COWLES FOUNDATION FOR RESEARCH IN ECONOMICS

AT YALE UNIVERSITY

Box 2125, Yale Station
New Haven, Connecticut

COWLES FOUNDATION DISCUSSION PAPER NO. 286

MATERIAL BALANCES UNDER UNCERTAINTY

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November 17, 1969

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by

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1. Introduction

Critical to the success of any operational (short term) central plan is the assurance that anticipated supplies will be adequate to fulfill projected demands. In Soviet type economies it is the task of the famed method of material balances to ensure that this coordination is achieved, at least on paper. For each centrally planned commodity a balance sheet is drawn up listing sources of anticipated supply (in a closed economy mainly current production plus initial stocks) and components of projected demand (intermediate consumption plus inventory accumulation plus deliveries to users outside the system). The central planners try to work things out so that total demands and supplies are about equal. In practice projected supplies usually exceed demands, an allowance normally being made for a safety factor. This is to ensure that operating reserves will be available for use during plan execution should the need arise for unanticipated rescue operations.

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*I would like to acknowledge useful conversations on general aspects of central planning with J.M. Montias and R.P. Powell. The research described in this paper was carried out under grants from the National Science Foundation and the Ford Foundation.

Intermediate consumption of industrial materials is usually estimated on the basis of material norms (input-output coefficients). If these norms are approximately correct, or if they err on the side of safety, planned output targets will probably be fulfilled. But what if the *ex post* input-output coefficients turn out to be higher than the projected norms? With total supplies of certain intermediate commodities inadequate to meet industrial consumption needs, shortages occur and the industrial supply system starts operating under strain. The immediate response is a priority rationing of the item or items in question which favors its most important users. Effects of plan errors are thus cushioned not only by reserves, but also by the existence of non-priority sectors which bear the brunt of a shortage. In the long run a supply imbalance will be corrected by increasing production relative to consumption, but in the meantime some capacity will stand idle for lack of materials.

Guided by this capsule summary, a highly simplified model of a Soviet type industrial system is created. The purpose is to set up a framework for studying certain issues of optimal plan formulation and execution under uncertainty. It turns out that the stylized problem being considered can be cast in the mathematical form of a classical inventory model. This is convenient because known and powerful methods of analysis can be brought to bear on its solution.

2. The Economic Environment

The industrial system we have in mind is best thought of as a conglomeration of mining, manufacturing, power, transportation, and construction. To remove the technical difficulties of dealing with an open industrial system and to make thinks easy to conceptualize, we imagine that the industrial system forms a closed self-sufficient sub-economy whose final products go directly into final consumption or investment. This idea is patently false in cases of outside supply, like agricultural raw materials or foreign imports. But the myth of self-sufficiency is not a bad abstraction of the industrial system as a whole, since day to day workings are so typically concerned with internally produced commodities. The stochastic planning problems associated with agriculture are of quite a different nature and for present purposes this sector is best disregarded altogether. Similar comments apply to services, distribution, and foreign trade.

It is assumed that each commodity can be meaningfully distinguished as being either primarily a final product or mainly an intermediate material. Unfortunately more than a few industrial items are really both, a troublesome technicality we naturally choose to ignore. We imagine that our hypothetical industrial economy is divided into two sectors--final products and intermediate materials.

Ordinarily one thinks of final products as simply those commodities which leave the system, like clothing, machines, or finished construction. For the purposes of the present paper it may be better to conceptualize the final products sector as vertically integrated a few stages back, to the extent of also including those specialized intermediate materials, like cloth, machine bearings, or cement, whose end use is clearly and directly tied up with the production of true final products. The intermediate materials sector is best thought of as consisting mainly of basic multi-purpose commodities like chemicals, metals, fuel, power, and transportation which are far back in the early stages of the production pipeline. Under this interpretation intermediate materials have the feature of being consumed in significant proportions by the intermediate materials sector itself, as well as by the final products sector.

It goes without saying that such a fuzzy demarcation could never be used for operational purposes. But for the primitive kind of model building we have in mind, the intuitive distinction outlined above is good enough.

Each of the two main sectors is thought of as further subdivided into a number of sub-sectors. In turn each sub-sector, headed by a ministry, is made up of enterprises (firms). An enterprise produces output according to laws of production embodied in a production function. For analytic convenience we assume that all firms throughout the economy have identical production functions. This assumption is patent nonsense as an approximation to reality. But its adoption will permit us to concentrate on the main features of the problem. With this assumption we can easily solve what would otherwise be tricky problems of plan balance, ensuring that a relatively simple optimal policy can be derived.

Production functions for each firm are postulated to be of the quasi fixed proportions type. Let firm j possess capacity Y_n^j during period n . If we like, we can think of capacity Y_n^j as being created by labor and capital according to the formula

$$Y_n^j = F_n(L_n^j , K_n^j) ,$$

with $F_n(\ )$ a constant-returns-to-scale capacity function common to all enterprises for period n . If intermediate materials M_n^j are available to enterprise j , output Q_n^j is given by

$$Q_n^j = \min\left\{ Y_n^j , \frac{M_n^j}{\theta_n} \right\} \tag{1}$$

where θ_n is the common input-output coefficient of each enterprise for period n .

If intermediate materials M_n^j were disaggregated into more specific individual types, a fixed proportions production relation like (1) would probably be too rigid a specification. With certain commodities in tight supply, users would be encouraged to keep up their own outputs by using less scarce substitute materials. But if materials as a whole are in short supply, there is relatively little room for maneuverability. Capital and labor may be fair substitutes for one another in the creation of capacity, but in most production processes either one is a poor substitute for materials. This fact is reflected in the assumption of a zero elasticity of substitution between capacity and materials in (1).

3. Mechanics of Planning

Plans are formulated instantaneously at times 0, 1, 2, ... A plan is executed during the unit of time directly following formulation, known as the plan period. We follow the convention that a plan formulated at time n-1 is executed during period n .

We suppose that the industrial economy has the potential of producing gross output Y_n during plan period n . This capacity estimate might be derived as $F_n(L_n, K_n)$, where L_n is the total man-hours, K_n is the aggregate capital stock, and $F_n(\ )$ is here interpreted as an aggregate capacity function.[1]

For the purposes of this paper operational planning is seen as having an essential putty-clay aspect. The putty-clay view of planning is based primarily on the notion that labor and capital are far more easily shiftable at the time of plan formulation than during the immediately following period of execution.

At time n-1 or before, total capacity Y_n can be split up in any proportions between intermediate materials capacity $\hat{I}_n$ and final products capacity $\hat{F}_n$, so long as $\hat{I}_n + \hat{F}_n \leq Y_n$. During plan execution, the planners are stuck with the chosen proportions in the sense that capacities $\hat{I}_n$ and

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[1] $F_n(\ )$ will be an aggregate capacity function provided that capital and labor have been efficiently combined in the same proportions for each enterprise.

$\hat{F}_n$ represent maximum allowable gross outputs of intermediate materials and final products during period n. These maximum levels would not both be simultaneously operative if relative to demand there were an insufficient supply of intermediate materials, due perhaps to poor planning or unforseen difficulties.

The scenario which has been presented must be visualized as an abstraction at best. In the real world, plans are not formulated instantaneously at a moment of time just before plan execution. Planning takes time. Sometimes the plans for a period are incomplete when even a significant part of the period has elapsed; at other times, except for some quick patch-up work plans for a given period have essentially been formulated several periods before.[2]

Even more disconcerting is the simultaneous existence in most centrally planned economies of several overlapping operational plans of varying length (chiefly the annual, quarterly, and monthly plans). Which plan do we have in mind as a prototype for our model economy? The answer to this question is bound up with our view of the relevant putty-clay horizon. The appropriate period should be long enough to make sense of the notion that (within a relevant range) capacities can be adjusted beforehand. Capital need not be literally freely shiftable, but there should be enough flexi-

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[2]Both of these are frequently the case with quarterly or monthly plans. Only in preparing the annual tekhfinprom plan is a careful job of material balances done, although the method is applied on paper to quarterly and monthly plans as well.

bility in some underlying factors (perhaps labor and newly installed capital) to permit such capacity changes of a reasonable size as might be required by the plan. On the other hand, the plan period must be sufficiently short to justify the imposition of capacity constraints <u>during</u> plan execution. About the only sure thing is that whatever period we choose, the present model will exaggerate both pre-plan flexibility and intra-plan rigidity.[3]

Even the real world calculation of overall economic capacity would have to be crude. Y_n is just an imperfect reflection of underlying shared resources fixed in the short run, and of decisions about how hard to work labor and capital. Unfortunately the planners' notion of capacity is partially determined as the outcome of a bargaining process between the center and the periphery; not surprisingly we find it convenient to disregard this aspect altogether.

4. Material Reserves

In plan formulation and execution, a significant role is invariably played by the stock of intermediate materials held by central agencies for dealing with unforseen contingencies. The Soviets use the word "reserves" in a very broad sense, denoting virtually any potential for increasing out-

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[3]If forced to choose, I would personally pick the quarterly plan as the best single compromise. However, the monthly plan is really more relevant for some industrial materials over which close central control is maintained, while the yearly plan is more appropriate for other, more loosely controlled commodities. A complicating factor is that fulfillment of the annual and quarterly plan tends to be a more significant success indicator for the ministry, whereas the quarterly and monthly plan targets are frequently more important to the enterprise.

put, including such intangibles as efficiency or even inspired improvisation. As we will use the term, material reserves (or just plain reserves) will mean physical stocks of warehoused commodities held and distributed by or for the supply departments of Gosplan and the ministries as part of the industrial materials supply system.

In Soviet parlance material reserves additionally include national defense and natural disaster state stockpiles, which we exclude from consideration. Also excluded from our usage of the term 'material reserves' are the ordinary day to day production inventories held by the enterprises. This class of raw materials, semi-fabricates, and finished products is conceptualized as being so closely tied up with normal production processes that removal would impair production immediately or within a short time. Enterprises are forbidden to hold in their own name material reserves as we are using the term, and are restricted by law to short term production inventories. Managerial hoarding of reserves certainly occurs, as an ample number of anecdotes bear witness, but for our purposes material reserves are best considered held by or for agencies higher than the enterprises.

The basic idea behind our usage of the term 'material reserves' should be clear even though in specific cases it might be difficult to judge the degree of overlap with state stockpiles at one end or production inventories at the other. As is made abundantly clear by the Soviets themselves, the purpose of holding material reserves is to be able to remedy such branch "disproportions" as may arise during plan execution.

5. Plan Formulation and Material Balances

In the context of the present model, planning material balances is an especially simple procedure.[4] Suppose that μ_n is a norm of materials consumed per unit of output which is to be used in plan construction for period n. The input-output coefficient μ_n might be obtained as an average input per unit of output over time. Let S_{n-1} be the stock of material reserves on hand at time $n-1$.[5] We take $\hat{I}_n$ and $\hat{F}_n$ as the period n target levels of intermediate materials and final products respectively.

Total supplies of materials for the coming period are $\hat{I}_n + \hat{S}_{n-1}$. Anticipated intermediate consumption is $\mu_n(\hat{I}_n + \hat{F}_n)$. The planners try to make sure that

$$\hat{I}_n + S_{n-1} > \mu_n(\hat{I}_n + \hat{F}_n)$$

If positive, the difference

$$\hat{I}_n + S_{n-1} - \mu_n(\hat{I}_n + \hat{F}_n)$$

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[4] We assume that all commodities are centrally planned. Technically this would only be true of the so-called "funded" and "planned" commodities. However, all of the important industrial materials are covered by these two categories.

[5] It is impossible to hold material reserves of electricity or transportation as such. But substitutes are available in the form of fuels and emergency standby equipment, the latter usually existing in a semi-retired state.

is a safety factor which is often built in to insure that sufficient material reserves will be available throughout the plan execution phase. Capacity constraints require $\hat{I}_n + \hat{F}_n \leq Y_n$. Real world plan formulation is of course much more difficult, in part because intermediate consumption requirements are <u>not</u> independent of output composition.

After it is composed the plan is handed out to the ministries, and through them is broken down into enterprise plans and dispersed to the firms. This is called "planning down." In reality there is also "planning up," so that in the end everyone is more or less reconciled to who produces what.

Real plan targets are set on many aspects of performance, including productivity and/or employment of labor and materials, profits, and costs. But there is no doubt that the most important target on both the ministerial and enterprise level is the output quota.[6]

6. Effects of Uncertainty

Uncertainty can interfere with plan fulfillment in many ways. We

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[6] Let all ministries and enterprises be called <u>micro-units</u>. Micro-unit output quotas are for end products of the unit only and would be strictly net of those end products simultaneously consumed as inputs by the producing unit. <u>Gosplan</u> is interested in the amount of sulfuric acid made available to programmed users outside the chemical sector, not in the amount internally consumed by the chemical ministry in the manufacture of other industrial acids. But note what happens when micro-units having input-output relations with each other are aggregated together into an artificial intermediate materials sector (which produces a single product functioning as both input and output). Output targets on the micro level framed <u>net</u> of self-produced inputs become blown up into an intermediate materials output target which is <u>gross</u> of self-produced input.

divide the obstacles to accurate planning by the method of material balances into two broad categories. The first, on which this paper concentrates, is Gosplan's inaccurate knowledge of input-output coefficients. There is no doubt that this is a significant and recurring problem in Soviet type planning. It is caused mainly by an inability to accurately represent complicated and continually changing production processes with a system of simple aggregate norms. There are also unforseen differences between various enterprises and ministries arising from the uneven quality of equipment, input materials, and labor skills, and from the unknown distribution of hoarded materials. In addition, errors are frequently compounded by faulty aggregation.

A second cause of disturbances, conceptually somewhat different in nature, are the unforseen contingencies which arise during plan execution. In this category are such diverse events as unexpected equipment failure, sudden change in final demand due to political or other events, unanticipated speed-ups or lags in delivering expected capacity, or general supply foul ups due to, e.g., adverse weather.

Actually, most disturbances of the second type can be translated into the language of norm uncertainty. The overriding importance of the output quota to a certain extent normalizes enterprise output levels. With enterprise bonuses and prestige linked primarily to output quota fulfillment, managers are in effect encouraged to use the enterprise fund or to cut into current profits in order to substitute labor for capital (with overtime, increased shifts, and "rush work" if necessary), or to take other emergency measures to ensure holding up their end by fulfilling the output target. This built-in flexibility in being able to partially adjust the timing and quantity of factors semi-permanently attached to the enterprise tends to stabilize output somewhat at the expense of making input requirements more variable. Such adjustments as occur will usually be automatic, without any explicit orders from higher up, and will tend to be therefore more or less instantaneous.

Of course, the authorities will frown on using up too much labor or materials, or not making a high enough profit, and the bonuses will be correspondingly lower. But within limitations, committing these offences will generally be preferable to cutting output below the target level. Should extra inputs over the budgeted amounts be required to meet output quotas, there will usually be no problem for an important enterprise or one supplying deficit materials to obtain. Supplementary <u>nariady</u> (procurement orders). At least a lower priority "non-plan allocation order" will usually be issued to any organization with a good story. Occasionally needed materials can be illegally obtained on the basis of pure <u>blat</u> (pull) alone. Since directors are almost always willing to sacrifice cost and profit targets to meet the output quota, the critical operational question is whether extra supplies <u>exist</u> anywhere in the system. If they do, the <u>tolkachi</u> ("pushers") from some organization will uncover them.

On the other hand, even an abundance of intermediate materials will not ordinarily lure enterprise managers or industrial ministers into over-fulfilling output quotas by a conspicuous margin. Due to the operation of an almost universal ratchet principle of planning, the formation of next period's plan targets will start off with this period's performance as a point of departure. Benefits, material or otherwise, increase tremendously for plan fulfillment but not very much more per degree of overfulfillment. An over-zealous performance in any given period can have disastrous long run effects of the organization in question.

We take as our point of departure the approximation that output targets will be exactly fulfilled if the necessary input materials are available.

One would think that as inventories are run down or pile up the center would revise upward the production targets of, respectively, intermediate materials or final products. We allow such changes to become effective starting <u>next</u> period. The whole idea of the underlying model is that plan periods are sufficiently short to make it difficult to increase outputs after the plans has been formulated. This comes about primarily because it is difficult to shift underlying resources on short notice. The tendency toward short run non-shiftability is reinforced because the time it takes for the center to notice imbalances, draw up new plans, and have target revisions reach down to the level of the enterprise introduces a lag of its own. As previously indicated, the relevant abstraction is that plan targets $\hat{I}_n$ and $\hat{F}_n$ are upper limits on gross outputs of intermediate materials and final products during period n.

7. Plan Execution and the Costs of Incorrect Planning

Let θ_n, with $0 < \theta_n < 1$, be the true value of the economy wide input-output coefficient in period n. During plan formation at time $n-1$, only the distribution of the random variable θ_n is known.[7] Let

I_n and F_n represent actual period n gross output of, respectively, intermediate materials and final products. If

$$\hat{I}_n + S_{n-1} \geq \theta_n(\hat{I}_n + \hat{F}_n) ,$$

all output targets will be fulfilled and $I_n = \hat{I}_n$, $F_n = \hat{F}_n$. Stocks of strategic reserves will change from S_{n-1} at time $n-1$ to

$$S_{n-1} + \hat{I}_n - \theta_n(\hat{I}_n + \hat{F}_n)$$

at time n.

If, on the other hand,

$$\hat{I}_n + S_{n-1} < \theta_n(\hat{I}_n + \hat{F}_n) \qquad (2)$$

an *ex-post* plan inconsistency exists. Not all planned output quotas can be simultaneously fulfilled because someone has to go short of inputs. Smooth operations of the materials supply system will start to break down as reserves dwindle and rationing becomes necessary.

The *ex-post* maximum attainable final product, F_n, is the solution to the linear programming problem

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[7] Only analytic convenience impels us to accept the idea that the input needs of both sectors are described by the *same* random variable. Two different, more or less independent random variables would yield a much more realistic description. But employing more than one random variable clutters up the analysis without really changing the basic ideas of the model.

$$\max \quad F$$

$$\text{subject to} \quad I \leqq \hat{I}_n$$

$$F \leqq \hat{F}_n$$

$$I + S_{n-1} \geqq \theta_n(I + F)$$

$$I,\ F \geqq 0$$

The production function implicit in the above formulation is based on (1).

With (2) holding and $0 < \theta_n < 1$, the solution to this linear programming problem is

$$I_n = \hat{I}_n$$

$$F_n = \frac{\hat{I}_n + S_{n-1}}{\theta_n} - \hat{I}_n$$

If shortages occur in intermediate materials it will not pay to cut inputs from sectors producing the deficit materials. Such action would only magnify the impact of the deficit via a multiplier effect.[8]

The linear programming problem need never be solved formally to obtain the solution I_n, F_n. Indeed it would be difficult to do so because the true value of θ_n only reveals itself over time through inventory level

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[8] This conclusion, so obvious in the present framework, has an interesting operational generalization to the issue of optimal rationing in a multi-sector model; cf. Manove [1969].

changes. The optimal solution will automatically be generated and enforced if an obvious rationing procedure is followed. As reserves decrease, pressure will mount for producers of input materials in short supply to keep up their target outputs (and even to increase outputs, a possibility we disallow until next period). Producers of deficit materials will tend to become priority users of rationed inputs, since they are holding up the system. Producers of final products will get whatever materials remain. Note the critical, if simple, role of reserve levels in determining who is a priority user. At the end of the plan period no material reserves will be left since they will have all been used up in bailing out sagging enterprises.

In our formulation, the cost of overtight planning is the loss of capacity $\hat{F}_n - F_n$ and the reduction of final product which it entails. Too little provision for intermediate goods can cause a plan to break down because the economy is temporarily frozen into a situation of insufficient capacity for intermediate materials production. On the other hand, the cost of excessively conservative planning is the final product lost by the failure to convert abundant material reserves into final products. In both extreme cases losses arise because capacity is temporarily locked into inappropriate plan proportions and cannot be instantaneously shifted to assist the overburdened sector. Optimal plans are a balance between the two extremes.

8. Short and Long Term Plans

We have been speaking of short term plans as if each one were independent of the others. In fact current operational plans are loosely embedded in the long term plan. The latter is a non-operational plan which outlines the general dimensions of economic growth over a period of several years. We assume that as of now (time zero) the long term plan embodies current growth strategy, although in reality the plan document may or may not formally be brought up to date at any given time.

Let N short term planning periods remain until the expiration of the current long term plan. To a first approximation we take capacities $\{Y_n\}_{n=1}^{N}$ as exogenously determined. Economic growth ensures that $Y_n \leqq Y_{n+1}$ for all n. The appropriate interest rate r is also treated as given. Since it is unlikely to be known with any degree of accuracy, assuming r to be constant during the long term plan is worth the convenience it creates. The short term planners are postulated to operate by treating $\{Y_n\}$ and r as data outside their ability to control.[9]

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[9] The reasoning behind the exogenous status of $\{Y_n\}$ and r can be explained by considering overall capacity as an aggregate function of total capital and labor, $Y_n = F_n(L_n, K_n)$. The size of the labor force is more or less exogenously determined at any time. The quantity of available man-hours additionally reflects decisions about how hard people should work, also treated exogenously. Capital stock is cumulated out of investments going back for many years. In that length of time the law of large numbers will tend to smooth out possible effects of plan performance fluctuations. These kinds of disturbances taken as a whole are rarely so violent as to alter investments in a given year anyway. This is especially true in Soviet practice because productive investment is insulated from input shortages at the expense of other sectors. The same remarks can be used to justify the exogenous treatment of the interest rate, which is roughly taken as representing the marginal product of capital. The assumption that interest rates are constant can be lifted at the expense of destroying part of the simplicity of an optimal policy.

Let $\alpha \equiv \frac{1}{1 + r}$. The discount factor α can be identified with the marginal social rate of substitution and also with the marginal rate of physical transformation between goods produced in any two periods of the current long term plan. The factor α^{n-1} will be used to convert the costs and benefits incurred during period n to a common base at time zero.

It is assumed that the random variables $\{\theta_n\}$ are independently identically distributed with probability density function $f(\theta)$.[10] On *a priori* grounds we restrict $f(\theta)$ to take on positive values only for θ between c and C, where $c > 0$ is the minimum conceivable and $C < 1$ is the maximum conceivable input-output coefficient. Thus,

$$\int_{c}^{C} f(\theta) d\theta = 1 \tag{3}$$

9. Optimal Planning and Dynamic Programming

The overall objective in formulating short term plans knit together into a long term plan is taken to be a maximand which is a sum of two parts. The first is the expected discounted value of final products produced during the current long-term plan,

$$\sum_{n=1}^{N} \alpha^{n-1} F_n$$

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[10] In fact, intermediate materials norms are really distributed neither independently nor identically from one time to another. But the convenient assumption to the contrary is not a bad first approximation in the present context. Independently non-identically distributed material norms could be handled at a cost of generating slightly more complicated optimal policies.

The second term is the expected discounted value of the strategic reserve which will be left over to be used during the next long-term plan. The value of the bequest R_N will be treated simply as $\alpha^N R_N$, consistent with our previous interpretation of α as the appropriate discount factor.

Plan targets for period n are set at time $n-1$. At that time the stock of strategic reserves is R_{n-1}, treated as an inheritance from the past about which nothing can be done.

Let $\Psi_n(R)$ represent the value of an optimal policy starting at time $n-1$ with material reserves R. At time N (period $N+1$),

$$\Psi_{N+1}(R) \equiv \alpha^N R \tag{4}$$

For periods $n = N, N-1, \ldots, 1$ $\Psi_n(R)$ is recursively defined by the dynamic programming equation

$$\begin{aligned}\Psi_n(R) = \max_{\substack{I + F \leqq Y_n \\ I,\, F \geqq 0}} & \Big\{\int_0^Z \alpha^{n-1} F f(\theta)d\theta + \int_Z^1 \alpha^{n-1}\left(\frac{I+R}{\theta} - I\right) f(\theta)d\theta \\ & + \int_0^Z \Psi_{n+1}(I+R - \theta(I+F))f(\theta)d\theta + \int_Z^1 \Psi_{n+1}(0)f(\theta)d\theta\Big\}, \end{aligned} \tag{5}$$

with $Z \equiv \frac{I+R}{I+F}$.

An optimal policy at time $n-1$, given reserves R_{n-1}, consists of the targets $\hat{I}_n(R_{n-1})$, $\hat{F}_n(R_{n-1})$ which maximize the right hand side of (5) subject to the constraints and for $R = R_{n-1}$.

The following theorem characterizes the form of an optimal policy for all n :

<u>An optimal policy can be described by a single critical number</u> s <u>defined as the unique solution of the equation</u>

$$-1 + \int_s^1 \frac{1}{\theta} f(\theta)d\theta + \alpha\int_0^s f(\theta)d\theta = 0 \qquad (6)$$

<u>If</u> $R_{n-1} < sY_n$, $\hat{I}_n = sY_n - R_{n-1}$. <u>If</u> $R_{n-1} \geq sY_n$, $\hat{I}_n = 0$. <u>In either case</u> $\hat{F}_n = Y_n - \hat{I}_n$.

As we will indicate later, the relevant situation is $R_{n-1} < sY_n$ with the corresponding rule $\hat{I}_n = sY_n - R_{n-1}$, $\hat{F}_n = Y_n - \hat{I}_n$. This rule has an obvious interpretation in terms of a stock adjustment principle. Let μ be a central statistic of the distribution $f(\theta)$ which is used as an "average" value of θ to aid in compiling plans.

The proposed planning rule is equivalent to

$$\hat{I}_n = \mu Y_n + [\lambda Y_n - R_{n-1}] \qquad (7)$$

with $\lambda \equiv s - \mu$. Projected consumption of intermediate materials is μY_n . We interpret λ as the desired reserves to output ratio; λY_n is the optimal safety level of reserves during period n . The quantity $[\lambda Y_n - R_{n-1}]$ is the difference between current desired and current actual reserves. Production of intermediates is targeted to cover anticipated materials consumption and to bring reserves to the desired safety level. Taking the analogy one step further, μY_n consists of those already committed input materials for which nariady have been issued to the enterprises, whereas $[\lambda Y_n - R_{n-1}]$ is the current uncommitted output of intermediate materials set aside for possible emergency used by plan administrators.

The critical number s is a ratio of the total supply of intermediate materials available as inputs during the plan period divided by the total output of the economy. Equation (6), which determines the optimal value of s, has an interesting economic interpretation. In any period consider transferring a small unit of capacity from $\hat{F}$ to $\hat{I}$, provided both $\hat{F}$ and $\hat{I}$ are positive. The expected loss of current final product is $\int_0^s f(\theta)d\theta$. The expected gain of current final product is $\int_s^1 \left(\frac{1-\theta}{\theta}\right) f(\theta)d\theta$. The expected increase in next period's stock of inherited reserves discounted back to this period is $\alpha\int_0^s f(\theta)d\theta$. If s is to be optimal and all capacity is being utilized, potential gains should exactly offset potential losses, resulting in equation (6).

10. Proof of the Form of an Optimal Policy

To prove the theorem we apply with appropriate modifications the kind of standard dynamic programming arguments used in determining the form of an optimal policy for inventory models. Indeed the present model is mathematically equivalent to the familiar dynamic inventory model with linear ordering costs and a specific form of non-stationarity.[11]

Proof:

Before going on to the main part of the proof, we give a preliminary argument to show that $\hat{I}_n + \hat{F}_n = Y_n$. This part of the theorem is intuitively obvious, since otherwise capacity is being needlessly wasted. We will then be able to replace the inequality $I + F \leq Y_n$ by the equality $I + F = Y_n$ without loss of generality, because the inequality will always hold as a full equality in any optimal policy. Reducing a nominally two variable problem to one involving a single unknown represents a considerable notational simplification which it behooves us to employ as early as possible.

Working with (5), it is easy to verify that if $\Psi_{n+1}(R)$ is monotone increasing in R, so is $\Psi_n(R)$. Obviously $\Psi_{N+1}(R)$ is monotone increasing in R. Hence, so too is $\Psi_n(R)$ for all n.

Suppose that (5) holds with $\hat{I}_n + \hat{F}_n < Y_n$. Partially differentiating the right hand side of (5) with respect to I, one obtains after simplification

$$\int_Z^1 \left(\frac{1}{\theta} - 1 \right) f(\theta) d\theta + \int_0^Z \Psi'_{n+1}(I+R - \theta(I+F))(1-\theta) f(\theta) d\theta ,$$

which is obviously positive.[12] Thus, $\hat{I}_n$ and $\hat{F}_n$ such that $\hat{I}_n + \hat{F}_n < Y_n$

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[11] There is a prolific literature on this model. See, e.g., Bellman, Glicksberg and Gross [1955], Arrow, Karlin and Scarf [1958], Karlin [1960], or Scarf [1963].

[12] There is a little hand-waving going on here because we don't yet know that $\Psi_{n+1}(R)$ has a derivative, but it is trivial to give a rigorous proof by induction.

cannot possibly maximize the right hand side of (5). Henceforth we work with $I + F = Y_n$.

Define M as follows:

$$M \equiv R + I$$

M represents the total materials available for intermediate consumption.

Let $L_n(M)$ be defined by

$$L_n(M) \equiv Y_n \int_0^{\frac{M}{Y_n}} f(\theta)d\theta + \int_{\frac{M}{Y_n}}^{1} \frac{M}{\theta} f(\theta)d\theta \tag{8}$$

Finally, $G_n(M)$ is determined by the equation

$$G_n(M) \equiv \alpha^{n-1}[-M + L_n(M)] + \int_0^{\frac{M}{Y_n}} \Psi_{n-1}(M - \theta Y_n)f(\theta)d\theta + \int_{\frac{M}{Y_n}}^{1} \Psi_{n+1}(0)f(\theta)d\theta \tag{9}$$

Equation (5) is equivalent to

$$\Psi_n(R) = \max_{R \leq M \leq R + Y_n} \{\alpha^{n-1}R + G_n(M)\} \tag{10}$$

The value of M maximizing the right hand side of (10) subject to the stated constraint is denoted $\hat{M}_n(R)$.

The proof is by induction on n , working backwards from $n = N$ to $n = 1$. For each n , propositions (i) and (ii) will be proved:

(i) There is a positive critical number S_n such that an optimal policy requires $\hat{M}_n = S_n$ for $R_{n-1} < S_n$ and $\hat{M}_n = R_{n-1}$ for $R_{n-1} \geq S_n$. Furthermore $S_n = sY_n$ where s is defined as the unique positive solution of (6).

(ii) The first derivative $\Psi_n'(R)$ exists and is continuous for all non-negative R, and $0 < \Psi_n'(R) \leq \alpha^{n-1}$. Furthermore $\Psi_n'(R) = \alpha^{n-1}$ for $0 \leq R \leq S_n$. The second derivative $\Psi_n''(R)$ exists and is non-positive for all R except possibly the point $R = S_n$; however left and right hand bounded derivatives exist at that point.

We start with $n = N$. Using (4), equations (9) and (10) become

$$G_N(M) = \alpha^{N-1}(-M + L_N(M) + \alpha^N \int_0^{\frac{M}{Y_n}} (M - \theta Y_N) f(\theta) d\theta \tag{11}$$

$$\Psi_N(R) = \max_{R \leq M \leq R + Y_n} \{\alpha^{N-1} R + G_N(M)\} \tag{12}$$

Let S_N be a solution of

$$G_N(S_N) = \max_{M \geq 0} G_N(M)$$

Differentiating $G_N(M)$,

$$G_N'(M) = \alpha^{N-1}[-1 + \int_{\frac{M}{Y_N}}^{1} \frac{1}{\theta} f(\theta) d\theta + \alpha \int_0^{\frac{M}{Y_N}} f(\theta) d\theta]$$

$$G_N''(M) = \frac{\alpha^{N-1} f\left(\frac{M}{Y_N}\right)\left[-\frac{Y_N}{M} + \alpha\right]}{Y_N} \tag{13}$$

From (13), $G_N''(M) \leqq 0$ for all M. Since $\lim_{M \to 0^+} G_N'(M) > 0$ and $\lim_{M \to \infty} G_N'(M) < 0$, we conclude that $0 < S_N < \infty$, and that S_N satisfies

$$G_N'(S_N) = 0 ,$$

which can be rewritten as

$$-1 + \int_s^1 \frac{1}{\theta} f(\theta)d\theta + \alpha \int_0^s f(\theta)d\theta = 0 \tag{6}$$

for $s \equiv \frac{S_N}{Y_N}$.

Only a value of s between c and C will satisfy (6). Note that s is unique because differentiating (6) with respect to s yields

$$f(s)\left[-\frac{1}{s} + \alpha\right] \tag{14}$$

which is negative for $c < s < C$ and zero for other values of s.

In view of the unimodality of $G_N(M)$, it is apparent that the policy described by (i) solves (12) except possibly for the inequality $M \leqq R + Y_N$. However, this inequality will be satisfied automatically by $\hat{M}_N = \max\{R, S_N\}$ since $S_N = sY_N < Y_N$.

From (i) and (12) we have

$$\Psi_N(R) = \begin{cases} \alpha^{N-1}R + G_N(S_N) & R < S_N \\ \alpha^{N-1}R + G_N(R) & R \geq S_N \end{cases}$$

Differentiation yields

$$\Psi_N'(R) = \begin{cases} \alpha^{N-1} & R < S_N \\ \alpha^{N-1} + G_N'(R) & R \geq S_N \end{cases} \tag{15}$$

where $-\alpha^{N-1} < G_N'(R) \leq 0$ for all $R \geq S_N$. $\Psi_N'(R)$ is continuous at $R = S_N$ because $G_N'(S_N) = 0$. The second derivative $\Psi_N''(R)$ exists everywhere except possibly at the point $R = S_N$ where, however, left and right hand bounded derivatives exist.

From (13) and (15),

$$\Psi_N''(R) \leq 0$$

for all R except possibly at $R = S_N$.

Assuming now that (i), (ii) has been proved for period n+1, we show that it holds for period n . Equations (9) and (10) define $G_n(S)$ and $\Psi_n(S)$. S_n is defined as a solution to

$$G_n(S_n) = \max_{M \geq 0} G_n(M)$$

Differentiating $G_n(M)$,

$$G_n'(M) = \alpha^{n-1}\left[-1 + \int_{\frac{M}{Y_n}}^{1} \frac{1}{\theta} f(\theta)d\theta\right] + \int_0^{\frac{M}{Y_n}} \Psi_{n+1}'(M - \theta Y_n)f(\theta)d\theta$$

$$G_n''(M) = \frac{-\alpha^{n-1} f\left(\frac{M}{Y_n}\right)}{M} + \frac{\Psi_{n+1}'(0) f\left(\frac{M}{Y_n}\right)}{Y_n} + \int_0^{\frac{M}{Y_n}} \Psi_{n+1}''(M - \theta Y_n)f(\theta)d\theta$$

$$= \frac{\alpha^{n-1} f\left(\frac{M}{Y_n}\right)\left(-\frac{Y_n}{M} + \alpha\right)}{Y_n} + \int_0^{\frac{M}{Y_n}} \Psi_{n+1}''(M - \theta Y_n)f(\theta)d\theta$$

Thus $\lim_{M \to 0^+} G_n'(M) > 0$, $\lim_{M \to \infty} G_n'(M) < 0$, and $G_n''(M) \leq 0$ for all $M \geq 0$. It follows that $0 < S_n < \infty$, and

$$G_n'(S_n) = 0$$

Suppose that $S_n > S_{n+1}$. Then $\Psi'_{n+1}(S_n - \theta Y_n) \leq \alpha^n$ for any θ satisfying $0 \leq \theta \leq \frac{S_n}{Y_n}$. Since $G'_n(S_n) = 0$, it follows that

$$-1 + \int_{s'}^{1} \frac{1}{\theta} f(\theta)d\theta + \alpha\int_{0}^{s'} f(\theta)d\theta \geq 0$$

for $s' \equiv \frac{S_n}{Y_n} > \frac{S_{n+1}}{Y_{n+1}} = s$. In view of the negative value of (14), the derivative of (6), this is impossible.

For $S_n \leq S_{n+1}$, $\Psi'_{n+1}(S_n - \theta Y_n) = \alpha^n$ so long as $0 < \theta < \frac{S_n}{Y_n}$. With $s = \frac{S_n}{Y_n}$, the condition $G'_n(S_n) = 0$ is equivalent to equation (6). The uniqueness of the positive solution to (6) has already been discussed.

The rest of the argument is identical to the corresponding demonstration for the case $n = N$. This concludes the proof.

Note that if $R_0 < sY_1$, then $R_n < sY_{n+1}$ for all n. This follows by induction from the fact that $R_{n-1} < sY_n$ implies $\hat{M}_n = sY_n \leq sY_{n+1}$, and $\theta > 0$ implies $R_n < \hat{M}_n$, together yielding $R_n < sY_{n+1}$. For our purposes it is essentially irrelevant to consider the unbelievable case where inventory stocks start out so super-abundant that no intermediates need be produced $(\hat{I}_1 = 0)$. Thus, we assume $R_0 < sY_1$. This justifies our exclusive consideration of $\hat{I}_n + R_{n-1} = sY_n$, $\hat{I}_n + \hat{F}_n = Y_n$ as the relevant planning prescription.

11. Sensitivity Analysis

The remainder of the formal part of this paper is a comparative statics analysis of the effects of various parameter changes on optimal plan target levels.

The easiest effect to analyze is that caused by changes in the discount rate. Differentiating (6) with respect to α,

$$\frac{ds}{d\alpha} = \frac{\int_0^s f(\theta)d\theta}{\frac{1}{s} - \alpha} > 0$$

The positive sign of $\frac{ds}{d\alpha}$ is intuitively obvious. As leftover reserve stocks are valued higher because of lower interest rates, an incentive is created to increase the production of intermediates relative to final products. Other things being equal, lower interest rates should be associated via higher s with a decreased likelihood that the industrial supply system breaks down and goes over to the critical phase where deficit materials are rationed.

This observation may have some bearing on the issue of "optimal tautness" in planning. Plan "tautness" can be described in very broad terms as the degree of "supply tension" under which economic units operate. In the present model some more or less equivalent measures of the degree of tautness in a formulated plan might be the target level of reserves as a fraction of capacity, $\lambda \equiv s - \mu$, or the probability of precipitating a supply crisis, $\int_s^1 f(\theta)d\theta$, or the percent of capacity expected to stand idle for lack of materials, $\int_s^1 (1 - \frac{s}{\theta})f(\theta)d\theta$.

It has been observed that plans are frequently more taut in the earlier than in the later stages of industrialization.[13] While there might be many reasons for this phenomenon, we merely record the existence of an economic rationale stemming from the present model. In the early stages of development when the marginal product of capital is relatively high, taut planning makes good economic sense. With a high implicit interest rate it is more important to use up available stocks of materials <u>now</u> at the expense of next period's initial stocks. This enlarges the chance that intermediate materials will become rationed deficit commodities and that some capacity will stand idle. Within the present framework the optimal tautness of plan targets should be eased over time as the interest rate declines.

In analyzing the effects of uncertainty on the target level of strategic reserves, we start with the simplest case. Were θ known in advance to be equal to μ , s would also be set at μ . In a world of perfect certainty $\lambda = 0$ --there is no need for positive reserves.

Whether the introduction of uncertainty will make s greater or less than μ depend on the distribution of θ . With θ relatively small, it will probably pay to keep a positive safety reserve because large capacity losses will accompany input shortages. On the other hand, if θ tends

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[13] Hunter [1961] concentrates primarily on the hortatory effects of high targets. The analysis presented here is not meant to suggest that motivational aspects of target setting are not important, especially in the early stages of development.

to be high and the discount rate α is low, the cost of breakdowns diminishes and the safety reserve might even be negative. These conclusions come from examining the equation

$$\int_{c}^{s}(1-\alpha)f(\theta)d\theta = \int_{s}^{C}\left(\frac{1}{\theta}-1\right)f(\theta)d\theta \tag{16}$$

which is equivalent to (6). The term $\left(\frac{1}{\theta}-1\right)$ could be greater or less than $(1-\alpha)$ depending on the values of θ and α.

Let the probability density function $f(\theta)$ have median μ. The value of s in (16) will be compared with the perfect certainty case $s = \mu$. Suppose that

$$C \leqq \frac{1}{2-\alpha} \tag{17}$$

with C the maximum conceivable value of θ. Condition (17) should hold for any realistic values of C and α (remember that the short run plan period we envision is probably less than a year in duration, making α higher than an annual discount factor).

With (17) holding, we can see from (16) that $s > \mu$. The presence of uncertainty has a positive effect on the size of the material reserves target ratio $(s - \mu)$. This accords with the common sense interpretation of material reserves as insurance against risk.[14]

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[14]Unfortunately, definite results can neither be obtained for general distribution changes affecting central tendency (e.g., increases or decreases in stochastic dominance) or for general distribution changes which alter the degree of dispersion (e.g., mean preserving spreads and contractions).

12. Concluding Remarks

A large number of the assumptions behind the present model have been motivated primarily by analytic convenience as opposed to realism. In many cases their replacement by alternatives closer to reality would result in a more intricate model with more complicated optimal policies. But such a model would still display many of the same basic features as the present one.

Unfortunately, this is only partially true of our two sector approximation of the planned economy. Planning in a multi-sector world has a flavor all its own which is difficult to capture with a mere two sectors. For one thing causality becomes very complicated with many goods--everything depends on everything else and it is not so easy to slap together consistent plans. For another thing, shortages or surpluses will usually exist in certain specific inputs and not for intermediate materials in general; an important feature of emergency resource allocation during plan breakdowns concerns the possibility of short run substitution between similar materials. All of these kinds of notions are lost in a two-sector model.

On the other hand, the two basic conclusions of the present model listed below are most clearly visualized in the present simplified framework. These would surely generalize to more complicated situations.

1) Short term plan proportions should be balanced between the production of intermediate and final goods. Resources are wasted with either over-taut or over-conservative plan proportions.

2) The level of material reserves plays an important role as a signaling device. In the short run plan execution phase when capacity is treated as fixed, inventory deficits correctly indicate the priority of inputs going to producers of deficit commodities. When capacities can be altered in the longer run, current material reserve levels point out the optimal direction of next period's plan proportions.

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