

# Lesson 3: Pathologies of Privilege

## Introduction

The inability of the various Socialist experiments to overcome the problems of control, knowledge and incentives invariably led to what the authors of *The Realities of Socialism* refer to as “Pathologies of Privilege”. This lesson illustrates how difficult it is for central planners to successfully plan and direct the economy, as it requires control of not only what was produced and how production took place, but also control of the citizens, their wants and desires as well as their actions in and out of the economy.

## Materials

Lesson 3 slide deck:

<https://docs.google.com/presentation/d/1rrxh-p0k445HQzqcn7H1tKfyUFapIRAP/edit?usp=sharing&ouid=116660462288476410506&rtpof=true&sd=true>

Optional: Lesson 3 **Background Information**. 1 copy per student (if assigned as student reading)

## Key Terms

Black Market	The exchange of goods and services in an illegal, uncontrolled and unregulated manner.
Bureaucracy	A system of government wherein power is divided among different departments and officials.
Control Problem	The difficulty central planners have in controlling human wants and desires.
Incentive Problem	The problem that occurs with central planning when individuals and central planners are not incentivized to serve the general interest.
Knowledge Problem	The idea that the information for economic planning is distributed across individual members of society and cannot be known by central planners.
Pathologies of Privilege	The problem that occurs in central planning when bureaucrats gain power, and they are privileged over others.
Shortage	The situation that arises when the quantity demanded of a good or service exceeds the quantity supplied.
Surplus	The situation that arises when quantity supplied of a good or service exceeds the quantity demanded.

# Objectives

Students will be able to

- Define socialism.
- Identify the goals of socialism.
- Explain the problems of knowledge, incentives and control that are present in centrally planned economies.

## Time Required

45 minutes

## Voluntary National Content Standards in Economics

### *CONTENT STANDARD 4: Incentives*

People usually respond predictably to positive and negative incentives.

Benchmark 1: Acting as consumers, producers, workers, savers, investors, and citizens, people respond to incentives in order to allocate their scarce resources in ways that provide them the highest possible net benefits

### *CONTENT STANDARD 8: Role of Prices*

Students will understand that prices send signals and provide incentives to buyers and sellers. When supply or demand changes, market prices adjust, affecting incentives.

- Benchmark 4: Scarce goods and services are allocated in a market economy through the influence of prices on production and consumption decisions.

### *CONTENT STANDARD 9: Competition and Market Structure*

Students will understand that Competition among sellers usually lowers costs and prices, and encourages producers to produce what consumers are willing and able to buy. Competition among buyers increases prices and allocates goods and services to those people who are willing and able to pay the most for them.

- Benchmark 1: The pursuit of self-interest in competitive markets usually leads to choices and behavior that also promote the national level of well-being.

## Procedures

- Prepare by reading the **Background Information** included at the end of this lesson.
- Use the **Lesson 3 slide deck** to teach the key ideas about the pathologies of privilege.
- Alternate Activity: Assign the **Background Information** as a student reading.

## Background Information

*The following background information is quoted directly from the Fraser Institute publications of “The Road to Socialism and Back: An Economic History of Poland, 1939-2019” published as a part of the Realities of Socialism materials. For a complete copy of the readings please go to RealitiesofSocialism.Org.*

The inability of the various Socialist experiments to overcome the problems of control, knowledge and incentives invariably led to what the authors of *The Realities of Socialism* refer to as Pathologies of Privilege. This term refers to the situation that occurs in centrally planned economies when bureaucrats gain power, and they are privileged over all other citizens.

To successfully plan and direct the economy central planners had to deal with the **control problem**. Not only did they have to control what was produced and how that production took place, but they also had to control the citizens, their wants and desires as well as their actions in and out of the economy. In most socialist economies the failure to satisfy consumers and attain economic growth led to increasing degrees of control. Control of what consumers might desire by limiting what products were even available in the shops and markets, and control of the means and processes of production and even control of human labor and where individuals were allowed to work.

As that control increases there is movement little by little to a more totalitarian state. Often the first strategy of control is to eliminate private property, then private choice of consumption and finally even private choice of labor effort and thought. Some examples of the control in Poland and across the USSR included deportation, imprisonment, and even execution of individuals. These drastic tactics lead to a society that was run by fear and the distrust of the government and your neighbor. In Poland and the USSR every aspect of life was channeled toward a collective state directed will rather than individual desire and efforts. This included schooling, farming, and how factory labor was organized.

The **knowledge problem** and the inability to get the necessary information to the central planners led to a growing **bureaucracy** of ministries with thousands of workers who tried to gather, and in some cases create, the information needed by the central planners. But as in Adam Smiths’ example of pieces on a chess board, the information was constantly changing and there were no market signals of price to convey that information to the central planners.

Poland and the USSR had hundreds of examples of how information failed to get to the right planners. **Shortages** and **surpluses** of goods were endemic and empty shop shelves on one hand along with long lines of citizens waiting for goods were a common sight. The quota system of output led to many measurements of production by weight or perhaps the number of items produced. However, no quota system can measure quality and consumer desire. Only the success or failure of a product in the marketplace can do that.

As the knowledge problem became more pronounced over time, so did the **incentive problem**. Though scarcity and failure are facts of life, socialist planners effectively ignored them. As one author put it, “Failure, in the true sense of the word, is impossible.” As a result, firms in socialist Poland were incentivized not to keep their costs down: they did not expect to go bankrupt when their costs exceeded their profits.

Instead, their survival depended on the favor of the bureaucratic authorities, who had a different criterion for the entities' survival: the fulfillment of predetermined output targets. 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. Losses were either covered automatically, or its administratively controlled prices would be adjusted from time to time to equal its costs.

What was demanded 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 the failure to meet production output targets.

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 incentivized 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.

The effects of the state-sponsored 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. 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.

In addition to this misallocation of resources, an informal market, outside the centrally planned economy developed. Considering their inability to deliver "to each according to his needs" socialist systems inevitably give rise to "parallel" or "second" economies. These second economies, better known as **black markets**, operated outside of the state planned and controlled economy. The state adopted an ambivalent, and at times contradictory, approach to these illicit markets, referred to as the "Second Poland." On the one hand, it attempted to suppress it. 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. 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. Though this helped address the control problem by securing the loyalty (or at least quiescence) of local managers, it incentivized a culture of corruption that spread through the population.

The problems of control, knowledge, and incentives led to the fourth problem with socialist economies, the **pathologies of privilege**. It was only through the privilege of position or illicit behavior that a person could better themselves in the Socialist system. 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. They were in 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. They also had access to luxurious summer resorts, spas, hunting grounds, special medical care, and their own retirement benefits. The elite did not pay taxes; and the party made sure that this fact was a state secret. 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 the privileges were extraordinary. Consider Maciej Szczepanski, who oversaw national broadcasting. He had ten luxury residences, a 32-acre sheep farm, a hunting lodge 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.

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.” 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.’”