

# Section 3 Centrally Planned Economies

## Preview

### Objectives

After studying this section you will be able to:

1. Describe how a centrally planned economy is organized.
2. Analyze the centrally planned economy of the former Soviet Union.
3. Identify the problems of a centrally planned economy.

### Section Focus

In a centrally planned economy, the central government controls the economy. Central planning has limitations and disadvantages not found in market economies.

### Key Terms

socialism  
communism  
authoritarian  
collective  
heavy industry

**C**entrally planned economies operate in direct contrast to free market systems. In practice, centrally planned economies result in inefficient economies that severely limit individual freedom.

## How Is a Centrally Planned Economy Organized?

In a centrally planned economy, the central government, rather than individual producers and consumers in markets,

answers the key economic questions of production and consumption. A central bureaucracy makes all the decisions about what items to produce, how to produce them, and who gets them. After collecting information, bureaucrats tell each firm what and how much to produce. It is up to the bureaucrats to ensure that each firm has enough raw materials and workers to meet its production goals.

### Government Control of Factor Resources and Production

In a centrally planned economy, the government owns both land and capital. In a sense it owns labor, too, by controlling

► Government posters in Cuba (left) and Cambodia (right) try to inspire worker productivity in these centrally planned economies.



where individuals work and what wages they are paid. The government decides what to produce, how much to produce, and how much to charge. Each year, it directs workers to produce a certain number of trucks, so many yards of cotton fabric, a certain amount of glass, and so on. Farmers are told what to plant, how to plant, and where to send their crops. The free market forces of self-interest and competition are absent from the system.

For example, let's follow the decision-making process for the production of military uniforms and a consumer product—sweaters.

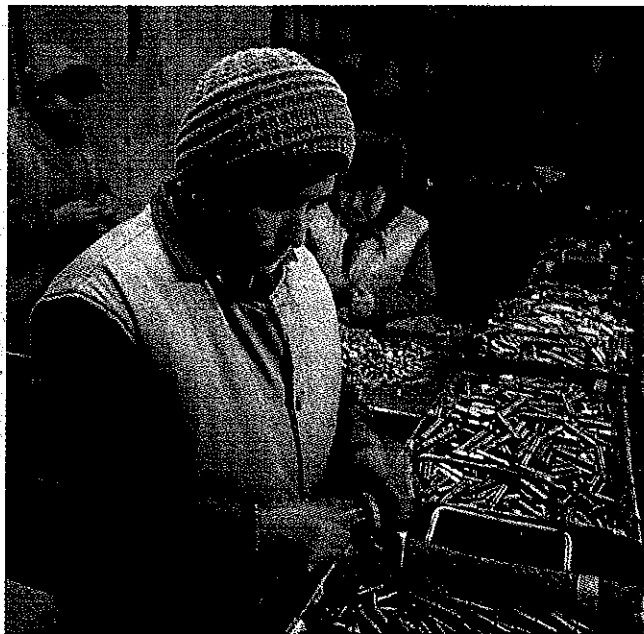
1. The top planners decide that more military uniforms than sweaters will be made. They send this decision to the materials committee.
2. Knowing how much cotton is available, the materials committee decides how many sweaters and how many military uniforms will be made. They send their decision to the cotton makers, the button makers, and the elastic makers.
3. The cotton, the buttons, and the elastic arrive at sweater factories and uniform factories where they are manufactured into sweaters and uniforms.

As you can see, decisions on what to produce and how much to produce are not determined by consumers. Chances are that many citizens living under this economy would still need new sweaters. This lack of consumer voice in production and distribution shows that under centrally planned economies, consumers do not have consumer sovereignty.

### Socialism and Communism

The words most often associated with centrally planned economies are *socialism* and *communism*. They are often used interchangeably, but we need to make a distinction between the two terms.

**Socialism** is a social and political philosophy based on the belief that democratic means should be used to distribute wealth evenly throughout a society. Real equality, socialists argue, can only exist when



▲ How would you describe production in this Romanian factory?

political equality is coupled with economic equality. Economic equality is possible only if the public controls the centers of economic power. Although socialist nations may be democracies, socialism requires a high degree of central planning to achieve economic equality.

In socialist countries the government often owns major industries, such as utilities. Socialism, as you will see in Section 4, exists to varying degrees in different nations throughout the world.

Communism is a political system that arose out of the philosophy of socialism. **Communism** is characterized by a centrally planned economy with all economic and political power resting in the hands of the central government.

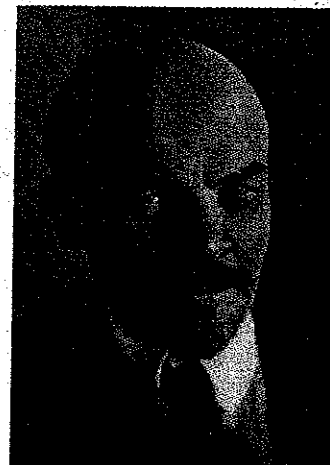
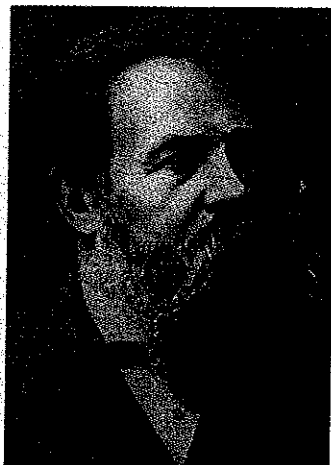
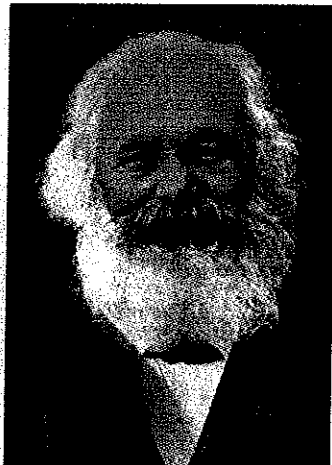
Unlike socialists, however, communists believed that a socialist society can only come about after a violent revolution. While socialist economies can still allow for democracy, communist governments are **authoritarian**. Authoritarian governments exact strict obedience from their citizens and do not allow individuals freedom of judgment and action. Throughout history, communist nations have been dominated by a single political

**socialism** a social and political philosophy based on the belief that democratic means should be used to evenly distribute wealth throughout a society

**communism** a political system characterized by a centrally planned economy with all economic and political power resting in the hands of the central government

**authoritarian** requiring strict obedience to an authority, such as a dictator

► Karl Marx (left) and Friedrich Engels (center) introduced their socialist philosophy in *The Communist Manifesto* in 1848. The term *communist* was adopted by the Bolsheviks who, led by Vladimir Lenin (right), took control of Russia in 1917.



*collective large farm leased from the state to groups of peasant farmers*

party or dictator. The former Soviet Union was a communist nation that provides us with a good case study of how a centrally planned economy works—and doesn't work.

## The Former Soviet Union

The Soviet Union arose out of a pair of revolutions in Russia in 1917. In March, imperial rule in Russia came to an end when Czar Nicholas II was forced from the throne. A provisional republican government was set up, but by November it, too, was toppled. It was taken over by the Bolsheviks, revolutionary socialists led by Vladimir Lenin. Once in power, they renamed themselves communists. Under the control of the Communist party, central planning was introduced during the 1920s and continued to operate until the breakup of the Soviet Union in 1991.

Soviet planners were most concerned with building national power and prestige in the international community. As a result, they allocated the best land, labor, and capital to the armed forces, space program, and production of capital goods such as farm equipment and factories. The committees that ran the system were responsible for deciding the quantity, production process, and distribution of 24 million different goods and services.

► How would you describe the farming techniques shown in this photo of a Soviet collective?

## Soviet Agriculture

In the Soviet Union, the central government created large state-owned farms and collectives for most of the country's agricultural production. On state-run farms, the state provided farmers with all equipment, seed, and fertilizer. Farmers worked for daily wages set by economic planners.

**Collectives** were large farms leased from the state to groups of peasant farmers. Farmers managed operation of the collectives, though they still were required to produce what the government instructed them to. Farmers either received a share of what they produced or income from its sale.

Agricultural workers were guaranteed employment and income, and the govern-

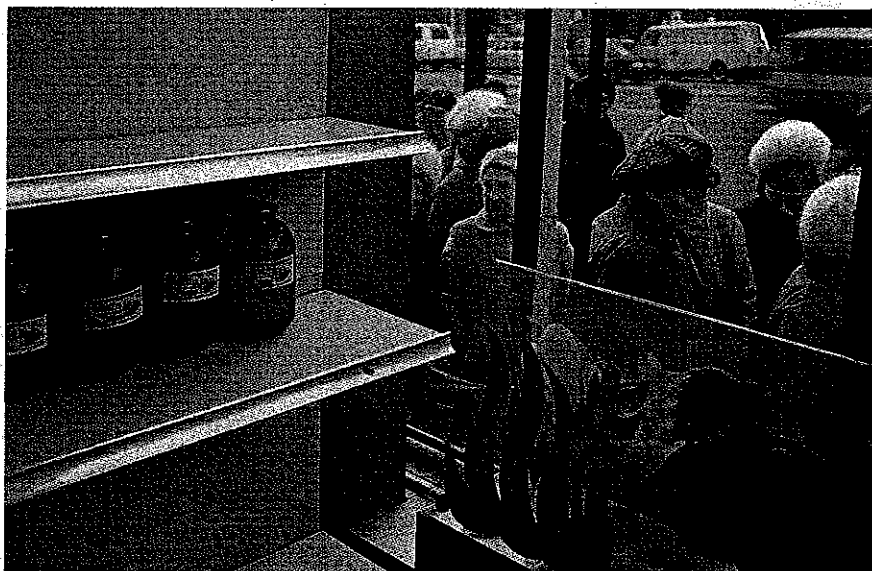


ment established quotas and distribution. Under such a system, individuals had few incentives to produce more or better crops. While Russia had been a major exporter of wheat until 1913, before long the Soviet Union could not keep its own people fed. Soviet agriculture bore much of the opportunity cost of Soviet central planning decisions.

### Soviet Industry

Soviet factories also were state-owned. Planners favored the defense industry, the space program, and **heavy industry**. (Heavy industry requires a large capital investment to produce items used in other industries. Chemical, steel, and heavy machinery manufacturing are heavy industries.) The makers of consumer goods and services paid the opportunity cost of this concentration of resources. They were stuck with leftover, lower-quality resources with which to create their products.

Like agriculture, industry was characterized by a lack of incentives. Jobs were guaranteed, and wages were set by the government. Once a production quota was met, there was no reason to produce more goods. Workers had little incentive to work harder or to innovate. In fact, it was illegal for workers to exhibit entrepreneurial behavior.



▲ Soviet consumers often waited hours in long lines only to discover nearly empty store shelves.

### Soviet Consumers

Consumers, too, experienced the opportunity cost of central planners' decisions. Consumer goods were scarce and usually of poor quality. Manufacturers had the incentive to focus on quantity, not quality. For example, a manufacturer assigned to produce a certain number of suits could loosely stitch the buttons and forget the buttonholes and mismatch coats and trousers. Still, the state store had to accept delivery of the suits. Consumers would be left with no alternatives.

Consumers often had difficulty getting goods, too. They wasted countless hours waiting in line to purchase goods and services. Luxuries such as meat were made affordable by government price setting, but they were rarely available. Housing shortages forced people to live in crowded and poorly constructed apartments. Because of the long waiting list for apartments, it was not unusual to find a family living in just two rooms.

*heavy industry industry that requires a large capital investment and that produces items used in other industries*

#### THE WALL STREET JOURNAL CLASSROOM EDITION

*In the News* When Alexander Lukashenko became president of Belarus in 1994, the former Soviet republic retreated to a centrally planned economy. As this excerpt from a Wall Street Journal Classroom Edition article shows, entrepreneurship was discouraged.

City authorities in Minsk "threw the book at Patto Pizza's pasta. Inspectors from the Public Nutrition Department, or Obshepit, decreed the restaurant's menu wasn't in keeping with the official Belarussian cookbook, a 200-page tome designed to guarantee that national dishes are prepared exactly the same way throughout Minsk. For this and [various] other violations, including unauthorized ice levels in [drinks], the city closed the restaurant."



▲ Statues of Lenin were toppled after the collapse of communism in the Soviet Union in 1991.

## Problems of Centrally Planned Economies

Central planning can be used to jumpstart selected industries and guarantee jobs and income. The other side of the coin, however, is poor quality, serious shortages of non-priority goods and services, and diminishing production.

In theory, centrally planned economies can work effectively toward explicitly stated goals. For example, in 1928, Soviet leader Joseph Stalin instituted the first of

several five-year plans to boost production. While a disaster in terms of agriculture, Stalin had some success in increasing output in heavy industries.

Perhaps the greatest disadvantage of centrally planned economies is that their performance almost always falls far short of the ideals upon which the system is built. In addition, such systems generally cannot meet consumers' needs or wants. Since the government owns all production factors, workers lack any incentive to work hard. These systems also do not reward innovation, actively discouraging any kind of change. The large, expensive bureaucracy necessary to make the thousands of production and distribution decisions to run the

economy lacks the flexibility to adjust to consumer demands. Decisions become overly complicated. Finally, command economies sacrifice individual freedoms in order to pursue societal goals.

Many areas of the world, especially less developed countries, have experimented with centrally planned economies, but most of these experiments have failed. Instead, most of these nations have moved toward mixed economies over the past twenty years. In the next section, you will read about today's mixed economies.

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