet one’s factory’s plan quota to finding chocolate for a child’s birthday party—become indispensable, as in [communist political economies] human relations suffer. People expect both too much and too little from friends, family, and acquaintances: too much, since almost every aspect of your life depends on what others can do for you; too little, since the instrumentalization of these relations means that they are sucked dry of any inherent pleasure. (Clark and Wildavsky, 1991: 332-33)

Not long after they wrote this, Jane Jacobs coined the memorable phrase “monstrous moral hybrid” to describe this sort of moral perversion. She argued that it arises when an ethical system which has evolved for one sphere of human life is (mis)applied to another (Jacobs, 1992). Like so much of the socialist experience, the monstrous moral hybrid that characterized life in Poland bore a striking resemblance to the Marxian indictment of capitalism.<sup>15</sup> Under capitalism, 20th century Marxists claimed, the workers would find themselves spiritually impoverished even if they were surrounded by material prosperity (Marcuse, 1964). In socialist Poland, workers seemed to be both materially and spiritually impoverished.

And this impoverishment created alienation:

To have been among the Poles before the collapse of communism in 1989 was to understand the meaning of alienation, to have witnessed a visceral rejection of existing political and economic institutions. It is a wholesale and unrelenting rejection of what the party-state does—imprison, beat, lie, and destroy—and what it had made most Poles become—criminals, manipulators, cynics, dissemblers. (Clark and Wildavsky, 1991: 222)

### **Socialist cycles of crisis**

Recurring crises were another source of alienation. As we have seen, Poland slipped into economic and then political crisis on a regular basis. As Koryś (2018) points out, “the scale and scope of the protests were larger in each successive wave: in 1956, the protests took place in Poznań and then Warszawa, in 1970, in all the main cities on the coast (Gdańsk, Gdynia, Szczecin, Elbląg) and a few cities in other regions, in 1980—all over Poland” (Koryś, 2018: 291).

Marx had criticized capitalism for its “regularly recurring catastrophes,” which “lead to their repetition on a higher scale,” and would eventually culminate in “its violent overthrow”

(Marx, 1861/1993: 750).<sup>16</sup> Unfortunately, socialist regimes proved to be more susceptible than their capitalist counterparts to regularly recurring economic (and political) crises. Zielenski reports that “European socialist countries during the period 1958–1968 show even *higher* fluctuations than capitalist countries over the same period” (Zielinski, 1973: 7).

With no separation between state and economy, economic crises were often intertwined with political crises. And when the public protested or went on strike, the regime reacted with a mix of repression and conciliation. For example, the government would often respond to protests with violence but then alter whatever policy was being protested.

The regime’s response to protests also confirmed Hayek’s hypothesis that collectivist governments find it easier to rally the public around “hatred of an enemy” than on “any positive task” (Hayek, 1944/2007: 153). In 1968, students took to the streets to protest the suppression of free speech. The Six Day War (in which the Soviets supported the Arabs) was raging in the Middle East, and Gomułka decided to respond to the protests by blaming the Jews. In what became known as the “Zionist speech” Gomułka told Polish Jews to leave Poland, declaring “We do not want a Fifth Column in our country” (Judt, 2006: 434–35). Since the Nazis had murdered about 90 percent of Jews in Poland, the population was not large. But following Gomułka’s speech, some 13,000 Polish Jews were given one-way tickets and special documents that allowed them to leave, but not return (Bash and Sharpe, 2022).

Scholars have offered several explanations for socialist business and political cycles. One theory, offered by economics professor (and Polish resistance fighter) Bogdan Mieczkowski, is that the regime’s relentless focus on investment and consequent neglect of consumption occasionally boiled over into public rage to which the regime then reacted. The regime responded by permitting increased consumption but eventually returned to its old policy (Mieczkowski, 1978; 1979).<sup>17</sup> Political scientist Valerie Bunce contends that when new leaders took control they permitted more consumption as a way to consolidate power. They were able to do this because, as new leaders, they were less beholden to the previous leader’s commitments to input industries’ ministerial lobbies (Bunce, 1980). Once they were established, however, leaders would once again begin to ignore consumption and favour input industries.

To these theories, we can suggest others. The control problem contributed to cycles of political repression as people chafed under the constraints of a command economy and as the government oscillated between violently suppressing dissent and accommodating it. The knowledge problem and the incentive problems ensured that resources were regularly misallocated, necessitating painful reallocations when shortages grew too large or painful to ignore. Soft budget constraints meant that firms’ mistakes were covered up, never addressed, and allowed to accumulate. Thus, by guaranteeing stability for individual firms, the regime sowed instability for the entire system.<sup>18</sup> And finally, the bias toward below-equilibrium prices caused the regime to adopt an all-or-nothing approach to price adjustments. Reluctant to anger consumers or the ministerial lobbies that benefited from shortages, the regime would freeze prices for long periods of time only to raise them

precipitously when the consequences of disequilibrium could no longer be ignored (Clark and Wildavsky, 1991: 134).

### Solidarity and the crisis of the 1980s

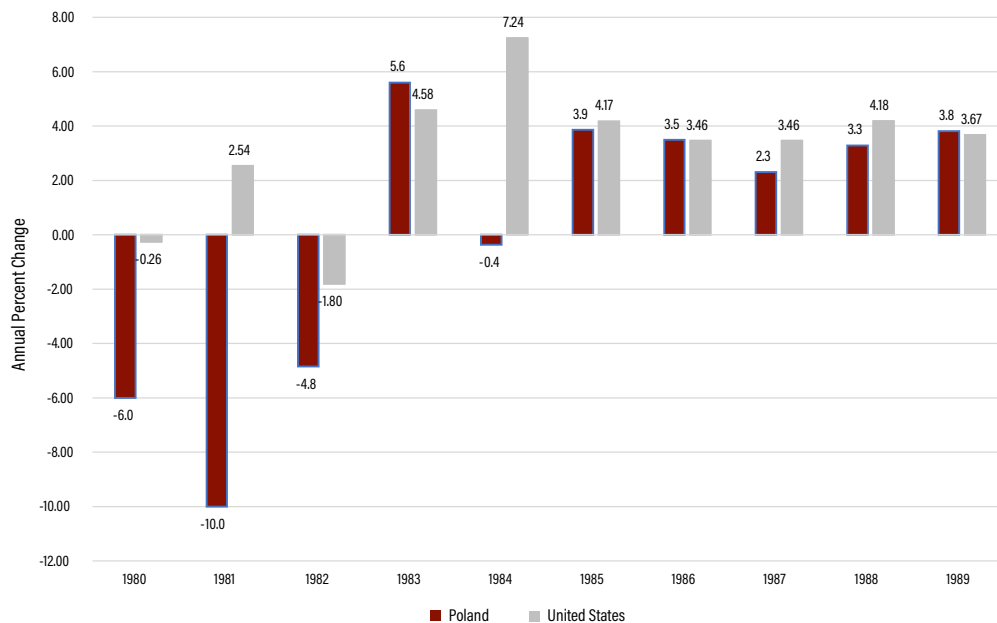
Socialist Poland's worst economic and political crisis began in the early 1980s. The economy contracted sharply and the country was gripped by dangerous shortages and civil unrest. As figure 2.14 shows, real gross domestic product contracted for three straight years beginning in 1980, including by 10 percent in 1981. For comparison, the figure also shows the annual change in US real GDP over this time. Americans of a certain age will recall the recession of 1982 as especially painful and yet it pales in comparison to what the Poles experienced.

As figure 2.15 illustrates, real GDP per capita fell by 18 percent from 1980 to 1982. Investment fell by 50 percent and consumption by 15 percent (World Bank, 1987: xi). The collapse was so steep that per capita GDP did not get back to 1979 levels until 1985.

As production collapsed, Poles encountered shortages of nearly all products, but especially of soap, coffee, sugar, laundry detergent, cigarettes, rubber, transportation, and—above all—meat. The already meager meat allotments were reduced by 20 percent in the summer of 1981 to just 3 kg per person per month and citizens stood in line for days and even weeks for basic necessities (Ash, 2002: 192).

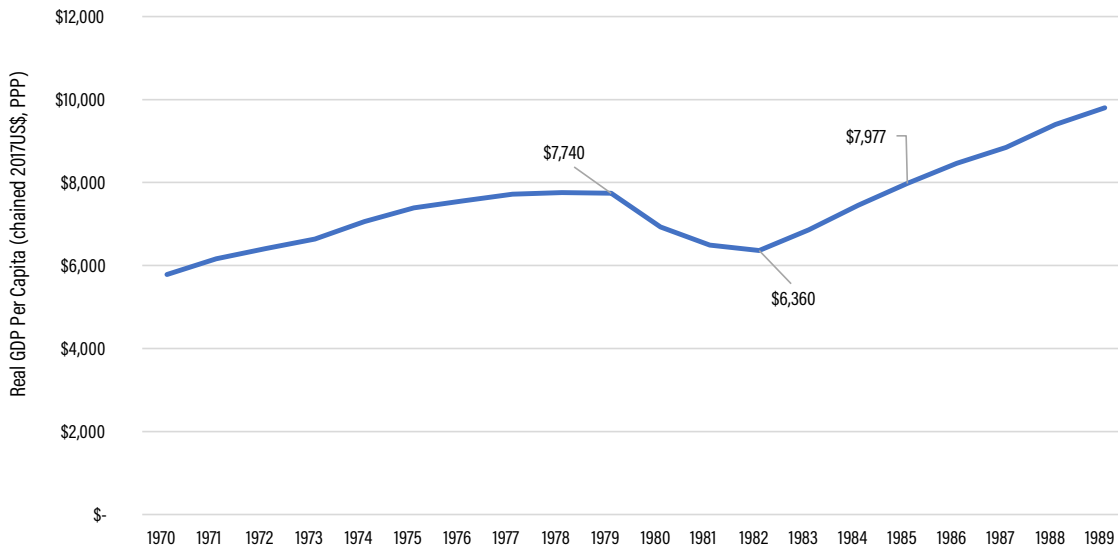
As had happened before, the economic pain turned to political unrest. But several factors bolstered the protests of the early 1980s. Ironically, one factor was exposure to markets.

Figure 2.14: Annual Percent Change in Real Gross Domestic Product, 1980-1989



Source: IMF, 2021.

Figure 2.15: Real Gross Domestic Product per Capita, 1970-1989



Source: Feenstra, Inklaar, and Timmer, 2001.

By permitting trade with the West in the 1970s, Gierek unintentionally exposed Poles to a better way of life. He also gave them a glimpse of capitalism closer to home: In 1976, the regime had raised the price of meat, sparking protests and prompting the government to backtrack. But to appease protesters, Gierek allowed commercial shops to open in 1977 (Clark and Wildavsky, 1991: 134). This accommodation, however, exposed the absurdity of the shortage economy. Here is how one Pole described it:

We are always being told that in the West there is rationing by price—though a lot of products are on the market, the ordinary person cannot possibly afford them. This rings very hollow in Poland, for not only do we have genuine rationing, we have rationing by price and then rationing by dollars as well. If anyone had told me in the forties that, after forty years of Socialism, the only store in Poland with a decent selection of goods would be stores that refuse our own currency and accept only the American dollar, I would not have believed them. (Steven, 1982: 84)

The Catholic Church was another factor bolstering the protests. Early in his term Gierek had abandoned the government's longstanding antagonism toward the Church, allowing it to grow in prominence throughout the 1970s. This *détente* proved especially significant when, in 1978, Polish Bishop Karol Wojtyła was unexpectedly elected to the papacy, taking the name Pope John Paul II. The next year, the anti-communist pope visited his native country where he was greeted by throngs of admirers, telling them, "be not afraid." Angelo Codevilla described the impact of the Pontiff's visit:

Visiting his native Poland in 1979, Pope John Paul II struck what turned out to be a mortal blow to its Communist regime, to the Soviet Empire,

[and] ultimately to Communism.... Had the Pope chosen to turn his soft power into the hard variety, the regime might have been drowned in blood. Instead, the Pope simply led the Polish people to desert their rulers by affirming solidarity with one another. The Communists managed to hold on as despots a decade longer. But as political leaders, they were finished. (Codevilla, 2009: 207-8)

The next important step toward reform occurred in August of 1980 when the authorities at the Lenin Shipyard in Gdańsk made the fateful decision to fire a 51-year-old worker named Anna Walentynowicz. Once celebrated by party leadership as a model worker, she had a strong sense of social justice and spoke out when she saw a supervisor steal money from the worker's bonus fund. She was fired for impugning her superior. Outraged at her treatment, workers at the shipyard went on strike while Walentynowicz worked with the charismatic electrician, Lech Wałęsa, to form a union that would eventually become known as Solidarity (Liulevicius 2015).

Within a year, 10 million Poles were members of Solidarity, representing one-third of the working-age population. The movement gained steam just as economic conditions worsened; Solidarity's publications fueled further outrage. The historian Timothy Ash captured the effects:

No, it was not just the fact of queuing. It was that while they stood in those queues they could read in the local paper, or, even more, in the uncensored Solidarity news bulletins, the latest scandal of corruption or maladministration. Here, 3,000 lb. of butter had gone rancid due to official neglect; there, lard had been used to feed animals; while people could obtain neither in the shops. Truckloads of cigarettes were found on a rubbish-dump, while people queued for two hours to buy one packet at the tobacconist. In Silesia whole consignments of letters from Britain, France and Sweden (centres of Polish emigration) were found at the bottom of a lake. On one page the housewife would read about a hospital in Lower Silesia where fourteen babies died from a serious infection caused, incredibly, by a shortage of water—the local authorities having failed to invest adequately in the municipal water system. On the next, she could read about the pasha-like lifestyle of the men responsible for this mess. (Ash, 2002: 193)

In mid-1981 Solidarity organized widespread hunger demonstrations. Most of the participants in these peaceful protests were women and their children. Their banners read “We want to eat,” “How do you eat ration coupons,” and, in an obvious reference to the closing lines of the Communist Manifesto, “The hungry of all countries—unite” (Markham, 1981). A common saying began to appear in graffiti: “Workers of the world... I apologize. – Karl Marx” (Clark and Wildavsky, 1991: 15).

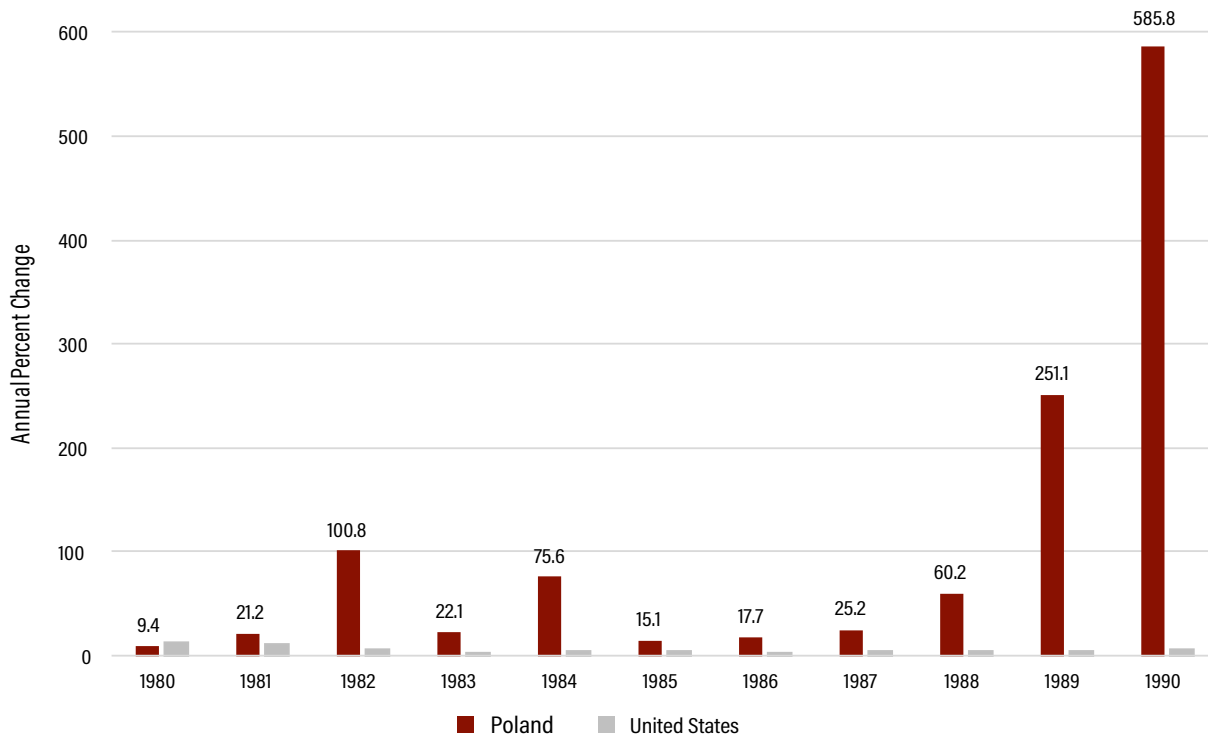
The regime's response was swift and merciless. On December 13, 1981, General Wojciech Jaruzelski, the First Secretary of the Polish United Workers' Party and the de facto head

of the government, declared martial law (Mastny, 2006: 30). During the night he sent 80,000 soldiers and 60,000 militiamen and secret police to round up the troublemakers (Kozłowski, 2022). In all, some 200,000 Poles were fined, 10,000 were arrested, and 3,500 were ultimately sent to prison. Kozłowski reports that “there is a story of an engine driver who started a train whistle for 60 seconds as a symbol of opposition to martial law, and was sentenced to two years’ imprisonment” (Kozłowski, 2022). When they came for Walesa he was defiant, telling his captors: “This is the moment of your defeat. These are the last nails in the coffin of communism” (Gaddis, 2006: 259).

All public meetings, demonstrations, and strikes were banned and the government imposed a news blackout. Solidarity was eventually outlawed (Perdue, 1995: 9, 65). To justify these heavy handed tactics, Jaruzelski repeatedly warned that if order was not restored then the Soviets might invade at any moment as they had done in East Germany in 1953, Hungary in 1956, and in Czechoslovakia in 1968 (Clark and Wildavsky, 1991: 323). Under the so-called Brezhnev Doctrine, announced in the last of these interventions, the Soviets had asserted the right to intervene militarily if any socialist state wavered in its commitment to the cause. While no one knew it at the time, the Politburo had already decided to abandon this doctrine (Gaddis, 2006: 258).

The economy began to grow again in the second half of the 1980s, but shortages persisted. And inflation, already a problem, spiraled out of control. Figure 2.16 shows the annual inflation rate from 1980 to 1990. For comparison, it also shows the inflation rate in the

Figure 2.16: Annual Inflation Rate, 1980-1990



Source: International Monetary Fund, 2021.



United States, which had reached the scandalous height of 13.5 percent in 1980. From 1981 onward, the Polish annual inflation rate never dipped below 15 percent. And as the decade ended, inflation spiked to more than 250 percent and then to nearly 600 percent. This was a problem that was unique to Poland. As one economist has put it, comparing Poland with other socialist countries, “Only in Poland inflation approached the hyperinflation level” (Gomulka, 2016: 19).

As so often happens, policy makers attempted to tame inflation through price controls rather than by addressing its root causes in monetary policy. In 1982, the government introduced the “tax on excessive payroll payments” which came to be known by the acronym *popiwek* (Dabrowski et al., 1997:10).<sup>19</sup> Under *popiwek*, firms were levied heavy taxes if they raised wages significantly more than the price level. As we will see below, *popiwek* was briefly employed during the transition period as well.

Fiscal conditions were no less concerning: the budget deficit reached 10 percent of GDP by September 1989 (Slay, 1994: 86). And in that year foreign debt stood at \$40 billion, becoming increasingly hard to manage (Slay, 1994: 87).

But for the socialist leaders, the tasks of managing fiscal and monetary policy were not nearly as difficult as the task of managing the control problem. Over four decades, the regime had employed various strategies to rearrange the pieces of the Polish chess board, some heavy-handed, others conciliatory. The pieces, of course, always had their own principles of motion. And as the Soviet Union lost its ability to control its satellite states, Poland’s leaders had little choice but to give up controlling their subjects. We turn, now, to this part of the story.

## Notes

- 1 We will have more to say on his views of commodification below.
- 2 Francis Spufford captures the promise and the hope of socialist abundance in *Red Plenty* (Spufford, 2012).
- 3 The investment gap may be one reason why Western observers such as Paul Samuelson repeatedly predicted that the Soviets would over-take the Americans (Levy and Peart, 2009). The Soviet-turned-American economist Igor Birman was one observer who got it right (Shapiro, 2011).
- 4 The number of planning targets tended to rise over time. As one manager put it: “I have to produce not only machine tools but also indicators... to arrange my product mix so that it fits all the directives imposed on me: directives concerning the total sale value and the value of per capita terms of the work force, the ratio between the average rise in wages and the gains in productivity, the share in export production, the cost factor, the size of accumulation, and so on. Compared to all this activity, the development of a new generation of tools seems child’s play” (Vale, 1981: 48).
- 5 Joseph Stalin orchestrated Bierut’s rise to power and trusted Bierut.
- 6 Three men—Lavrentiy Beria, Georgy Malenkov, and Vyacheslav Molotov—initially shared power following Stalin’s death. Working with Malenkov, Khrushchev accused Beria, the longtime chief of the Soviet secret police, of treason. Beria was tried and executed in December of 1953. Malenkov was then demoted, having been accused of, among other things, facilitating Beria’s rise to power. Molotov was allowed to keep his position, if not his power, until he too was removed from the Party and power in 1961.

- 7 Despite its name, the speech was no secret. While only party members were allowed to read it, its contents were soon widely known.
- 8 As the economist Władysław Balicki has observed, “Wherever a centrally planned economy exists, there exists the inevitable shortages or queues in shops” (quoted in Hunter, 1986: 306).
- 9 The Polish Thaw was part of a broader thaw throughout the Soviet sphere following the death of Stalin (Alexeyeva and Goldberg, 1993).
- 10 Gomułka backtracked on many of his earlier, more liberal, policies. He reintroduced censorship of the press and reinstated commissions to control science, culture, and education (Hunter, 1986: 304).
- 11 Montias points out that in the immediate post-war period prices were artificially determined based on multipliers of prewar cartel prices (1974: 218). But we do not know what multipliers Polish planners used in a later period. Montias notes the arbitrariness of prices by citing a journalist who referred to the price system as “abracadabra” (1974: 209).
- 12 The socialist mindset encouraged this pilfering. “Poles, of course, condemn theft: but they define ‘theft’ as theft from other individuals, not from the state” (Clark and Wildavsky, 1991: 330).
- 13 We discuss the reasons for these cycles below.
- 14 That dominion and discrimination go hand-in-hand is a theme of Nobel Laureate James Buchanan’s work. See, for example, Buchanan and Congleton (1998).
- 15 This is a theme to which Clark and Wildavsky (1991) return again and again.
- 16 Though it is beyond the scope of the current analysis, macroeconomists debate the degree to which recessions are a natural feature of capitalism or of government interference with the market process. For an overview of this debate, see Snowdon and Vane (2005) and White (2012).
- 17 Though it is not his focus, Mieczkowski also finds evidence that the party’s focus on investment is misplaced: “Periods of weakened CP [Communist Party] rule which lead to improvement in consumption performance also produce an acceleration in economic growth—and ironically—faster growth of investment, thus proving the incorrectness of the traditional policy of CP leadership” (Mieczkowski, 1978: 262).
- 18 Anticipating Taleb’s (2014) arguments in *Antifragile*, Clark and Wildavsky write: “In the hope that they can avoid the fluctuations and instability of capitalism, command economies do not allow bankruptcy. The result may seem surprising. Because the stability of its parts is low, the stability of capitalism as a system is high. The opposite, we have seen is true in [communist political economies], where the stability of the parts leads to the instability of the system” (Clark and Wildavsky, 1991: 341-42).
- 19 Popiwek stood for podatek od ponadnormatywnych wypłat wynagrodzeń.

## POLAND'S TRANSITION FROM SOCIALISM TO THE MARKET SYSTEM

The Solidarity movement had given voice to what many had long felt: Socialism had failed in its promise to deliver prosperity and equality. Instead, socialist Poland had come to resemble Marx's worst characterizations of capitalism. It was not just a poor society, but a profoundly unequal one, with great luxuries for some and shortages for the rest. Instead of serving the needs of the humble worker, it catered to the desires of its largest enterprises, indulging their insatiable hunger for investment at the expense of the environment and the consumer. The new socialist man was not the selfless creature of Marxist writing. He was a grifter who had no choice but to make his way by cheating the rest of society, just as the rest of society cheated him. In the face of pervasive shortages, he was forced to commodify his friendships and familial relations, using them as instruments to supply him with what the command economy could not. "Even the privileged were victimized," as Clark and Wildavsky put it, "by living in a country that was far poorer than it had any right to be" (Clark and Wildavsky, 1991: 163). Though the elite were spared many of socialism's greatest hardships, by the end of the 1970s even members of the party seemed to be overcome by "pervasive cynicism" (Smolar, 1983: 48).

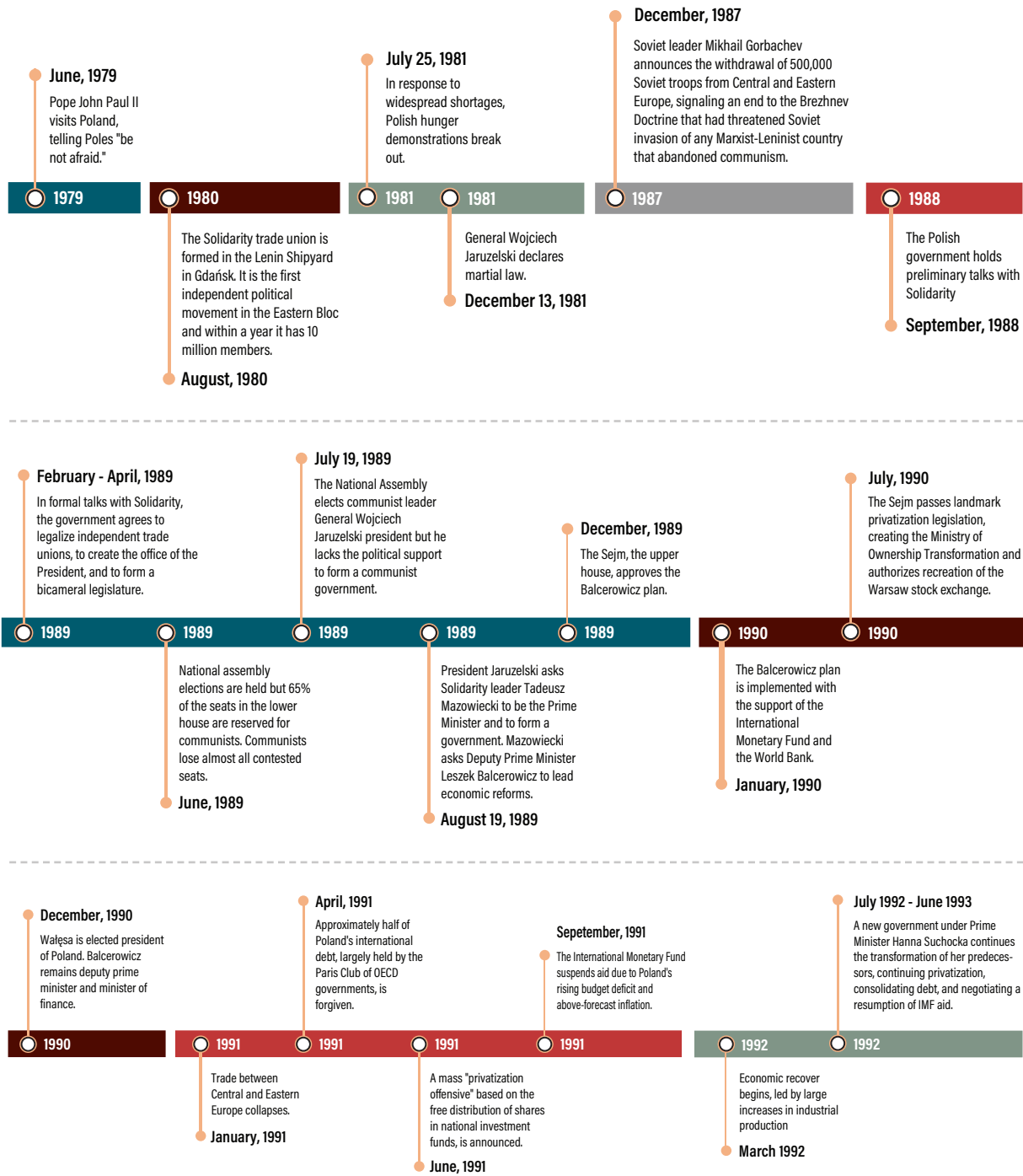
So at least in retrospect, it seems obvious that by the 1980s Poland was ready for change. In this chapter we will document the institutional and policy changes that swept over the country in that decade and the next. In the following chapter we will assess the effects of these changes.

### The end of the socialist era

Though the major changes began in 1989, Poland made several important steps toward liberalization throughout the 1980s (see figure 3.1 for a timeline of events). The regime had hoped that these measures would quench the desire for more sweeping change. Instead, they only seemed to emphasize the necessity and inevitability of radical change in both the political and economic organization of Polish society (Koryś, 2018).

Although reforms throughout the 1980s did make the soon-to-be-followed transition easier by removing regulations limiting new firms and further liberalizing foreign trade, the reforms failed to substantially alter and revitalize the economic system. For instance, at the time of the collapse of socialism in 1989, state and cooperative sectors still accounted

Figure 3.1: Timeline of Crisis and Reform



for nearly 80 percent of Polish national income (Slay 1994, 87). And Polish planners continued to focus on heavy industrial production, neglecting the consumer sector.

Despite attempts to introduce market prices earlier in the decade, most prices continued to be fixed by the state or regulated by it. Subsidies to inefficient state firms continued to crowd out private production and discourage more efficient management. The

private financial mechanisms capable of supporting entrepreneurs—like banks and a stock exchange—were in embryonic stages. And Poland was highly depended on its fellow Com-econ (Council for Mutual Economic Assistance) countries, relying on the Soviet Union to buy its exports of machinery, coal, electronics, and pharmaceuticals, and depending on its fellow members for cheap imports like oil and gas that were sold at below market prices (Koryś, 2018: 307).<sup>1</sup>

One possible exception to this trend is the Economic Activity Act of 1988, which would prove to be successful. It began the process of deregulating firms across all industries, helping to create an environment for market entrepreneurs to take advantage of the new conditions (Slay, 1994: 92).

The ascendance of Mikhail Gorbachev as the General Secretary of the Communist Party of the Soviet Union was a catalyst for Polish reform. Gorbachev's *perestroika* (reconstruction) and *glasnost* (openness) signaled newfound Soviet tolerance for change. At the same time, the general secretary renounced the Brezhnev Doctrine, which had threatened Soviet force against any communist bloc nation that abandoned communism (Davies, 2005: 501).

The turning point in the liberation of the country came after the Polish Round Table negotiations in the spring of 1989 between the ruling elite and the opposition. The agreement that the parties struck at the Round Table talks re-established Parliament and the Office of the President (Dudek 2003). Shortly thereafter, on June 4th, 1989, general parliamentary elections were held symbolically marking the end of socialist rule in the country and the beginning of the Third Polish Republic. These elections were only partially free since 65 percent of the seats in the lower chamber were reserved for the communist party and its coalition parties. Nevertheless, this was significant progress. The National Assembly selected the communist leader General Wojciech Jaruzelski as president, but given the weak performance of the communists in the contested parliamentary elections that summer, he lacked the political capital to form a communist government. Instead, he asked Solidarity leader Tadeusz Mazowiecki to be prime minister and to form a government.

It may be tempting, in retrospect, to think of the reforms as an experiment. But after the four-decade experiment with socialism, the Poles didn't see it that way. In his parliamentary address shortly before he was elected the first non-Communist prime minister in the Eastern bloc, Mazowiecki put it this way:

I am fully aware of the great effort that repairing the economy will require of the new government and everybody. The long-term, strategic goal of government's activities will be restoring to Poland economic institutions long known and tested. I understand by this a return to a market-oriented economy and a role for the state similar to that in economically developed countries. Poland cannot afford ideological experiments any longer. (Mazowiecki 1989)

Crucially, Mazowiecki selected Leszek Balcerowicz as deputy prime minister and minister of finance. A western-educated economist, Balcerowicz led Poland's transition to a market-oriented economy, pushing for as quick a change as possible. In 1990, the country held direct presidential elections, and Solidarity's Lech Wałęsa was chosen to be Poland's president. The first free parliamentary elections were held a year later in 1991.

### The Washington Consensus

The new government set the country on a new path. Their guide was the Washington Consensus, a set of widely accepted reforms to help nations transition from a socialist to a market economy. Broadly, the Washington Consensus called for:

1. Fiscal discipline,
2. Substitution of broad-based spending (such as spending on public goods) for narrow spending on subsidies,
3. A broadened tax base with lower marginal rates,
4. Market-determined interest rates,
5. Competitive exchange rates,
6. Liberalized trade,
7. Liberalized foreign direct investment,
8. Privatization of state enterprises,
9. The elimination of anticompetitive regulations, and
10. Legal security of property rights. (Global Trade Negotiations, 2003)

The Consensus was based on a market-oriented restructuring of the economy that gave priority to macro-economic stability (Gomulka, 2016). Advocates hoped that these measures would unleash market forces and spur economic growth, increasing Poles' standard of living. While some left-leaning groups such as social democrats and post-communists raised some concerns regarding welfare-related considerations and the transparency of the privatization process, according to the Polish economic historian Piotr Koryś, "the transformation model was not criticized by any of the mainstream political groups" (2018: 341).

With the general support of the major political groups, Leszek Balcerowicz, the Polish minister of finance between 1989-1991 and 1997-2001, spearheaded reforms. The economic strategy Balcerowicz adopted addressed two primary problems in the Polish economy at the time: macroeconomic fiscal imbalance and a large foreign debt. A package of measures that could be broadly divided into macro-economic stabilization (hereafter, stabilization policy), microeconomic liberalization (liberalization policy), and institutional restructuring (institutional policy) dealt with these problems (Balcerowicz, 1994).

Stabilization policies aimed to combat unsustainable macroeconomic fiscal and monetary policies by reducing the budget deficit, seeking foreign debt relief, cutting subsidies,

stabilizing the growth of the money supply via the Central Bank of Poland, and moving towards a positive real interest rate.

Since inflation was still raging and since previous concessions to labour had put upward pressure on prices, wages, and the budget deficit, the government introduced temporary wage controls. The main instrument was the *popiwek*, the tax on excessive payroll payments that had been introduced by the communist government in the early 1980s. It imposed steep penalties on firms that raised wages significantly faster than inflation. Private firms were exempted from the tax in 1991, it was relaxed in 1992, and finally abandoned in 1994 (Dabrowski et al., 1997: 10).

Liberalization policy also aimed to alleviate macroeconomic imbalance and product shortages by limiting state intervention into the economy, permitting increased flexibility of the supply of goods, and by permitting market-determined pricing. The hope was that this would stabilize the economy and infuse the market with desired goods and services.

Institutional reforms removed economic regulations and restrictions on private activity, eliminated the central allocation of resources, permitted price liberalization, and opened foreign trade, moving Poland closer to a market economy. Institutional policy also sought to privatize the state sector by breaking up domestic monopolies, establishing an independent central bank, and commercializing the financial and insurance sectors (Balcerowicz, 1994).

These policies were implemented jointly, since all three policies complemented one another. Macroeconomic stabilization and the capacity to service foreign debt depended on economic growth and the development of private enterprises, while firms relied on this stability and an absence of distorting factors like inflation.

### Shock therapy

Poland attempted a radical pace of reform that came to be known as “shock therapy.” With shock therapy, reforms are implemented quickly and immediately, as opposed to gradually over time. Economists are divided between the shock therapy approach and a more gradual process of transformation, where reforms are spread out over a longer period of time (Wolf, 1999). On the one hand, supporters of shock therapy view gradualism as limited in its potential gains. They worry that if change is too gradual, there will not be the political will to see it through. Moreover, as time passes, special interests will have an easier time hijacking or derailing reforms in order to preserve their privileges (Sachs, 2012; Olson, 1965). On the other hand, gradualists note that attempted reforms do not unequivocally bring about actual reforms and could in fact worsen economic conditions, especially if all the pieces for reform are not in place. For example, the imposition of a hard budget constraint on firms could lead to a wave of bankruptcies if the existing banking system and stock exchange are at a rudimentary stage of development.

In Poland's case, several factors proved to be decisive in attempting to adopt a relatively fast pace of reform. First, there was an urgent need to arrest runaway inflation. Second, incomplete and sluggish reforms throughout the 1980s had led to the belief that policies must be implemented as a package and within a short timeframe so that changes in the whims of policy-makers or the public could not throw them off track.

Policy-makers also hoped that shock therapy would improve the synergy between stabilization, liberalization, and institutional change. For instance, price liberalization would encourage firms to use resources effectively, while eliminating subsidies and increasing competition from foreign trade would further discipline firms, leading to the elimination of inefficient enterprises and freeing up resources to be used by other, more efficient, firms. Concurrently, disciplined macroeconomic policy would avoid the pitfall of rapid price increases amidst price liberalization across the country. Perhaps the most important factor was the reformers' political capital. The general public expressed strong support for economic and political transition after the collapse of the regime and waiting for another several years would have run the risk of eroding this support (Balcerowicz, 1994).

So the reform process went full steam ahead beginning in January 1990. The Polish currency, the zloty, was devalued and pegged to a basket of currencies instead of its previous peg to the dollar (Balcerowicz, 1994: 80). Poland's central bank increased the real interest rate to the market-clearing level, creating an incentive for private savings, eliminating credit shortages, and encouraging borrowers to account for the marginal opportunity cost of loanable funds. Over time, the central bank attempted to distance itself from direct influence over the economy by letting newly established private banks supply credit to firms and households. The Warsaw securities market was reestablished in 1991 and policies to marketize state insurance funds were developed between 1990 and 1992, all with the aim of providing private financial mechanisms operated by new market participants.

Poland significantly opened up to foreign trade by eliminating quantitative import restrictions in manufacturing, reducing tariffs, and creating a favourable environment for foreign direct investment. In addition to these measures, close to 90 percent of prices were liberalized (Slay, 1994: 92).

Additional reform measures liberalized the labour market, allowing private enterprises to set their own wages, ending inflationary wage indexation and the *popiwiek* tax on excessive payroll payments (Slay, 1994). Additional labour legislation sought to establish a consensus-based system of collective bargaining, in which workers' rights to strike were guaranteed in instances when all other methods of collective bargaining were exhausted.

### **Privatization**

Privatization was a crucial step in institutional restructuring. In 1985 the state sector produced close to 82 percent of total output in Poland, and 71 percent of all employment was in state-owned enterprises (Sachs and Lipton, 1990: 300). If reformers sought to



transform the structure of their economy in accordance with the Washington Consensus model, it was essential for Poland to privatize state enterprises. It took close to 10 months to select the appropriate framework.

In the end, the privatization law adopted in July of 1990 authorized several privatization strategies (Blanchard, 1994). It is beyond the scope of this volume to offer an extensive discussion of the privatization tools used in the process of transition. Nevertheless, we offer a general overview of the major developments to present a more complete picture of the new economic environment and transformation.<sup>2</sup>

The Ministry of Ownership Transformation facilitated the transfer of state property into private hands. One of the first goals was the privatization of capital, as authorities were eager to rid the industrial sector of central oversight. Capital privatization occurred via public offerings, trade sales, management or employee buy-outs, or a combination of each (Frydman, Rapaczynski, and Earle, 1993). Capital privatization was only partially successful. By 1992 only 32 companies were privatized by more than 51 percent ((Frydman, Rapaczynski, and Earle, 1993: 181). The slow pace of capital privatization can be partly attributed to the inchoate private capital market. Poland had no domestic investment banks, a low household savings rate, and a rudimentary stock exchange, all of which made public capital offerings difficult to successfully implement (Sachs, 1991).

By contrast, privatization through liquidation was considerably more successful and became the most common method of privatization in Poland, accounting for nearly 90 percent of privatization in the country between 1990 and 1992 (Slay, 1994: 107). The strategy consisted of selling or leasing a state firm's assets. The new owners could then use the assets in private firms. Despite the widespread use of this method, it is difficult to evaluate its effectiveness due to a lack of data. Moreover, since many assets were only temporarily leased, some worried that this approach would forestall permanent private ownership (Slay, 1994). Other scholars have noted that privatization by liquidation was potentially advantageous to insiders—employees and managers—who could gain from their knowledge and positions (Frydman and Rapaczynski 1993). At any rate, as of March 1992, 1,055 enterprises were liquidated and were replaced by 545 new private economic units (Frydman and Rapaczynski 1993, 192).

To further bolster privatization, the Ministry of Privatization initiated additional reforms known as sectoral privatization,<sup>3</sup> small privatization,<sup>4</sup> quick privatization,<sup>5</sup> and mass privatization.<sup>6</sup> As of March 1992, 46 firms were privatized via quick privatization (Frydman, Rapaczynski, and Earle, 1993: 193). Moreover, the Ministry of Privatization claimed that in 1990 close to 80 percent of 100,000 small firms were privatized through small privatization. Others figured that 300,000 small stores were privatized in 1990 alone, while sources outside the ministry claimed privatization numbers for small firms varied between 30,444 as of mid-1992 and up to 35,000 in 1990 alone (Frydman, Rapaczynski, and Earle, 1993: 202).

There were also efforts to privatize financial markets. Reformers sought to grant the National Bank of Poland more independence from the government and to establish a robust financial private sector. To the latter end, market-based policies facilitated the formation of over 80 private banks by 1992. Here too the process was not without problems as inexperience and high levels of economic uncertainty caused banks to accumulate non-performing loans, which made up 20 to 30 percent of all bank loans by the end of 1992 (Balcerowicz, 1994: 88). The fairly high percentage of non-performing loans could also be considered hidden subsidies that were provided to state firms within the first few years of the transition and that were meant to cover firms' losses (Blanchard, 1994: 1170). Privatization of state property sought to eliminate privileges as state firms that were incapable of repaying their debts were ordered to either shut down or to restructure.

The privatization process proceeded slower than expected for large firms, and this became one of the major criticisms of the transition (Sachs, 1991; Balcerowicz, 1994). There were many reasons for the sluggish pace of privatization. Given the complexity of the task at hand and the sheer magnitude of the required changes, problems were to be expected. A host of macroeconomic, political, bureaucratic, and structural problems decelerated privatization (Rondinelli and Yurkiewicz, 1996). The transition also presented a major shock to the economy, with people uncertain as to what activities to pursue and where to apply their talents. This uncertainty was magnified by the public's inexperience in operating within a different institutional environment and by the initial incoherence of the economic structure. There was a great deal of regulatory uncertainty and enforcement mechanisms for private agreements were at embryonic stages of development, leaving many opportunities for exploitation (Balcerowicz, 1994). Finally, privatization was slowed by lengthy deliberations and conflicts between political parties (Sachs, 1991; Slay, 1994).

Nevertheless, despite its imperfections, the privatization program produced tangible results within several years of its inception. Balcerowicz reports that the private workforce was just 13 percent of the total workforce in 1989, but increased to 34 percent in 1992 (Balcerowicz, 1994: 87). One estimate suggests that the private sector created one million new jobs between January 1990 and July 1991, with private employment reaching 50 percent of total employment by 1993 (Slay, 1994: 102). Similarly, Rapacki reports that private employment reached 61 percent of the total labour force by 1994 (Rapacki, 1995: 59).

Private entities saw a similar boom in numbers, though privatization of industrial and large firms was not as successful as reforms in the retail and service sectors. For instance, according to Slay (1994), 1.631 million private businesses had been established by late 1992, including 59,000 wholly private domestically owned joint-stock firms, and 10,800 joint ventures (Slay, 1994: 102). The number increased to 1.95 million private enterprises by 1996 (Blaszczyk et al., 1999: 14).

Private output increased from 19 percent of total output in 1989 to 60 percent of total output by 1995 (Blaszczyk et al., 1999: 16). Between 1989 and 1996 the share of private firms in industry grew from 16 to 52 percent, the share of private firms in construction

grew from 26 to 88 percent, the share in transportation rose from 12 to 40 percent, and the share in retail rose from 60 to 93 percent (Błaszczuk et al., 1999: 16).

### Macroeconomic reform

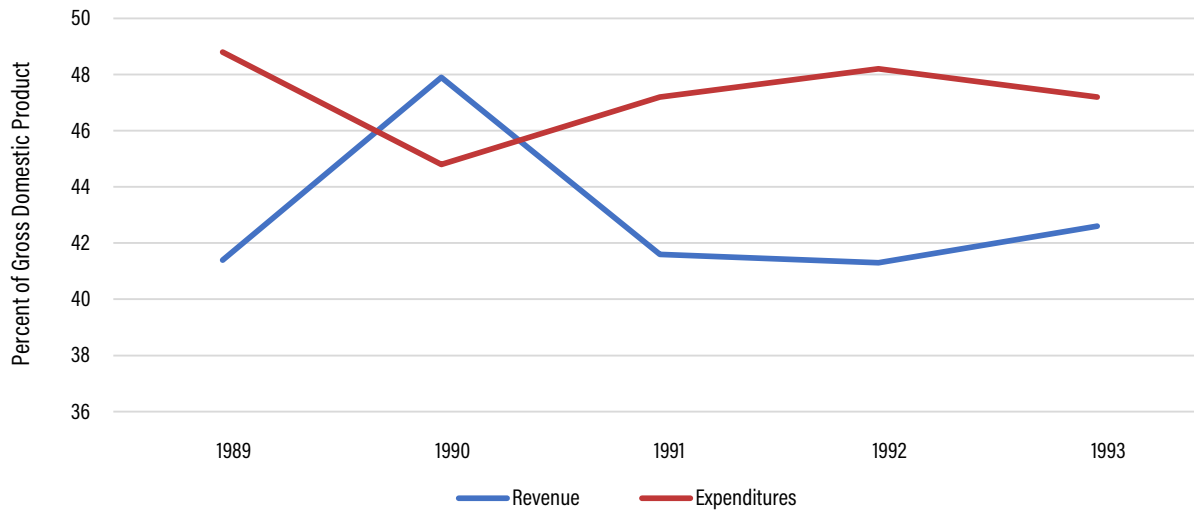
Poland experienced macroeconomic instability at the beginning of the transition. Prices and wages were liberalized while monetary policy remained accommodative. Since planned prices were systematically biased downward and since the central bank had been willing to monetize the debts of state-owned firms, the liberalization of 90 percent of all prices between 1989 and 1991 unleashed extraordinary inflationary pressures (Frydman, Rapaczynski, and Earle, 1993; Balcerowicz, 1994). The annual inflation rate rose to 251 percent in 1989 and 586 percent in 1990, but then gradually declined to 70 percent in 1991 and 28 percent in 1995 (IMF, 2021). The decline in inflation was a monetary phenomenon. The rate of growth of the broad money supply declined from 509 percent in 1989 to 36 percent in 1995 (World Bank, 2021). While the zloty had a fixed exchange rate to the dollar until May 1991, thereafter it was devalued and pegged to a basket of foreign currencies. Together, these policies helped to break hyperinflationary pressures. A reduction in subsidies to state firms, open international trade, and privatization further decreased inflationary pressures and eliminated shortages. These changes also significantly increased the supply of goods and services to the market.

### Foreign debt

At the time of its transition, Poland faced significant foreign debts; they amounted to \$48.4 billion of gross hard currency at the end of 1991 (Frydman, Rapaczynski, and Earle, 1993: 156). Paying off the debt would have been essentially impossible for a transition economy that was undergoing dramatic changes. Thus, while reformers encouraged Poland to pursue market-based reforms, they also encouraged Western governments to forgive Poland's debts (Sachs, 2012). Debt relief came from the capitalization of unpaid interest and, most importantly, from partial debt write-offs provided by the Paris Club of Western governments and the London Club of private Western banks. These groups reduced debt contingent on Poland's ability to implement reforms and set economic targets, like decreasing its budget deficit. This process was by no means smooth; Poland frequently failed to reach its required targets, which delayed the partial forgiveness of its debt.

### Budget deficits

The Third Polish Republic inherited a clumsy and complex fiscal system from its predecessors. The country ran a \$3 billion deficit in 1991 alone (Frydman, Rapaczynski, and Earle, 1993: 155). Poland needed to find ways to restrain its ballooning budget deficit. Its failure to meet its fiscal targets in 1991 cost Poland temporary support from the IMF, which suspended disbursements of its conditional adjustment loan. Figure 3.2 shows expenditures and revenue as a share of GDP during the transition. Initially, revenue

**Figure 3.2: Polish Revenue and Expenditures as a Share of GDP During the Transition**

Source: Gomulka, 1994.

declined while spending rose, widening the budget deficit as a share of GDP. In time, however, revenues rebounded, shrinking the deficit.

The main sources of government revenue during the socialist period had been profit taxes on enterprises, sales taxes, and social security contributions. Most profit taxes were derived from state-owned firms. Several factors initially depressed revenue during the transition. First, there were fewer government firms to tax as state firms were liquidated (Green, Holmes, and Kowalski, 2001). Second, the profits of government firms that continued to operate declined as they faced new competition from both domestic and foreign competitors, as they had to restructure their supply chains, and as their management struggled to adapt to the new market environment. Third, it was necessary to build a new administrative system capable of maintaining and enforcing the new tax structure and its associated regulations. This inevitably took some time to develop and while this capacity was being built, some revenue went uncollected.

Just as revenue was falling, expenditures increased, driven largely by increased spending on extrabudgetary funds. Like Social Security or Medicare in the United States, these are funds with their own sources of revenue that are outside of the general budget. Also like Social Security and Medicare, these funds could and often did receive infusions of money from the general budget. In 1990, there were several dozen extrabudgetary funds, but the most important of these were the Social Security Fund (general workers' pensions), the Farmers' Social Security Fund (farmers' pensions), and the Labour Fund (unemployment). Total expenditures on these funds increased from 11 percent of GDP in 1987, to 18 percent of GDP in 1991, and to 21.6 percent of GDP in 1992 (Gomulka, 1994: 48). Most of the increase was in pensions. As Stanislaw Gomulka put it: "As subsidies to the

household sector were reduced, the authorities apparently felt compelled to increase the average pension to about two-thirds of the average wage rate in 1992, up from about 50% [of] the average wage rate before the reform” (Gomulka, 1994: 48).

The fiscal conditions necessitated adjustments on both the revenue and cost side of the ledger. On the cost side, reformers eliminated a significant portion of extrabudgetary funds in 1990 and clarified budgetary procedures in 1991, making finances more integrated and transparent.

Subsidies and financial support to state firms were cut, especially in the food, raw materials, production inputs, and energy sectors (Balcerowicz, 1994; Gomulka, 1994). According to Gomulka, government subsidies declined from 16 percent of GDP in 1987-1988 to 4.8 percent in 1991 (1994: 47). Those subsidies that remained were of a different nature, as pre-reform subsidies were allocated according to produced items (food, coal, etc.), and post-reform subsidies were allocated to specific entities (Dabrowski et al., 1997). The government also reduced national defense expenditures due to changes in the geopolitical climate and the end of the Cold War. Meanwhile, local authorities took over some costs related to government services and local police.

Some of the obstacles to a balanced budget were left unresolved, however, as hidden subsidies were continued through bank loans and tax exemptions. Moreover, the aging population and inefficiencies in the pension system made the social security system increasingly costly, with pension expenditures reaching up to 15 percent of GDP by 1993 (Balcerowicz, 1994: 89).

On the revenue side of the ledger, reforms simplified the fragmented and complex tax system by implementing a flat corporate tax rate of 40 percent and closing loopholes. In addition, a personal income tax as well as a goods and service tax were introduced in 1992, along with a value-added tax in 1993. Other relevant revenue sources included a 30 percent tax on dividends paid to foreign investors, employer contributions of 43 percent of total employee wages to social security, and an additional 2 percent to an unemployment fund. These measures took time to implement, however, and there was a high degree of tax evasion as the new fiscal administration was inexperienced at enforcing collection from private firms (Frydman, Rapaczynski, and Earle, 1993: 155).

In September 1989 Poland's budget deficit stood at 10 percent of GDP. By November 1991 the deficit was still 4 percent of GDP and 15 percent of budgetary expenditures (Slay, 1994: 86, 99). The unexpectedly protracted privatization process failed to bring in forecasted revenues from private firms adding to the difficulty of restraining budget deficits (Green, Holmes, and Kowalski, 2001).

Ultimately, Poland was able to avert a fiscal crisis. The new income tax and VAT increased revenues, and the administrative system became more effective in collecting taxes. At the same time the growth rate of budgetary expenditures decreased as the growth in expenditures on wages and pension benefits eased and as the growth in the proportion of pensioners decreased.<sup>7</sup> (Dabrowski et al., 1997: 28). Bond restructuring and debt forgiveness

by the London and Paris Clubs were instrumental in alleviating the debt burden and reducing the cost of interest payments. With these changes, the deficit was eliminated by 1994 (Slay, 1994: 114).

### **Institutional liberalization**

As the reformers worked to stabilize the economy they also liberalized and adjusted the institutional structure.<sup>8</sup> As noted above, privatization played a significant role in restructuring the economy in accordance with the Washington Consensus. But freeing private activity from bureaucratic restrictions was no less important. Take, for instance, the elimination of shortages and queues. As we have emphasized, shortages were an endemic feature of socialist Poland. Some inefficiencies were eliminated in the post-socialist period through privatization, as private profit-seeking firms took the place of public firms. The new private entities had an incentive to produce goods to satisfy consumer demands rather than to satisfy the demands of the state leaders and the ministerial lobbies. Privatization alone, however, would have been insufficient to eliminate shortages as administrative restrictions and price controls hampered free exchange.

Additional institutional reforms were necessary and price liberalization was one of the most important of those reforms. By the end of 1991 close to 90 percent of prices were free from central authority control, with the important exception of prices in utility services (Balcerowicz, 1994). The government also increasingly eliminated restrictions on the entry of new firms to markets. Coupled with the development of financial institutions, entrepreneurs finally had the resources and the ability to start new ventures. As we will show below in our assessment of the transition, there was an explosion in private economic activity. These policies had an impact on all sectors of the economy, but the most dramatic and exciting changes took place in the wholesale and retail trade and banking services that the state had hitherto monopolized. Deregulation and price liberalization opened the gates for productive entrepreneurial activity, as now individuals could legally benefit by creating value for others. “Thus,” Balcerowicz writes, “the fastest growing sectors have been the ones which were the most neglected under socialism” (Balcerowicz, 1994: 90).

### **Trade liberalization**

In 1995, economists Andrew Warner and Jeffrey Sachs argued that trade liberalization was especially important for transition economies. Not only did open trade establish “powerful direct linkages between the economy and the world system,” they argued, “but [it] also effectively forces the government to take actions on the other parts of the reform program and the pressures of international competition” (Warner and Sachs, 1995: 2).

In Poland, increased foreign trade was marked by a reorientation of exports and imports to the West, as former trade arrangements and routes with Comecon countries were altered due to new economic and political realities. As Blanchard put it: “In thinking about transition in Poland, two dates are important. The first is January 1990, when economic

transition started in earnest, with price liberalization and stabilization; the second is January 1991, which saw the collapse of trade between Central and Eastern European countries” (Blanchard, 1994: 1169).

With these changes, domestic firms faced not only competition from local rivals, but also from foreign firms that were more experienced in operating a private enterprise. Exports reached \$12 billion in 1990 and increased by another 25 percent in 1991. Similarly, convertible currency imports increased from \$8.3 billion in 1990 to \$15.5 billion in 1991 (Frydman, Rapaczynski, and Earle, 1993: 157).

Exports to the West increased by 61 percent between 1990 and 1991, and by another 13 percent between 1992 and 1993 (Balcerowicz, 1994: 92), while exports to Comecon nations dropped by 65 percent in 1991 (Frydman, Rapaczynski, and Earle, 1993: 157). A similar situation took place on the imports side, as imports from Western countries increased by 53 percent from 1990 to 1991 and by 40 percent from 1992 to 1993 (Balcerowicz, 1994: 92). Finally, openness to trade can also be illustrated by foreign direct investments, which increased from \$60 million in 1989 to \$1.5 billion in 1993 (Balcerowicz, 1994: 92).

As foreign investments poured in, they brought fresh capital, technology, and expertise to newly established enterprises in the service, trading, and financial sectors. The percentage of Poles employed in the trade and service sectors increased from 36 percent of total employment in 1989 to 54 percent in 2004 (Koryś, 2018: 339). As we will see in the next section, Warner and Sachs were right to argue that trade liberalization would make it easier to commit to further reforms.

## Notes

- 1 According to Koryś (2018: 307-8), imports of fuel and energy increased from 7.5 percent of total imports in 1960 to 18 percent of all imports in 1980, while exports of coal constituted 20 percent of all export value in 1975. Moreover, trade with Western capitalist countries increased over time, from 10 percent of all exports in 1956 to 44 percent in 1980, while trade with Comecon countries decreased from 60 percent of all exports in 1956 to 54 percent in 1980. A similar situation occurred with imports.
- 2 For more details, see *The Privatization Process in Central Europe* by Frydman, Rapaczynski, and Earle (1993) and *How Capitalism Was Built: The Transformation of Central and Eastern Europe, Russia, the Caucasus, and Central Asia* by Anders Åslund (2012).
- 3 Sectoral privatization was not, strictly speaking, privatization, but was rather a preparatory step in launching the privatization of firms in related sectors.
- 4 Small privatization targeted small firms that were owned by local authorities, and the strategies differed by locale.
- 5 Quick privatization transferred ownership of small and medium size firms. By this method, firms would be bundled up in groups of approximately six units and offered for sale to potential investors.
- 6 The mass privatization plan announced in June 1991 aimed to commercialize more than 400 of the largest industrial firms in the country. The firms were to be transformed into joint-stock companies, and 60 percent of their shares were to be distributed to financial intermediaries called National Investment Funds. The investment funds would then monitor the firms' performance, selling or restructuring firms accordingly, and over time distributing shares among Poland's adult population free of charge. Thirty percent of

the remaining stock would remain state property, and 10 percent would be distributed between workers of the respective enterprises (Slay, 1994: 105). The program underwent several modifications after 1991 and was approved by Parliament in April 1993.

- 7 Expenditures related to unemployment benefits, however, were increasing (Dabrowski et al., 1997: 28).
- 8 During the transition process, the intellectual focus of attention moved from macroeconomic stabilization to microeconomic reforms and within microeconomic reforms from “getting the prices right” to “getting the institutions right.” As a result, the contributions of New Institutional Economics became more and more part of the mainstream of economic science and political economy through the 1990s and into the first decade of the 2000s. A key figure in this literature was Andrei Shleifer and his work not only on privatization in Russia, but also the difference between the invisible hand of the market and the grabbing hand of the state.



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## ABOUT THE AUTHORS

**PETER J. BOETTKE** is a professor of economics and philosophy at George Mason University, the BB&T Professor for the Study of Capitalism, and the director of the FA Hayek Program for Advanced Study in Philosophy, Politics, and Economics at the Mercatus Center at George Mason University.

Boettke's work has earned him numerous awards, including a doctorate honoris causa in social sciences from Universidad Francisco Marroquín in Guatemala and an honorary doctorate from Alexandru Iona Cuza in Romania. Boettke received his PhD in economics from George Mason University.

**KONSTANTIN ZHUKOV** is a PhD student in the department of economics at George Mason University. He earned his MA in economics at Troy University, and his BBA in business and accounting at Northwood University. His research interests include Austrian economics and economic sociology.

**MATTHEW D. MITCHELL** is a senior fellow in the Centre for Economic Freedom at the Fraser Institute. Prior to joining the Institute Mitchell was a long-serving senior fellow at the Mercatus Center at George Mason University, where he remains an affiliated senior scholar. He is also a senior research fellow at the Knee Center at West Virginia University.

Mitchell received his PhD and MA in economics from George Mason University. His writing and research focus on economic freedom, public choice economics, and the economics of government favouritism.

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