THE HIDDEN INEQUALITY IN SOCIALISM

Abstract

In the same time period over which the former socialist countries of Eastern Europe and Central Asia became freer, measured inequality of income for those countries increased. Researchers linked the increase to the egalitarian values of socialism and to the process of economic and political liberalization. We question that link, because we question whether socialism was egalitarian. The inequalities in socialism were hidden but, nevertheless, were real.

Keywords: Inequality Transition Socialism Eastern Europe

1. Introduction

The collapse of the socialist regimes in Eastern Europe and Central Asia brought an unprecedented increase in economic freedom for hundreds of millions of people. Many people, however, still believe that their lives have become worse since the start of the transition period. One of the apparent reasons for this belief is a perceived increase in income inequality, a perception that is supported by income surveys. However, an analysis of these survey results shows that the argument that democratization led to a real increase in income inequality is rather weak and that the pre-transition survey data are poor and are biased in an unknown direction (Henderson, McNab, and Rózsás 2003).

Unfortunately, reconstructing pre-transition data with greater accuracy is not possible. But because the nostalgia for the communist past is one of the major obstacles to further political and economic liberalization, it is important to understand as clearly as possible how equal or unequal the socialist economies were. Therefore, even though no one can reconstruct pre-transition data, we can do a much more thorough analysis of the hidden inequality of socialism than has been done heretofore. This analysis is important because it will help to determine whether the apparent increase in income inequality after socialism was just the revelation of existing inequalities or was real. In this paper, we examine the hidden inequality of the socialist economies of Eastern Europe and Central Asia in the pre-transition period and find much more inequality than shows up in the official statistics.

This paper is structured as follows. In the first part, we illuminate why economic inequality was important for the operation of the centrally-planned economies and how its real political purpose distorted its measurement and interpretation. In the second part, we identify several sources of inequality in the pre-transition period, the effects of which were often overlooked or underestimated by the researchers. The last section concludes and suggests courses for future research.

2. The Hidden Inequality in Socialism

In this paper, we use an unorthodox approach to the pre-transition period, an approach required by the state of the data. Instead of trying to reconstruct inequality data from low-quality surveys, estimates, and assumptions, we show how the socialist system could generate, tolerate and hide inequalities of the order of magnitude measured in Ukraine, Russia, and the Kyrgyz Republic today. While many of these factors have been known to the research community, their cumulative effect has rarely been considered and, as a result, has been underestimated.

2.1. Market Forces and Socialism

The widely recognized inefficiency of the centrally-planned economy was a fundamental reason for the high hidden inequality in socialism. The desires of one group or individual could be fulfilled only at the expense of others, which means that for central planning to work, central planners had to rank order the various wants of various people, and compare the importance of, say, one person's desire for health care with another person's desire for housing. In a centrally-planned economy, planning did not attempt to ensure production occurred so that prices and quantities approximated what would have been the market equilibrium. Because socialist leaders denied the importance of market forces, they did not even attempt to find or estimate these equilibrium values. Their stated goal was to provide basic goods in “sufficient” quantities at a low price by directing production resources from luxury goods to the production of these basic goods. Pricing was based on a kind of cost-based calculation in which unprocessed raw materials were assigned almost no value. Since profit was regarded as a sin, and the distinction between the cost of capital and real profit was not understood or ignored, the cost of capital was not included in the calculations. Price control measures and dictated production quantities were the means to achieve this goal.

Central planning over time distorted the behavior of producers and consumers alike while completely destroying the feedback mechanisms of the market. As a result, socialist economies displayed many failures besides the classic inefficiencies caused by price control.

Price control was among the first implemented measures in all of the socialist countries after the communist takeover. Shortages appeared quickly, as prices no longer reflected the true cost of production. Government requisition of agricultural products was common practice in socialist countries. The outright seizure of agricultural products in Eastern Europe culminated with the collectivization of farms by the 1960s (Courtois et al. n.d.).

Central planning has two solutions for shortages: rationing and dictated production quantities. Both were used widely in socialist economies. Rationing, however, was a short-term solution because it made the contradictions of the system visible. Therefore central planners tried to avoid rationing by finding other solutions to shortages, at least in the case of basic commodities. Because dictated production quantities seemed to solve shortage problems, they became prevalent in socialist countries. A real market, however, did not exist, making it hard to determine whether the actual regulated quantities were below or above the already non-existing market equilibrium. The regulated quantity must have been higher than the quantity voluntarily supplied by the producers, because if the producers had been willing to produce the required quantity, there would have been no need for dictated quantities. Regardless of this, people still had to wait in lines and to pay bribes to shopkeepers to obtain products that were commonplace in the marked-based economies of the West. Therefore, the dictated quantity must have been lower than the quantity demanded at the regulated price.

But for certain basic commodities, the case was different. Each country had its own set of basic goods that appeared to reflect some normative judgment of what were the "needs" of the people. For these products, dictated quantities were well above the demanded quantity even at the regulated price. Examples include white bread and milk in plastic bags in Hungary[i], and cornmeal and bottled milk in Romania[ii]. These measures resulted in some strange situations. For example, because of the overproduction of bread, animals were fed on bread not only on household plots[iii], but often even in cooperatives getting their "supply" of unsold bread directly from the shops[iv]. In Hungary, milk was packed in plastic bags and thus could not be sold the next day, and so had to be destroyed. These goods, however, were only a few selected favorites of the regime, considered to be essential, not by the people, but by the government.

At the same time many other products, considered to be basic in more developed countries, were not available even for a higher price. To estimate the supply and demand for bananas or oranges, for example, would be difficult. Oranges were sold only at Christmas and at Easter in many of these countries; bananas appeared at Christmas only.[v] Even in these limited periods, the prices of these fruits were regulated and the resulting small amount supplied allowed the average citizen to buy no more than a few pounds. In contrast, some people bought a large number of bananas, such as the man in a Hungarian village who stated that he had made brandy from bananas.[vi] In addition, Hungarian military officers participating in live firing missile exercises in the deserts of Kazakhstan frequently told stories about very cheap watermelons being available in huge quantities in the Caucasian region.[vii] This watermelon production was dictated to supply the whole country, but, because the planners did not allocate enough trucks and gasoline to deliver the watermelons to the North, the watermelons were overabundant in a small area in the South.

Smith (1976) tells similar stories. He writes:

> In spite of the various tinkering reforms, the Soviet economy still operates by Plan from above rather than in response to consumer demand from below and this produces a lopsided assortment of goods. Goods are produced to fill the Plan, not to sell. Sometimes the anomalies are baffling. Leningrad can be overstocked with cross-country skis and yet go several months without soap for washing dishes. In the Armenian capital of Yerevan, I found an ample supply of accordions but local people complained that they had gone for weeks without ordinary kitchen spoons or tea samovars. I knew a Moscow family that spent a frantic month hunting for a child's potty while radios were a glut on the market. In Rostov, on a sweltering mid-90s day in June, ice-cream stands were all closed by 2 P.M. and a tourist guide told me that it was because the whole area had run out of ice cream, a daily occurrence. (Smith, 1976, 78)

Still, basic commodities were not the most inefficient segments of the socialist economy. The "heroes" of socialist economies were the military and the heavy industry sectors. The central planners' goal in these cases was to produce more in these industries no matter how much it cost the country. Initially the planners used the heavy casualties of World War II to justify forced development of heavy industry. But even as the prospect of conflict diminished over time, these industries continued to absorb significant quantities of resources. No one wanted these products at the price the state paid for them, but the members of top nomenklatura received them free of charge. These goods included huge Soviet cars that guzzled large amounts of gasoline, unbreakable "military" wristwatches, and hand-crafted luxury ornaments. Nevertheless, the most important products in the "heroes" of socialism category were products of the defense industry and the "services" of secret police organizations. Because none of these countries was threatened by external aggressors, except maybe other socialist countries, the defense rationale for producing them was bogus. The real reason for production of these defense goods and secret police "services" was that the communist elite needed these goods and services to stay in power. These industries were able to expand their control over a major part of resources, therefore becoming politically influential, especially in the former Soviet Union. By continuing to draw resources away from other uses, this military-industrial complex slowed development and democratization of the former Soviet republics during the transition.

2.2. The Need for Economic Indices

According to the logic of central planning, measuring production in money terms would be "unsocialist" when the government set both prices and quantities. As a consequence of this logic, socialist statistical agencies did not use the United Nations (UN) System of National Accounts (SNA) during most of the socialist regime. They instead used the material product system that was based on production quantities instead of values expressed in money terms (Estrin, Urga, and Lazarova 2001; Campos 2001). Interestingly, though, these countries started to use the UN SNA *before* the transition. Why they did so is an important question.

Signals of an impending economic crisis were already visible during the 1960s. At the macroeconomic level, the Soviet economy was beginning its slow decent into stagnation. Thomas Hammond, a researcher who visited Moscow in 1966, described the following:

> An exhibition boasting of Russia's agricultural achievements seemed a bit ironic, because the food situation that year was the worst the country had seen in a long time. Indeed, the crop failure was so serious that Russia was forced to buy wheat from the United States. (Hammond 1966, 319)

At the microeconomic level, rationing and shortages continued long after World War II. A basic rule of thumb was: "If you see something for sale that you want, buy it, because tomorrow there probably won't be any." (Hammond 1966, 320) Hammond also cited his conversation with a Russian professor mentioning food riots in Novocherkassk in 1962.

Signals of a serious economic crisis were also visible during the 1970s and 1980s. Indeed, in the 1970s, shortages were so widespread under socialism that New York Times correspondent Hedrick Smith, who won the Pulitzer Prize for his coverage from Moscow, titled one chapter of his classic book, *The Russians* (1976), "Consumers: The Art of Queuing." In the midst of various stories about queuing for basic consumer items, Smith writes, "The accepted norm is that the Soviet woman daily spends two hours in line, seven days a week . . ." (Smith 1976, 83).

Technological development was slow under socialism and the increasingly quick technological change in the West in the 1970s and 1980s meant that the socialist economies fell further and further behind. General Secretary Mikhail Gorbachev recognized this. "Over the last few years," he stated at a conference in November 1989, "the gap between the USSR and the developed countries in the assimilation of new, high, and in the first place information technologies, based upon the broad use of the latest achievements in science, has steadily increased."[viii] Many socialist countries, especially the Soviet Union and Romania, experienced serious shortages in almost everything during the 1980s.

These problems, however, could not be reflected in socialist statistics. The statistics instead registered steadily increasing production quantities, and recording fulfillments and over-fulfillments of plans was the ideal method to show development where there was no development at all. Using this method to cover the problems in statistics, however, did not solve the underlying problems. Inefficiencies of socialist economies caused the planners to look for resources elsewhere. "Exporting revolution" did not help because central planning destroyed the economy in all of the countries newly subscribing to the collectivist ideology. The only way to sustain the regime for additional decades was to borrow from Western banks, governments, and international financial institutions. Because these lenders required economic indices in the form accepted by the rest of the world, socialist countries first used the material product system and the System of National Accounts parallel to each other, and finally abandoned the material product system before the political changes.

2.3. Statistics in Socialism

Switching to a new system of aggregating numbers from the same sources caused little change to the deceiving nature of socialist statistics. Filer and Hanousek (2002, 234) caution about the consequences of the differences between Western and socialist accounting standards and the danger of seemingly identical meanings of totally different variables. Campos argues that socialist statistical offices, originally set up for measuring quantities, “were poorly equipped to deal with issues such as price changes and unemployment.” (Campos 2001, 667) Campos also observes that fulfilling plan targets, the main incentive of socialist statisticians, led to overreporting the results.

In fact, the newly implemented economic indices had no real meaning in centrally-planned economies anyway. The reason is that in a situation where all prices and production quantities are regulated, calculating GDP values from five-year plans would have been just as good, and just as meaningless, as measuring them using sophisticated statistical methods. Once the key numbers for the next period were established by the planners, it was easier to derive false data to support these numbers than to accurately measure productivity and output, measurements which would have showed the fallacy of the planning process. Since statistical offices did not have the power to question the sensibility of the plans, providing the “right” input for calculating aggregated indices was safer than providing the *real* one.

In summary, pre-transition statistical data cannot be used to describe the real economic and social conditions of the socialist era. Therefore, researchers must turn to other sources to reconstruct the real past. Unfortunately, practically no useful independent data sources existed for these countries, because they were different from many developing countries having insufficient statistical capabilities. While in the case of many developing countries, a weak but willing state often welcomed independent researchers from developed countries, in socialist countries the state was strong enough to prevent most, if not all, independent research.

For the reasons above, the reported experience of various individuals and generalizations from typical examples are the only possible ways of reaching the truth. In the next section, we rely mainly on these tools to describe the sources and real levels of inequality in the socialist era.

2.4. Examples of Hidden Inequalities and Income Transfers in Socialism

When price regulation causes shortages, people make up the difference between the low regulated price and the equilibrium price by standing in lines, paying bribes to shopkeepers, or using other practices. In every political system, the politically powerful have an advantage. Under the comprehensive price controls of World War II in United States, for example, gasoline was rationed and Congressmen and high government officials were given "A" ration stickers that allowed them all the gasoline they wanted at an artificially low price; the average citizen was often unable to drive from one city to another, given the small amount of gasoline allowed him. Airplane and railway tickets were also rationed. The famous television newsman, David Brinkley, for example, tells how, as a young man during the war, he broke up a romance because he was unable to travel to the city where his lady friend lived. Brinkley writes, “The new gasoline ration was too small to allow me to drive. Airplane and railroad tickets required a priority.” (Brinkley 1995, 46)

Under socialism, where there was a one-party state, the rationing system was one of even more extreme privilege. Because no legal political forces existed outside the communist party in these countries, there was little limit on political power. Although all of these countries had a certain kind of legislative body, it was subordinated to the communist party through the party membership of the legislatures. As a result, real decisions were made by party leaders, who took no direct responsibility for these decisions. This system led to a plethora of privileges for top state officials and party members at all levels with privileged access to goods and services among them. Moreover, privileges often meant not only privileged access, but also different prices.

Since members of the nomenklatura had power over the disposition of various scarce resources, they frequently used their connections to receive and provide favors to each other at the expense of the rest of society. In addition, this group was not only able to use these resources but also to overuse them or give them away, due to the lack of oversight and the concentration of power in the elite of the communist party. The only price they had to pay for these privileges was their loyalty to the regime, which was more important to the regime than actual party membership.

2.4.1. The Real Value of Privileges

While the extended system of privileges obviously had an impact on income inequalities in the socialist era, this impact did not appear in pre-transition income inequality measures. As one discontented Soviet put it, "Everything is *markirovannoye*—masked."[ix] Leonid Brezhnev, for example, General Secretary of the Soviet Communist Party and President of the USSR, had a Rolls Royce, Mercedes, Cadillac, Lincoln Continental, Monte Carlo, Matra, and Lancia Beta.[x] Of course, these items never showed up in Brezhnev's reported income. Referring to the effect of subsidies on essential items and the quality of vacation homes for the top party brass, one author, Milanovic (1996) argues that these privileges would not have altered income inequality measures to a great extent, saying that the value of these privileges was exaggerated by others:

> Elite privileges were exaggerated both by indigenous population, because of the secrecy in which privileges were held, and by overly credulous Western analysts. In effect anybody who has visited vacation homes previously kept strictly off-limits for all but the top Party brass can testify, their level of comfort and service is below that of an average Holiday Inn. (Milanovic 1996, 200)

The problem here is that, in dismissing the value of a vacation home by comparing it unfavorably to a Holiday Inn, Milanovic is, wittingly or not, implicitly appealing to Western standards. Few middle-class readers in the United States will regard a Holiday Inn as a luxury hotel. To almost any one in the eastern European socialist countries, however, a Holiday Inn would have been the height of luxury. So, if we want to "translate" Milanovic's statement for Western ears, it would go something like this:

> In effect anybody who has visited vacation homes previously kept strictly off-limits for all but the top Party brass can testify, their level of comfort and service is below that of an average Hyatt.

In other words, access to a vacation home that was rather high-quality by socialist standards, for a couple of weeks each year free of charge, was a substantial perquisite for those with political connections, one that would have been widely envied by those without.

The nomenklatura had access, not only to goods, but also to state resources. This was clearly true for those at the top:

> During the past decade tens of thousands of workers slaved to satisfy Ceaușescu and his wife, Elena, by creating gold-leaf walls, crystal chandeliers, marble columns, intricate parquets, handwoven carpets. Their reward: breadlines and winters without heat. With more than a thousand rooms the palace is one of the largest buildings in the world. (Szulc 1991, 5)

Another set of privileges that researchers tend to underestimate is the special treatment in health care, education, and housing, exceptions to rules about traveling abroad, customs, and the possession of foreign currency. Take just one of these special treatments, the ability to travel abroad. One way for Westerners to understand the importance of this one difference is for us to imagine that our Western government has a generally-enforced stricture on travel abroad, but that it relaxes this stricture for the small percent of the population that is politically connected. So, for example, if we live in New York, we are prohibited from traveling to Montreal, Toronto, London, Paris, Tokyo, or any other place outside of the United States. Most of us would regard this one stricture as a huge drop in our real income and would, therefore, regard permission to travel to these newly-exotic cities as a substantial benefit.

Not just the exceptions to the rules on travel abroad, but also all of the other rules—on health care, housing, and education—exacerbated income inequality. These differences were less visible for the general public and also more difficult to understand while they were far more important in preparing for the political changes and privatization. We discuss some of these differences in this section.

2.2.2. Corruption

An unmeasured but pervasive practice, corruption, may have also significantly influenced income inequality in the pre-transition period. Corruption, as measured through surveys and other subjective practices, appeared to rise early in the transition process, especially with respect to the privatization process (Goorha 2000, World Bank 2000). Corruption, through its negative influence on economic growth, tax progressivity, and asset ownership, has been, in general, found to influence income inequality. Thus, some researchers have concluded that income inequality must have increased in the transition period with the precipitous declines in economic growth and tax progressivity, and with the concentration of former state-owned assets in the hands of the few (Gupta, Davoodi, and Alonso-Terme 1998).

However, even though corruption during the transition to private ownership must surely have increased personal wealth for those who were corrupt, the increase in measured inequality cannot be due to this corruption because the increases in personal wealth were not counted as income in the surveys in transition countries. On the other hand, corruption in public administration, health care, education, or law enforcement directly affected income inequality in both the pre-transition and transition period. The most important thing to note here is that this kind of corruption was much more prevalent in the socialist era. Measuring this corruption, however is much more difficult than measuring corruption in privatization, or in business practices in the transition period.

Interestingly, both Goorha and the World Bank study cited above identify the origins of today's corruption in pre-transition practices. These sources cite, as the cradle of today's practices, the formation of the *nomenklatura* through the influence of communist parties that appointed individuals to key positions. Among the origins of corruption, the World Bank study also mentions the culture of state intervention together with the rapid devaluation of the salaries of bureaucrats during the early years of transition. Despite this, neither study considered whether corruption might have been higher in the era when the legislature and the judicial branch were inseparable from the executive branch of the government, with the Communist party controlling all of them as well as the researchers' access to data on these countries. Yet basic economic theory, in this case, the idea that when people can more easily get away with something that benefits them personally, they will do so, implies that corruption must have been greater under Communism. Corruption in privatization was only one aspect of corruption, which was relatively easy to measure in a new era when conducting independent surveys was newly possible. Focusing on corruption related to privatization might have caused researchers to assume that there had been little corruption in the past. In fact, there was no connection between corruption and privatization in the socialist era for one main reason: the socialist era, by definition, had no privatization.

But we need not rely on basic economic theory; we can also look at the evidence. Shortages and artificially-low official prices, the existence of privileges and black markets, and the uncontrolled power of bureaucrats all helped corruption to thrive in an era of lies and nationalized plunder. People without connections had to pay unofficial service fees for practically everything. Those who paid the fees were, typically, already in the lower part of the income scale. Those who received the fees, on the other hand, were, typically, already in the upper part of the income scale. Therefore because such fees were unmeasured, the degree of income inequality was understated. This system of bribery became so prevalent during the socialist era that few people in the socialist countries considered it as corruption. These conditioned reflexes, not political liberalization and termination of direct state control, are the main driving forces behind corruption in the transitional economies today.

2.2.3. Health Care

Informal payments in the health care sector also received attention in the transition period as serious impediments to health care reform (Lewis 2000). The research shows that in the former Soviet republics, informal payments were made in over 60 percent of transactions; the frequency of informal payments was 91 percent in Armenia. Informal payments are also reported in most Eastern European countries.

While these payments were undoubtedly frequent during the transition, what is left out is what happened before the transition: in socialist countries, the majority of people regularly paid for health care. Referring to such payments as gratuities rather than bribes was simply a way of rationalizing and justifying a practice. Moreover, the health care was low-quality and often dangerous. Smith, for example, tells of a conversation he had with an East German gynecologist who had practiced for three years in Leningrad. She stated:

> Hospitals are overcrowded. Now they are building them with smaller rooms, say six to a room, but the ones I saw had many beds. Not a very pleasant atmosphere. The food is poor. Most families bring food to their relatives in hospitals and they give gifts to the *saniturki*, nurses' aides, so that bed linens will be changed regularly and things will be kept cleaner. (Smith 1976, 96)

On the other hand, no payment was required from the well connected, who were already in the higher income portion, because they could do favors for the doctors and nurses at the expense of the state. In addition, well-connected people did not wait in lines while the average citizen could not even make an advance appointment. Special hospitals for the privileged had better equipment, more trained personnel and better collateral services. In the Soviet Union, for example, the *nomenklatura* could get zero-price care at the Kremlin Clinic, which was not one clinic but a system of clinics and hospitals. Other *nomenklatura* could go to sanitariums and clinics along the Baltic Coast and the Black Sea, run by the "Fourth Administration" of the Ministry of Health. Other prestigious organizations like the Academy of Sciences and the Bolshoi Ballet and Opera Company had special clinics and hospitals that were much higher-quality than the average.[xi] Because these institutions were also part of the state provided "free" health care system, the fee was either very low or zero. And the most powerful political leaders often had the doctors come to them.

Another form of discrimination was to prescribe different medicines for privileged and non-privileged people with the same health problems. In more difficult cases, differences in methods and available equipment were also evident. While for the privileged elite even an expensive operation in a Western hospital would have been available at government expense, the citizen without connections would be subject to inferior treatment and conditions.

All of these factors made the actual income distribution much more unequal than official data imply.

2.2.4. Education

Pre-transition inequality in education is another important factor overlooked or underestimated by most researchers. Mickelwright observed, for the transition, an increase in the ratio of household education expenditures per child in the top decile to expenditures per child in the bottom decile of per capita income in Slovakia and Bulgaria (Mickelwright 1999, 365, Figure 7). Based mainly on this observation, he argued that access to education became more restricted for low-income families during the transition. But this conclusion doesn't follow from his data. The increasing difference in education expenditures is consistent with a much more plausible explanation, given how socialism operated. That simpler explanation is that the elite presently spend more on education to obtain a higher quality education for their children, whereas, under socialism, the elite could get a better education for their children without spending more because the government provided better schools for the children of the elite.

A recent study of the World Bank on the challenges faced by transition countries in the field of education (World Bank 2000.) also focuses on problems that arose during the transition, depicting education in the communist era as ideal. The study reports enrollment rates in tertiary education[xii] for the transition period from 1989 to 1997. The reported enrollment rates are displayed in Figure 2.2.

{Figure 2.2 goes here]

As shown in the figure, enrollment rates in tertiary education have increased in most transition countries, even in some of the otherwise weakly performing former Soviet republics. Far from showing increasing inequality, this increase shows the opposite. The opportunities to study became more evenly distributed in a freer society than in the communist past, when all efforts were concentrated on building a static society with emphasis on basic education and barriers to higher education. Important to notice is that the communist motive for emphasizing basic education was not philanthropic. The main purposes were to build loyalty to the regime and to maintain the hierarchy of society. The main problem of central planners in this field was a direct consequence of assuming the role of organizing the economy. With total control of the economy, communist leaders had to realize that they became responsible for assigning people even to the most menial jobs. As one Hungarian government official asked, “who will get the hoe if everybody studies?” Although most of the early leaders of the socialist countries were not highly educated, this ruling elite soon realized that privileged access to education was an important factor in maintaining their power. The barriers built into the educational system served this purpose effectively.

On the other hand, education had to be "free" for the sake of socialist rhetoric. As a result, "free" higher education, available for everybody in theory, benefited the elite even more than a higher education with high tuition fees. Communist decorations, party membership of the parents, and references from the secretary of the local section of communist youth organizations all played a part in the entry process into higher education. This facilitated selection in favor of the already-privileged, already-higher-income groups. Interestingly, despite his claim that, during the transition, access to education became more restricted for lower-income people, even Mickelwright noted that these biased selection methods under communism created privileges for the elite:

> Studies and data emerging in the 1990s, however, have confirmed that as in some other aspects of life in the socialist system there were considerable disparities in educational opportunities and achievements. Access to upper

> secondary and tertiary levels of education showed many of the differences associated with social class background that are found in Western countries. … In both countries [Hungary and Poland], the children of the highest social class were almost four times as likely as the average person to obtain an academic upper secondary or tertiary qualification, while children from other non-manual backgrounds were about twice as likely to do so. This fits strikingly with the pattern shown for Western European countries. (Mickelwright 1999, 351)

Two important distinctions must be made, though, between the West and the socialist countries. First, in Western countries, parents or students had to pay more for better education, unlike the situation in the socialist countries. Second, those in the West who have higher incomes are typically more productive than those with lower incomes; in the East, by contrast, those with higher incomes were typically well-connected politically.

2.2.5. Housing Programs

Subsidized housing was another forgotten source of inequality in socialist countries. Parallel to the forced industrialization in the late 1950s and the 1960s, socialist countries started massive residential construction programs in the cities. The main purpose of these housing programs was to provide subsidized housing for the working class, at the expense of the rural population and the homeowners in the cities. The new housing units were usually owned by the state and administered by the city councils. While the allocation of these units was characterized by the usual corrupt practices of the socialist regime, the rents were very low. People in villages, by contrast, did not receive subsidized housing programs; instead, they experienced forced collectivizing of privately-owned farms and nationalizing of livestock and farming equipment. By the 1970s, construction programs had slowed, but housing in the cities was still heavily subsidized by the state, with rents well below the cost of maintenance. In Romania, state residential construction reached the villages also in the 1980s. In most cases, however, Romania’s housing programs for the rural population were forced relocations, not subsidies, because construction was started by destroying family houses. As a result, many villagers were forced to live in four or five-story concrete panel buildings without central heating, carrying firewood by foot to their apartment every day. Despite these programs, the share of the population living in state-owned apartments was only around 20 % in most Eastern European countries, with a substantially higher rate in the former Soviet republics (Diamond 1999).

According to the data, private rental was either extremely rare or non-existent. In contrast, shortages in state-provided housing led many people to rent rooms or apartments from individuals. This practice, however, was illegal or quasi-illegal in the socialist era. On the other hand, private rentals from individuals had a significant impact on income inequalities in both the pre-transition and the transition period. In the pre-transition period, income from subletting rooms or apartments was an invisible income transfer, often from commuters living in villages to the already subsidized part of the urban population. This transfer caused income inequality to be higher than reported. For the transition period, income from sublets has been heavily underreported in income surveys, since this income is easy to hide from the tax authorities. In the transition period, however, this income transfer may cause a decrease in income inequality, because in many cases the landlords are low-income individuals living in former industrial cities that suffered most from recession. Reporting the income, therefore, would cause a measured decrease in income inequality. The net result, therefore, is that both the underreporting of rental income in the Communist era and the underreporting of rental income during the transition cause the increase in inequality to be overstated.

2.2.6. Cities vs. Villages in Socialism

The level of housing subsidies was not the only difference between cities and villages under the socialist regime. Virtually all urban development under socialism was at the expense of the rural population. While income from farm self-employment is usually counted in income surveys, the value of subsidies not directly allocated to individuals is not counted. On the other hand, most of the schools at the level of secondary education or above were in cities, even if they trained workers for agriculture. Health care institutions and public administration were also concentrated in the cities. These were, however, not the most serious factors shaping the differences between the rural and urban population.

While concentrating on forced industrialization, central planners overlooked a less interesting, but more important sector of the economy: agriculture. As a consequence of this failure, socialist countries experienced serious food shortages during the 1950s. Since land was still privately owned, communists concluded that private ownership was the reason for food shortages. As early as 1929, Stalin announced that the Soviets would turn to the annihilation of the kulaks as a class instead of limiting their exploiting ambitions (Courtois et al. n.d.). Their solution was to fulfill the needs of the cities by requisitions in the villages. In many cases, they took even the seed and workstock needed for the next production year. When the communists realized that requisitions did not solve the problem, they turned to forced collectivization, practically turning landowners into slaves of the state. Neither the impact of these measures on inequality, nor the cost of replacing this capital, which was often paid by the former farmers in the form of money and of overtime work, was counted in income surveys of socialist statistics. Thus, again, income inequality was understated. A good illustration of this gap between the city and the village can be found in Berend's description of the reforms in Hungary during the early 1980s, when the communist government experimented with new concepts to incentivise workers of state-owned companies. In describing the 1980s reforms, Berend refers to the earlier situation in agriculture:

> In the state-owned large industrial enterprises, worker-engineer cooperatives were established. Members sign contracts with their own companies, whose machinery and tools they use. They do overtime on their own for considerably higher pay, increasing labor input significantly. The result is that while legal working hours had been curtailed to 40 hours per week, the activities of these cooperatives and individuals increased the total working hours on a voluntary basis. *Previously this phenomenon was observable only in agriculture, where half the number of those employed in industry contributed the same number of working hours as the industrial work force.* [emphasis added] (Berend 1990, 400-401)

In other words, according to Berend, people working in agriculture were working twice as many hours as people outside agriculture. Thus what might have looked like a small difference between country and city in the statistics really showed that real income per hour was much lower in the country.

2.2.7. Savings

Lost savings have probably been the most common reason for nostalgia during the transition. Savings provided a perception of security, and savings in socialist countries were "among the highest in the world, averaging about 30 percent" (Denizer and Wolf 2000, 446). During the first few years of transition, however, saving rates dropped dramatically in the transition countries. Remarkably, these changes followed the same pattern as many other variables like inequality, economic growth, or per capita GDP. In the pre-transition period, socialist countries looked like a homogenous group with economic indices corresponding to the socialist ideology. Shortly after the political changes, however, this uniformity ceased to exist with saving rates reflecting much worse conditions during the early years of transition than in the pre-transition era.

This coincidence supports the argument of Denizer and Wolf (2000) that the reason for the rapid decrease in the saving rates was involuntary saving in the pre-transition period. Because access to goods and services depended on privileges and connections in the centrally-planned economy, those not privileged or connected could not spend on goods they wanted. As a result, these citizens were able to save. Savings under socialism, therefore, were a passive result of a generalized shortage of goods.

During the transition to a market-oriented economy, spending on goods previously unavailable became possible. At the same time, however, high inflation devalued these savings, giving the impression of growing poverty. However, because savings in the socialist era could not be spent, their real value was well below the perceived value. In other words, the part of income saved during the socialist era was less valuable for people without privileged access to certain goods, causing income inequality in the pre-transition era to be underreported.

2.2.8. Privatization and the Last Decade of Socialism

It was not an accident that socialist countries started to experiment with reforms from the mid 1970s on. While the increase in world oil prices seems to be an obvious explanation, it was not the real reason. In fact, the escalation of oil prices in 1974 even helped the Soviet Union because of its huge oil reserves. The real reason was different. World War II caused serious losses for the Soviet Union and also for the new socialist countries of Eastern Europe. When the Soviet Union tried to cover its losses by forcing some of the Eastern European countries to pay compensation, these countries' governments decided to nationalize industries to generate revenue. Nationalization partly provided the funds for war compensation to be paid to the Soviet Union, and the material basis of the new socialist regimes. On the other hand, nationalization did not create wealth or raise the capital assets of these countries. As a result, socialist countries experienced their first economic crises as early as the late 1950s. Since central planning did not create the incentives necessary for economic development, socialist leaders turned to the "proven" method of taking property by force again. This time they quasi-nationalized the agriculture sector by forced collectivization during the 1960s. By collectivizing, however, they exhausted their last reserves. There was nothing to take and nobody to take from any more. You can't nationalize the same asset twice.

At this point, central planners had two choices. They could either satisfy their needs by further expansion to countries outside the socialist block, or incentivise people by letting them own private property beyond immediate consumption purposes. The first option was not sustainable because wherever socialist economic principles were introduced, they destroyed the economy of the given country. As a result, economic liberalization remained the only option. On the other hand, communist leaders and beneficiaries of the socialist regime did not always recognize these problems. Reforms in Czechoslovakia, for example, led to a Soviet-led intervention by Warsaw Pact countries in 1968. Another example is the case of Hungary, where the reforms of 1968 caused internal social conflicts as well as a rapid rise in acknowledged inequalities. As Berend stated, "before 1968 the ratio between the lowest and highest salaries was 3:1; it quickly changed after that year to 9:1." (Berend 1990, 397)

Major changes, however, could not be postponed for long. Starting in the early 1980s, socialist countries followed similar paths of reforms directed by the communist governments. The first step was the creation of small, semi-independent production units within state enterprises (as described by Berend (1990) in the case of Hungary.) These units were composed of employees who performed certain tasks as regular employees and others on a contracted basis. Although these units created an incentive for overtime work, they had serious disadvantages. The main problem was that, when working in these production units, employees used the same equipment provided by the same company for their regular jobs. They were also better paid for contracted tasks. As a result, these employees became almost counterproductive in their regular jobs in order to guarantee that they could perform the same tasks as contracted work later.

Parallel to the introduction of these production units, socialist governments allowed some primitive forms of small private enterprises. Connections or bribes, however, were essential when applying for a license. As a result, communists often became the first "successful entrepreneurs" in an environment without competitors, as in the case described below:

> In the wine country south of Budapest, I meet Gábor Kemény in the little town of Izsák. Kemény, a former Communist Party member, is Izsák's most successful entrepreneur. He owns a pleasant restaurant named Fekete Bárány (Black Sheep), the general store, and the local gas station. He makes wine and champagne on land leased from the local cooperative. (Szulc 1991, 25)

Another component of preparing for the transition period was the increase of consumer prices, resulting in high inflation in the last decade of the pre-transition period and the erosion of the real value of savings for those unable to spend their money on goods and services due to shortages. Some of these savings were also spent on shopping trips in Western Europe, mainly Austria, Germany and Italy, during the last few years of the socialist regime and the early years of transition. The intensity of this shopping tourism also indicates that the lack of access to desired consumer goods, not socialist frugality, was the reason behind savings in the pre-transition era.

Parallel to the process of the devaluing savings, communist leaders of the former socialist countries prepared for privatization. Enterprise reforms starting in the 1980s, and in some countries even earlier, were aimed at "lightening the amount of control of planners" (Nellis 2002, 3). The stated goal was to create incentives through more autonomy. On the other hand, these measures had a serious side effect observed by Estrin (2002), a side effect that was probably intentional.

> Under communism, the monitoring of management and the incentives for efficiency were already weak. But with the collapse of central planning and the lack of any other external constraints, managers and insiders in transition economies gained almost total discretion to follow their own objectives, leading to "asset stripping" by managers, job and wage guarantees for workers and rent absorption by all parties. This pattern was exacerbated in countries with well-entrenched black economy and sometimes led to a virtual "capture" of the state-owned apparatus, including the natural resource and utility sectors, by unscrupulous managers. (Estrin 2002, 107)

The word "rent" in the above quote is used in the economic sense—a payment over and above the amount necessary to keep the resource in its current use. Given that the elite was well-positioned and that the public wanted changes, the first wave of privatization passed over quickly. Fearing that the reform process would reverse, most researchers and external advisors also preferred rapid massive privatization to a slow, but, possibly, more-considered process, advocated by Kornai (1990). This speed, however, had a price. In Russia, for example, "The need to reward the key stakeholders had led to firm managers and workers, 'insiders' as they became known, ending up with a dominant 2/3 of the shares in about 2/3 of all firms divested." (Nellis 2002, 50)

Another important aspect of privatization was the exclusion of foreign purchasers. With the exceptions only of Hungary and Estonia, where foreign capital purchased about 20 and 50 percent of the privatized assets respectively, foreign investors were unable to participate in the privatization (Estrin 2002). While local media mainly attributed this exclusion to a public aversion to foreign ownership, it was probably due more to aversion by the elite. Their interest was in convincing the public about the advantages of excluding foreign investors. With this measure, the elite eliminated competition from foreign investors, allowing them to pay lower prices for their asset purchases. Another advantage of excluding foreign investors was that doing so made it easier to hide valuable information from the public.

Ingrown reflexes from the socialist era and the willingness of the old-new elite of the early transition, who continued the practices of the past in order to take advantage of their position in the government, also affected the outcomes of privatization. Consider this example from the former Czechoslovakia:

> At the last moment some cracks had appeared in the Stalinist walls: Officials in Prague in May 1990 noted that from late 1988 workers in large firms had been allowed to select their managers from a list of three presented to them by the branch ministry. They said they had regarded this as a revolutionary change at the time. What was striking, however, was that the post-communist regime reversed this decision in April of 1990, and reinstated managerial appointment solely by the branch ministries. Why? Because 'the professors and researchers' who made up the new administration accepted – unlike the Poles, with their longer history of struggle and suspicion, and the availability of alternatives – that *it was the state that had to define and allocate property rights* [emphasis added]. (Nellis 2002, 24)

In his 2002 article, Roland argues that while privatization policy favoring insiders could result in a high concentration of wealth and power, these policies themselves may not be the ultimate reasons for such concentration. These privatization policies themselves could be the results of prior privilege-seeking activities during the pre-transition period. The above quote also supports this second statement: not the policy choices of the transition period, but the efficiency of the elite to position itself was the main determinant of today's differences in the transition countries. In other words, privatization did not increase inequality; it only made it visible and measurable. The control over the same wealth had been more concentrated before the transition than in the transition period; it only changed its form from political control to a control based on ownership.

3. Conclusion

In the past few years, research on transition economies found that income inequality increased in spite of a parallel liberalization of political and economic life in the former socialist countries of Eastern Europe and Central Asia. Since the observed increase in inequality occurring parallel to political liberalization contradicted previous findings in other regions (Gradstein and Milanovic 2000), and many authors warned about poor data quality (Milanovic 1998, Rosser, Rosser, and Ahmed 2000), overlooked factors (Kattuman and Redmond 2001), and the effect of special circumstances (Ferreira 1999), the apparent increase of income inequality was suspect and required further analysis.

Other research into the various factors that affected either the level or the measure of income inequality showed that the argument that economic and political liberalization of centrally-planned economies led to higher income inequality is rather weak (Henderson, McNab, and Rózsás 2003). This research also showed that an explanation based on a large uniform bias in the pre-transition data towards smaller measured inequality is more likely. Unfortunately, reconstructing pre-transition data on income inequality with greater accuracy and reliability is not possible.

This paper analyzes the hidden inequality in socialism with a different approach. As seen in the first part of the analysis, statistical data from the socialist era did not provide a valid base for comparison between the socialist and the transition period. Economic indices were meaningless in a centrally-planned economy and the purpose of statistics was to justify the existence of the regime – not to reveal its real character. As a result, the methods used by the regimes were unreliable and inaccurate, and could hide huge inequalities.

In addition, the socialist economy and society had built-in mechanisms to hide huge income transfers from even the most accurate survey methods. Consequently, the ultimate source of the inequalities was neither the economic or political liberalization, the transformation from a centrally-planned to market oriented economy, nor any other aspect of the transition process. Rather, what caused the inequality was uncontrolled political power in the socialist era. Being uncontrolled, this power provided the ruling class the opportunity to concentrate on the benefits of the economy through legalized pillage of private property, the promotion of corruption and the system of privileged access to consumer goods.

In summary, inequalities in real disposable income were so high in these societies, and survey methods were so unreliable that, even if the real inequality measures of the socialist era cannot be reconstructed, a real increase in income inequality during the transition is not likely. In addition, programs that increased income inequality by helping some of the higher-income people looked to the outside world like programs that actually helped the poorest. The reason is that most of these countries were much poorer than the official communist propaganda reported. Therefore, a program that subsidized, say, petty party functionaries and miners, who were poor by Western standards, actually transferred wealth from the poorest to the second-highest tier in communist society.

Beyond being a source of nostalgia for the communist past, income inequality in transition countries is important as an indicator of the "state of affairs" in these countries. The equality of income and wealth, however, is only one aspect of welfare and not the most important.

In fact, the causes of income inequality are more important than the level of income inequality itself. In a market economy, income inequality can create incentives to work harder, study more, and take sensible risks, and thus may contribute to economic growth. On the other hand, inequality caused and maintained by plunder discourages people from working or studying more and hinders economic development. Therefore, further research should focus on the causes of inequality instead of its level, with special attention on corruption and income redistribution through government transfers.

After decades of socialism, people in the transition countries cannot always differentiate between inequalities caused by different factors. For this reason, eliminating income inequality that is due to corruption, fraud, abuse of power, and unjustified government transfers is even more important in these countries, and the appropriate way to do it is to eliminate or reduce corruption, fraud, abuse of power, and unjustified government transfers. The economic miseries caused by more than four decades of central government planning cannot be cured with other government programs. Instead of nurturing nostalgia, governments and legislators of the transition countries should abolish unnecessary restrictions on their economies, eliminate subsidies and decrease taxes, and cut back on the overgrown and inefficient system of government transfers, including social security. Additionally, transition countries should reinforce public administration and jurisdiction through extended training of government officials, and determined measures against corruption and fraud.

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[i] Based on the experience of one of the authors as a teenager and young adult in socialist Hungary.
[ii] Based on the experience of one of the author's spouses as a teenager in socialist Romania.
[iii] Shane (1994), 80.
[iv] Goldman (1987), 35.
[v] Based on the experience of one of the authors as a teenager and young adult in socialist Hungary.
[vi] Based on the experience of one of the authors as a teenager and young adult in socialist Hungary.
[vii] Based on conversations of one of the authors with Hungarian military officers participating in military exercises in the former Soviet Union.
[viii] BBC 1989, SU/0616, November 17, 1989, p. B/8, quoted in Shane 1994, 69.
[ix] Smith 1976, 41.
[x] Goldman 1983, 104, referenced in Lebergott 1993, 29.
[xi] Smith (1976), 43.
[xii] The study defines tertiary education as follows: "Education programs offered to students who have successfully completed prerequisite studies at the upper secondary level. There is usually opportunity for post-secondary technical as well as university training. Program completion is marked by the awarding of a university degree or a recognized equivalent qualification." (World Bank 2000, 136)