The Hidden Inequality in Socialism

DAVID R. HENDERSON, ROBERT M. MCNAB, AND TAMÁS RÓZSÁS

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. One apparent reason for this belief is a perceived increase in income inequality, a perception 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 weak and that the pretransition survey data are poor and biased in an unknown direction (Henderson, McNab, and Rózsás 2004).

Unfortunately, reconstructing pretransition data with greater accuracy is not possible. Still, because 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 economic conditions were in the socialist economies. Therefore, even though no one can reconstruct pretransition data, we can make a much more thorough analysis of the hidden inequality of socialism than anyone has made previously. This analysis helps to show whether the apparent increase in income inequality after socialism was just the revelation of existing inequalities or was real. In this article, we examine the hidden inequality of the socialist economies of

David R. Henderson is an associate professor of economics at the Naval Postgraduate School in Monterey, California, and research fellow with the Hoover Institution, Stanford University; **Robert M. McNab** is an assistant professor of economics in the Defense Resources Management Institute at the Naval Postgraduate School in Monterey, California; and **Tamás Rózsás** is leading councilor in the Ministry of Economy and Transport, Department of Information Technologies and Statistics, Budapest, Hungary.

The Independent Review, v. IX, n. 3, Winter 2005, ISSN 1086-1653, Copyright © 2005, pp. 389–412.

eastern Europe and central Asia in the pretransition period and find much more inequality than the official statistics reveal.

Our exposition proceeds as follows. First, 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. Next, we identify several sources of inequality in the pretransition period, the effects of which researchers often overlooked or underestimated. Finally, we reach some conclusions and suggest courses for future research.

Methodology

In view of the state of the data, we take an unorthodox approach to the pretransition period. Rather than trying to reconstruct inequality data from low-quality surveys, estimates, and assumptions, we show how the socialist system generated, tolerated, and concealed inequalities of the order of magnitude measured in Ukraine, Russia, and the Kyrgyz Republic today. Although 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. It should be noted that within the Soviet bloc both physical conditions—weather, natural resources, and so forth—and institutions varied widely. In Russia, to take one extreme, there was no privately owned land. Even the so-called private plots that individual Russians used to produce vegetables and other important crops were not really private, but part of the collective farms. Individuals used the plots at the pleasure of the authorities and could neither sell them nor use them as collateral for mortgages. In Poland, at the other extreme, the government never nationalized all the land. Because of such variation in the area under consideration here, our analysis itself is necessarily full of variation: comments or insights about hidden inequalities in one socialist economy may not apply completely to others.

Market Forces and Socialism

The widely recognized inefficiency of the centrally planned economy was a fundamental reason for the high hidden inequality in socialism. One group or individual's desires could be fulfilled only at the expense of others' desires; thus, for central planning to work, central planners had to rank various people's wants and to compare the importance of, say, one person's desire for health care with another person's desire for housing. In a centrally planned economy, the planners did not attempt to ensure that production occurred so that prices and quantities approximated what they would have been in a market equilibrium because socialist leaders denied the importance of market forces. Although socialist economist Oskar Lange (1936, 1937) made a case for "market socialism," under which managers would be free to adjust prices to eliminate shortages and surpluses, and although many Western economists treated Lange's views seriously, planners in the socialist economies did not. Their stated goal was to provide basic goods in "sufficient" quantities at low prices by directing production resources from luxury goods to the production of these basic goods. Pricing rested on a kind of cost-based calculation in which unprocessed raw materials were assigned almost no value. Because profit was regarded as a sin, and the distinction between the cost of capital and real profit was not understood or was ignored, the cost of capital was not included in the calculations.[1] Price controls 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 market's feedback mechanisms. As a result, socialist economies displayed many failures besides the classic inefficiencies caused by price control.

Price control was among the first measures implemented 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 system's contradictions 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 difficult to determine whether the actual regulated quantities exceeded or fell short of (unrevealed) market-equilibrium quantities. Moreover, when various production managers reported their outputs, they often falsified the information, so no central planner could know how much was really produced anyway. Not surprisingly, people had to wait in lines and pay bribes to shopkeepers to obtain products that were common in the marked-based economies of the West.

For certain basic commodities, however, the situation differed. Each country had its own set of basic goods that appeared to reflect some normative judgment of the people's "needs." 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[2] and cornmeal and bottled milk in Romania.[3] These measures resulted in some strange outcomes. Because bread was overproduced, for

1. In the early 1960s, Soviet economist Yevsei Liberman, whom Khrushchev took seriously, did advocate relating Soviet managers' rewards to the level of profitability, measured by the ratio of profits to the capital stock. Such reforms would have caused managers to treat capital as a scarce good rather than as a free good. See Pejovich 1969, 156.

2. Based on the experience of one of the authors as a teenager and young adult in socialist Hungary.

3. Based on the experience of one of the author's spouses as a teenager in socialist Romania.

example, animals were fed on bread, not only on household plots (Shane 1994, 80), but often even in cooperatives getting their "supply" of unsold bread directly from the shops (Goldman 1987, 35). In Hungary, milk was packed in plastic bags and thus could not be sold the next day and had to be destroyed. These goods, however, were only a few of the regime's selected favorites, considered to be essential not by the people, but by the government.

Many goods, including food, were distributed at the workplace, presumably to keep the workers motivated to come to work. That arrangement may explain why, during socialism's collapse, when some employers quit paying the workers, the employees often still showed up for work. The food that was handed out then constituted their "wages."

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 Easter in many of these countries; bananas appeared at Christmas only.[4] 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.[5] 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.[6] 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.

In the mid-1970s, Hedrick Smith told similar stories:

> 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

4. Based on the experience of one of the authors as a teenager and young adult in socialist Hungary.

5. Based on the experience of one of the authors as a teenager and young adult in socialist Hungary.

6. Based on conversations of one of the authors with Hungarian military officers participating in military exercises in the former Soviet Union.

> 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. (1976, 78)

Nevertheless, basic commodity industries 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. The planners initially used the heavy casualties of World War II to justify the 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 products at the price the state paid for them, but 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. These industries expanded their control over a major part of resources, thereby becoming politically influential, especially in the former Soviet Union, which was not so much an economy as a glorified arsenal. By continuing to draw resources away from other uses, this military-industrial complex slowed the development and democratization of the former Soviet republics during the transition.

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 System of National Accounts (UNSNA) during most of the socialist regime. They used instead a material-product system based on production quantities rather than on values expressed in money terms (Campos 2001; Estrin, Urga, and Lazarova 2001). Remarkably, though, they began to use the UNSNA right *before* the transition. Why they did so is an important question.

Signs 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" (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 who mentioned food riots in Novocherkassk in 1962. Another common saying was, “If you see something for sale that you do not need, buy it anyway. You can trade it with others for what you need.”[7]

Signs 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 wrote, “The accepted norm is that the Soviet woman daily spends two hours in line, seven days a week” (1976, 83).

Technological development was slow under socialism, and the fast technological change in the West in the 1970s and 1980s left the socialist economies farther and farther behind. General Secretary Mikhail Gorbachev recognized this widening gap. “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.”[8] Many socialist countries, especially the Soviet Union and Romania, experienced serious shortages of almost everything during the 1980s.

These problems, however, could not be reflected in socialist statistics. These statistics registered steadily increasing production quantities. Recording fulfillments and overfulfillments of plans was the ideal method to show development where in actuality none was occurring. Using this method of accounting, however, did not solve the true underlying problems. The inefficiencies of these 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 began to employ both the old material-product system and the UNSNA, then finally abandoned the material-product system altogether even before the end of communist rule.

Statistics in Socialism

Switching to a new system of aggregating numbers from the same sources did little to change the deceptive nature of socialist statistics. Filer and Hanousek (2002, 234) warn us about the consequences of the differences between Western and socialist

7. We thank an anonymous referee for this quotation.

8. BBC 1989, SU/0616, November 17, 1989, B/8, qtd. in Shane 1994, 69.

accounting standards and the danger of seemingly identical meanings of totally different variables. Campos argues that socialist statistical offices, originally set up to measure quantities, "were poorly equipped to deal with issues such as price changes and unemployment" (2001, 667). He 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. Where all prices and production quantities are regulated, calculating gross domestic product (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 measure productivity and output accurately; accurate measurements would only have shown the fallacy of the planning process. Because statistical offices did not have the power to question whether the plans made sense, providing the "right" input for calculating aggregate indices was safer than providing the *real* input.

In sum, pretransition 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, scarcely any useful independent data sources existed for these countries because they were different even from many developing countries that have insufficient statistical capabilities. Whereas in many developing countries a weak but willing state often welcomes independent researchers from developed countries, in socialist countries the state is strong enough to prevent most, if not all, independent research.

In light of the foregoing deficiencies of official data for the centrally planned economies, the reported experience of various individuals and generalizations from typical examples are the only possible avenues for reaching the truth. In the next section, we rely mainly on such sources to describe the causes and true degrees of inequality during the socialist era.

Hidden Inequalities and Income Transfers in Socialism

The total price of any good equals the monetary component and the nonmonetary component. An important part of the nonmonetary component is the time taken to get the good. When price controls keep prices lower than they otherwise would be, the drop in the monetary component is offset by an increase in the nonmonetary component because effective maximum-price controls cause shortages, so people spend more time waiting in line. (Sometimes, also, they pay bribes to shopkeepers and other sellers, thereby increasing the monetary component in an unmeasured way.) In every political system, the politically powerful have an advantage. Under the comprehensive price controls of World War II in the United States, for example, gasoline was rationed, but congressmen and high government officials were given "A" ration stickers that allowed them all the gasoline they wanted at an artificially low price; at the same time, average citizens often could not drive from one city to another because of the small amount of gasoline allowed them. Airplane and railway tickets also were rationed. The famous television newsman David Brinkley, for example, tells how as a young man during the war he broke off a romance because he could not 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" (1995, 46).

Under socialism in a one-party state, the rationing system facilitated even more extreme privileges. Because no legal political forces existed outside the Communist Party, political power had few effective limits. Although all Soviet bloc countries had some kind of legislative body, it was subordinated to the Communist Party through the legislators' party membership. 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, including privileged access to goods and services, for top state officials and party members at all levels. Moreover, these privileges often included lower prices as well as privileged access.

Because members of the *nomenklatura* had power over the disposition of various scarce resources, they frequently used their connections to provide favors to each other at the expense of the rest of society. In addition, this group not only used these resources but also overused them or gave them away, owing to the lack of oversight and the concentration of power in the Communist Party elite. 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. In short, competition by personal characteristics replaced more impersonal market competition.

The Real Value of Privileges

Although the extensive system of privileges obviously had a substantial effect on income inequalities in the socialist era, it did not appear in pretransition measures of income inequality. As one discontented Soviet put it, "Everything is *maskirovannoye*—masked" (qtd. in Smith 1976, 41). Leonid Brezhnev, general secretary of the Soviet Communist Party and president of the USSR, for example, had Rolls Royce, Mercedes, Cadillac, Lincoln Continental, Monte Carlo, Matra, and Lancia Beta automobiles (Goldman 1983, 104, as cited in Lebergott 1993, 29). Of course, the value of these high-quality vehicles never showed up in Brezhnev's reported income.

Referring to the effect of subsidies on essential items and to the quality of vacation homes for the top party brass, Milanovic argues that these privileges would not have altered measured income inequality to a great extent. He claims that others exaggerated the value of these privileges: "Elite privileges were exaggerated both by [the] indigenous population, because of the secrecy in which privileges were held, and by overly credulous Western analysts. In effect [as] 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" (1996, 200). However, 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. Although few middle-class Americans will regard a Holiday Inn as a luxury hotel, Americans are not the relevant group here; eastern Europeans are. In the mid-1970s, living space per person in the Soviet Union was approximately only 120 square feet (W. S. Smith 1973, 405, as cited in Pejovich 1979, 55). Every room at a Holiday Inn has its own bathroom, whereas in the early 1970s approximately half of all Soviet housing lacked running water or plumbing, and much of the other half shared bathroom facilities with other families (Pejovich 1979, 55–56). For almost anyone in the eastern European socialist countries, a Holiday Inn would have been the height of luxury. To "translate" Milanovic's statement for Western ears, it would need to read something like this: "In effect, as 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 of high quality by socialist standards for a couple weeks each year free of charge constituted a substantial perquisite for those with political connections, and it would have been widely envied by those without it.

Milanovic might have made the following more telling and accurate criticism of the idea that vacation homes increased the inequality of incomes. Not just the politically connected had access to such vacation homes. Rather, even those not so connected could get such access if they did what the authorities wanted them to do: refrained from criticizing communism, refused to support many of the victims of communism, showed up at work, and so forth. In other words, access to vacation homes, like so many other perquisites under communism, was a means of creating loyalty to the regime and cementing workers into the system.

The *nomenklatura,* especially those at the top, had access not only to goods but also to state resources. Thus, in Romania, "During the past decade tens of thousands of workers slaved to satisfy Ceaucescu 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 includes the special treatment in health care, education, and housing, as well as exceptions to rules about foreign travel, customs, and the possession of foreign currency. Consider just one of these special treatments—the ability to travel abroad. One way for Westerners to understand its importance is to imagine that our own government has a generally enforced stricture on travel abroad, but that it relaxes this stricture for the small percentage of the population that is politically connected. So, for example, if we live in New York, we would be 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 equivalent to a huge drop in our real income and would therefore regard permission to travel to these (now exotic) cities as a substantial benefit. Under socialism, all of the other rules—for example, on health care, housing, and education—also exacerbated income inequality.

Corruption

An unmeasured but pervasive practice, corruption, may also have significantly influenced income inequality in the pretransition period. Corruption, as measured by surveys and other subjective methods, appeared to rise early in the transition process, especially with respect to the privatization process (Goorha 2000; World Bank 2000a). This upsurge should not have been surprising. One important form of corruption in a socialist system is being paid illegally for something that someone else values. To be corrupt in this sense, therefore, one must produce something of value. Even if the corrupt person is diverting resources that are not his to others who value them, the diversion is productive. Being productive is a skill that differs greatly from the ability to fill out paperwork or to produce items that meet some central planner's goal. Therefore, when socialism ended, the people best situated to take advantage of the newfound economic freedom were those who were corrupt—that is, those who had been productive previously. They had formed the de facto entrepreneurial class, the risk takers, and had they operated in a free society their whole lives, many of them never would have been corrupt because they would have been able to carry out their entrepreneurial activities openly and legally.

In general, corruption has been 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 reported 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).[9]

However, even though corruption during the transition to private ownership surely must have increased personal wealth for those who were corrupt, the increase in measured inequality cannot spring from this corruption because the increases in personal wealth were not counted as income in the surveys in transition countries. Corruption in public administration, health care, education, or law enforcement, in contrast, directly affected income inequality in both the pretransition and the transition periods. We emphasize that this kind of corruption probably was much more prevalent in the socialist era. Measuring it, however, is much more difficult than measuring the corruption in privatization or in business practices during the transition period.

Both Goorha (2000) and the World Bank study (2000a) cited earlier identify the origins of today's corruption in pretransition practices. These sources cite, as the cra-

9. Because the socialist-era prices were meaningless, it is likely that output in the postsocialist era was actually higher than it had been during socialism, which renders the reported growth data useless.

dle 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. Still, neither study considers whether corruption might have been greater when the legislature and the judicial branch were inseparable from the executive branch of the government, and the Communist Party controlled all of them as well as the researchers' access to data. 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 more often—implies that corruption must have been greater under communism. Corruption in privatization was only one aspect of corruption, a relatively easy aspect to measure in a new era when conducting independent surveys had become possible. Focusing on corruption related to privatization might have caused researchers to assume that little corruption existed in the past. In fact, corruption and privatization had no connection during the socialist era for one main reason: that era, by definition, had no privatization.

We need not rely only on basic economic theory, however; 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 helped corruption to thrive in an era of lies and nationalized plunder. People without connections had to pay unofficial service fees for nearly everything. Those who paid the fees were typically already in the lower part of the income scale. Those who received the fees 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 regarded it as corruption.

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 more than 60 percent of transactions; in Armenia, the frequency of informal payments was 91 percent. Informal payments are also reported in most eastern European countries.

Although these payments were undoubtedly frequent during the transition, recent reports ignore what happened before the transition: in socialist countries, most 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" (qtd. in H. Smith 1976, 96).

In contrast, no payment was required from the well connected, who were already in the higher-income ranks, 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, but 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 a single 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, such as the Academy of Sciences and the Bolshoi Ballet and Opera Company, had special clinics and hospitals whose quality was much above average (H. Smith 1976, 43). Because these institutions were also part of the state-provided "free" health-care system, the user fee was either very small or zero.

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

All of these factors made the actual income distribution more unequal than official data imply. Two caveats should be added to the preceding analysis, though, both of which were important in the Soviet Union. First, those who received medical care at the most prestigious clinics did not always receive better care. In an ironic twist of poetic justice, the same system of privilege that gave the *nomenklatura* access to such clinics gave the prestige medical jobs to the politically well connected. Though better connected, they were not necessarily better as health-care professionals.[10] Second, access to health care, as to food at the workplace, was often widely distributed as a way of cementing loyalty to and reducing criticism of the socialist regime.[11]

10. This same form of poetic justice may have come into play in the United States in the case of the famed U.S. senator from Louisiana, Huey Long. On September 4, 1935, after Long had been shot, he was taken to Charity Hospital, where he was operated on by Dr. Arthur Vidrine, whom Long (then the state governor) had earlier appointed superintendent of the hospital. Doctors who showed up after the surgery were shocked to learn that Vidrine had not catheterized Long's bladder to check for blood. Had he done so, he would have realized that Long's kidney had been injured. The internal hemorrhaging caused by this injured kidney caused Long's death. Had Vidrine put a clamp on the kidney, the kidney would have died, but Long probably would have lived (see Williams 1970, 875).

11. We are indebted to one of the anonymous referees for these two insights.

Education

Pretransition inequality in education is another important factor that most researchers have overlooked or underestimated. Mickelwright observed during the transition in Slovakia and Bulgaria an increase in the ratio of household education expenditures per child in the top decile of per capita income to expenditures per child in the bottom decile (1999, 365, fig. 7). Relying for the most part on this observation, he argues that access to education became more restricted for low-income families during the transition, but this conclusion does not follow from his data. The increasing difference in education expenditures is consistent with a much more plausible explanation: 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 children of the elite.

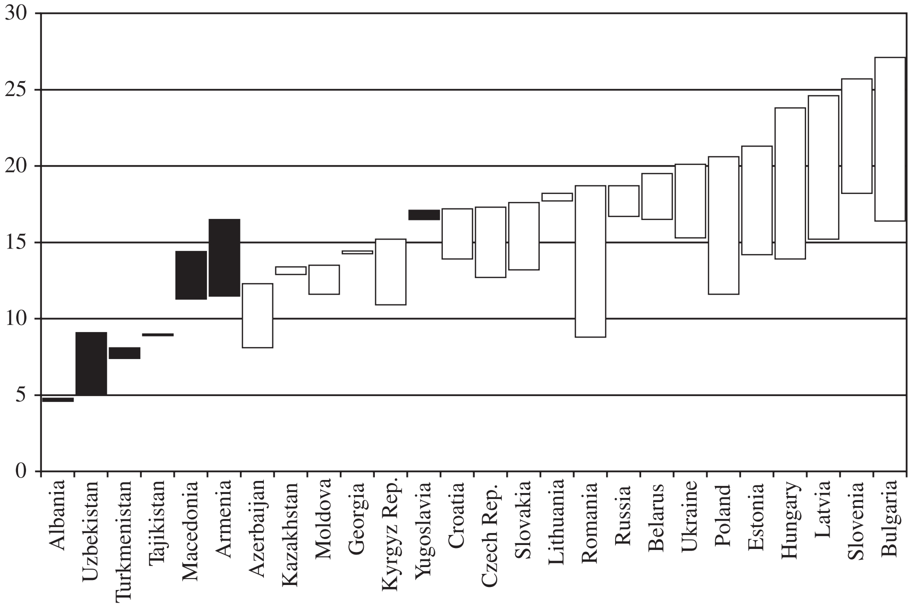
A recent World Bank study (2000b) of the challenges that transition countries face in the field of education also focuses on problems that arose during the transition, depicting education in the communist era as ideal. The study reports enrollment rates in tertiary education for the transition period from 1989 to 1997.[12]

As shown in figure 1, 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 evidence 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.

The communists' motive for emphasizing basic education was not philanthropic. Rather, the main purposes were to build loyalty to the regime and to maintain the social hierarchy. Hence, they set quotas for the number of workers' children admitted to higher education, and these privileged positions were assigned to those who were loyal to the regime. Even places in good high schools were assigned to those with solid political connections. Many people joined the Young Communists, for example, not out of conviction, but out of a desire to get into a good school. With total control of the economy, Communist Party leaders assigned 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, the 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.

12. 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 2000b, 136).

Figure 1
Change in Enrollment Rates in Tertiary Education in Twenty-six Transition Countries Between 1989 and 1997 (Percentage of 18–22 Age Group)



Source: Data from World Bank 2000b, table A11.

Note: Empty bars indicate growth, shaded bars decline, in enrollment rate.

Education had to be "free" for the sake of socialist rhetoric, however. 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, parents' party membership, 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 process facilitated selection in favor of the groups already privileged, with already higher incomes. Even Mickelwright, despite his claim that access to education became more restricted for lower-income people during the transition, notes 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. (1999, 351)

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

Housing

Government-provided 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. Their main purpose was to provide housing for the urban 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. Although the allocation of these units was characterized by the socialist regime's usual corrupt practices, the rents were very low. People in villages, by contrast, did not receive such housing. Instead, they experienced the forced collectivization of privately owned farms and the nationalization of livestock and farming equipment. By the 1970s, construction programs had slowed, but the government owned essentially all housing in the Soviet Union and much housing in other socialist countries, with rents set well below the cost of maintenance.[13] 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 because construction was started by destroying family houses. As a result, many villagers lived in four-story or five-story concrete panel buildings without central heating, carrying firewood by foot to their apartments every day. Despite these programs, the share of the population living in state-owned apartments was only approximately 20 percent 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 nonexistent. In contrast, shortages in state-provided housing led many people to subrent rooms or apartments from individuals. This practice, however, was illegal or quasi-illegal in the socialist era. Private rentals from individuals, however, had a significant impact on income inequalities in both the pretransition and the transition periods. In the

13. The large government-built and government-owned apartment buildings in the Soviet Union were called "Stalinist Gothic" because even though they were not built until after Stalin's death, he had commissioned them. See the *Soviet Encyclopedia* (1980) reference at www.ourheritage.net/Great_Adventures/Waterways_of_Russian/Itinerary/7-12-02.html.

pretransition 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 because this income is easy to hide from the tax authorities. This income transfer may cause a decrease in income inequality, however, because in many cases the landlords are low-income individuals who live 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 era cause the increase in inequality to be overstated.

Cities versus Villages under 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 occurred at the expense of the rural population. Although income from farm self-employment is usually counted in income surveys, the value of subsidies not directly allocated to individuals is not counted. Most of the schools at the level of secondary education or above were in cities, however, even if they trained workers for agriculture. Health-care institutions and public administration were also concentrated in the cities. These factors, however, were not the most serious ones 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 neglect, socialist countries experienced serious food shortages during the 1950s. Because land was still privately owned in some European socialist countries other than the Soviet Union, communists concluded that private ownership had caused the food shortages. As early as 1929, Stalin had announced that the Soviets would annihilate the kulaks as a class instead of limiting their exploitative ambitions (Courtois et al. n.d.). His solution was to fulfill the needs of the cities by requisitions in the villages. In many cases, government agents 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 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 give incentives to the workers of state-owned companies. 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.* (1990, 400–401, emphasis added)

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

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 reported variables, such as inequality, economic growth, and GDP per capita. In the pretransition 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, and saving rates reflected much worse conditions during the early years of transition than in the pretransition era.

This coincidence supports Denizer and Wolf's (2000) argument that the reason for the rapid decrease in the saving rates was involuntary saving in the pretransition 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. Large savings under socialism, therefore, represented a passive result of the general shortage of goods.

During the transition to a market-oriented economy, spending on previously unavailable goods became possible. At the same time, however, high inflation devalued savings, giving the impression of growing poverty. However, because savings in the socialist era could not be spent, their real value was well below their 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 pretransition era to be underreported.

Privatization and the Last Decade of Socialism

It was no accident that socialist countries started to experiment with reforms from the mid-1970s onward. Although 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 helped the Soviet Union because of its huge oil reserves. The real reason lay elsewhere. World War II had caused serious losses for the Soviet Union and 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. On the one hand, nationalization provided some of the funds for war compensation to be paid to the Soviet Union, and it formed the material basis of the new socialist regimes. On the other hand, nationalization did not create wealth or increase these countries' capital assets. As a result, socialist countries experienced their first economic crises as early as the late 1950s. Because central planning did not create the incentives necessary for economic development, socialist leaders again turned to the "proven" method of taking property by force. This time they quasi-nationalized the agricultural sector by forced collectivization during the 1960s. By collectivizing it, however, they exhausted their last reserves. There remained nothing to take, nobody to expropriate.

At this point, the central planners had two choices. They could either satisfy their needs by further expansion to countries outside the socialist bloc or give people incentives by letting them own private property beyond their immediate consumption purposes. The first option was not sustainable because wherever socialist economic principles were introduced, they destroyed a country's economy. Hence, economic liberalization amounted to the only real option. Communist leaders and beneficiaries of the socialist regime, however, did not always recognize these problems. Reforms in Czechoslovakia, for example, prompted a Soviet-led intervention by Warsaw Pact countries in 1968. In Hungary, the reforms of 1968 caused internal social conflicts as well as a rapid rise in acknowledged inequalities. As Berend states, "before 1968 the ratio between the lowest and highest salaries was 3:1; it quickly changed after that year to 9:1" (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 Berend (1990) describes for Hungary. These units were composed of workers who performed certain tasks as regular employees, but other tasks on a contracted basis. Although these arrangements created an incentive for overtime work, they had serious disadvantages. The main problem was that employees in them used for the contract jobs the same equipment provided by the same company for their regular jobs. They were also better paid for contracted tasks. As a result, the employees became almost counterproductive in their regular jobs in order to guarantee that they could perform the same tasks as contracted work later.

Along with 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 following example: "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 preparation for the transition period was the increase of consumer prices, resulting in high inflation in the last decade of the pretransition period and the erosion of the real value of savings for those unable to spend their money on goods and services because of shortages. Some of these savings were spent on shopping trips in western Europe, especially in 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 the large savings in the pretransition 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, but these measures had a serious side effect observed by Estrin, which 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 [a] 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 preceding quotation is used in the economic sense—a payment in excess of the amount necessary to keep the resource in its current use. Given that the elite were well positioned and that the public wanted changes, the first wave of privatization passed 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, as advocated by Kornai (1990). 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 $\frac{2}{3}$ of the shares in about $\frac{2}{3}$ 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 capitalists purchased approximately 20 and 50 percent of the privatized assets, respectively, foreign investors were unable to participate in the privatization (Estrin 2002). Although local media attributed this exclusion for the most part to the public's aversion to foreign ownership, it probably owed more to the elite's aversion. Their interest lay in convincing the public of the advantages of excluding foreign investors. With this measure, the elite eliminated competition from foreign investors and made possible their own acquisition of assets at lower prices. Excluding foreign investors also made it easier to hide valuable information from the public.

Ingrown reflexes from the socialist era and the willingness of the early transition's old-new elite, who continued the practices of the past in order to take advantage of their positions 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.* (Nellis 2002, 24, emphasis added)

In his 2002 article, Roland argues that although 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 preceding quotation also supports this second statement: not the policy choices of the transition period, but the elite's efficiency in positioning themselves was the main determinant of today's differences in the transition countries. In other words, privatization did not increase inequality; it only made inequality visible and measurable. The control over wealth had been as concentrated before the transition as in the transition period; only its form changed. Before the transition, inequality had been based on political control and connection; after the transition, it rested on ownership and productivity.

Conclusion

In the past few years, researchers on transition economies have found that income inequality increased in spite of the liberalization of political and economic life in the former socialist countries of eastern Europe and central Asia. Because this observed increase in inequality contradicted previous findings in other regions (Gradstein and Milanovic 2000) and because 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 observed increase was suspect and required further analysis.

Other research into various relevant factors reveals the weakness of the argument that the economic and political liberalization of the centrally planned economies caused greater income inequality (Henderson, McNab, and Rózsás 2004). This research also shows that there is a firmer basis for an explanation founded on the existence of a large uniform bias in the pretransition data toward smaller measured inequality. Unfortunately, the reconstruction of pretransition data on income inequality with greater accuracy and reliability is not possible.

Therefore, in this article we have taken a different approach toward understanding the hidden inequality in socialism. We have argued that statistical data from the socialist era do not provide a basis for valid comparisons of socialist-era inequality and transition-period inequality of incomes. Economic indices were meaningless in a centrally planned economy; their purpose was to justify the regime's existence, not to reveal its actual character. As a result, the socialist regimes' statistical methods were unreliable and inaccurate, and they concealed 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, in the transition period, the ultimate source of the inequalities was neither the economic or political liberalization nor the transformation from a centrally planned economy to market-oriented economy nor any other aspect of the transition process. Rather, the inequality reflected the uncontrolled political power in the socialist era. This power provided the ruling class the means to concentrate the economy's benefits in its own hands through legalized pillage of private property, the promotion of corruption, and the system of privileged access to consumer goods.

In summary, the inequalities of real disposable income were so great in these societies and survey methods so unreliable that even if accurate measures of inequality for the socialist era cannot be reconstructed, a real increase of income inequality during the transition seems unlikely to have occurred. In addition, programs that actually increased income inequality by helping some of the higher-income people looked to the outside world like programs that helped the poorest. 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.

Besides serving as 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. In fact, the causes of income inequality are more important than the degree of income inequality itself. In a socialist economy, income inequality hinges for the most part on differences in political power, political connections, and loyalty to the government. To better one's economic condition in a socialist economy, therefore, one must become politically connected or, at least, must display loyalty to the government. Also, because people have little incentive to produce valuable goods in a socialist economy, most people claw for improved position in a zero-sum game in which one person's gain is another's loss. In a market economy, by contrast, income inequality reflects differences in productive ability for the most part. The way to better oneself economically in a market economy, therefore, is to become more productive—that is, to contribute more to the wealth of one's fellow human beings in return for pecuniary rewards. Markets are positive-sum games. Bill Gates and Michael Dell are extraordinarily wealthy not because of their political connections (as Gates learned the hard way in the late 1990s, when the U.S. government sued his company), but because they have produced goods that consumers value. Inequalities in a market economy, therefore, serve a useful function, giving people incentives to work harder, study more, and take sensible risks, thereby contributing to other people's well-being. Further research should focus on the causes of inequality instead of its degree, 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 springs from corruption, fraud, abuse of power, and unjustified government transfers is even more important in these countries, and the appropriate way to do so is to eliminate or reduce the corruption, fraud, abuse of power, and unjustified government transfers. The economic miseries that more than four decades of government central planning caused cannot be cured by new government programs. Instead of nurturing nostalgia, governments and legislators of the transition countries should abolish unnecessary restrictions on their economies, eliminate subsidies, decrease taxes, and cut back on the overgrown, inefficient system of government transfers, including social security.

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