THE INVISIBLE BUDGET CONSTRAINT

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Abstract

Presumably everyone familiar with the Austrian school of economics is also acquainted with one of its most famous achievements: The discovery and elaboration of the economic calculation problem of planned economies, notably elaborated in Mises (1920 and 1953). Here we would like to compare two different, but equally famous analyses of planned economies: that of Ludwig von Mises, and that of János Kornai, the Hungarian political economist, who wrote extensively about socialist economic planning during and after the communist regime in Hungary. In his view, socialist economies are "soft budget constraint" environments. We will explore this concept and contrast it against the concept of "hard budget constraint", which characterizes capitalist economies. Our main goal in this paper is to show how, with an apparent superior method, Mises, without ever being personally exposed to a socialist system, was able to formulate a more satisfactory framework for the understanding of its workings, than Kornai, who himself was a very active and distinguished economist even during the socialist regime.

Keywords: Economic Calculation Problem; Socialism; Austrian School of Economics; Ludwig von Mises; János Kornai; Soft budget constraint; Hard budget constraint.

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La restricción presupuestaria invisible

Resumen

Aparentemente, todos los que están familiarizados con la Escuela Austriaca de Economía también están familiarizados con uno de sus logros más célebres: el descubrimiento y conceptualización del problema del cálculo económico en las economías planificadas, desarrollado en particular por Mises (1920 y 1953). Aquí nos gustaría comparar dos análisis diferentes, pero igualmente célebres, de las economías planificadas: el de Ludwig von Mises y el de János Kornai, el economista político húngaro, que escribió extensamente sobre la planificación económica socialista durante y después del régimen comunista en Hungría. En su opinión, las economías socialistas son entornos de "restricción presupuestaria blanda". Exploraremos este concepto y lo contrastaremos con el concepto de "restricción presupuestaria dura", que caracteriza a las economías capitalistas. Nuestro principal objetivo en este artículo es mostrar cómo, con un método aparentemente superior, Mises, sin haber estado nunca expuesto personalmente a un sistema socialista, pudo formular un marco más satisfactorio para la comprensión de su funcionamiento, que Kornai, quien fue un economista muy activo y distinguido incluso durante el régimen socialista.

Palabras clave: Problema del Cálculo Económico; Socialismo; Escuela Austriaca de Economía; Ludwig von Mises; János Kornai; Restricción presupuestaria blanda; Restricción presupuestaria dura.

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1. Introduction: The methodological divide between Mises and Kornai

In order to understand the difference between Mises' and Kornai's analysis of socialist economies, it is necessary to see the difference in their methods. Mises and Hayek didn't have much direct knowledge about the inner workings of socialist countries (in fact, when Mises' first article on economic calculation appeared (Mises, 1935 [1920]) only the young Soviet Union could have been examined as a socialist country). They used certain axioms of individual action, the most basic factor in economic decision-making, and used them to derive conclusions that would apply to a planned economy that satisfied *certain conditions*, most importantly that the state directs all the means of production. Thus, their conclusions only apply to a perfectly isolated and perfectly centralised planned economy.

Kornai's works are of a different nature, specifically, his magnum opus, The Socialist System (Kornai, 1993). In this book, Kornai clarifies the method and scope of his inquiry in the very first chapter (35–49. p.). Here he declares at numerous instances, that his work is not concerned with the conclusions that may be derived from the principles of economic planning, and he is not seeking to explain the workings of an "ideal" centrally planned economy. He explains his subject matter thus:

> "This book […] is not intended to define what counts as »true« socialism. It is necessary to unambiguously inform the reader that in this book, the phrase »socialist system« solely applies to a system of countries that are governed by communist parties. Any other system will only be mentioned for the sake of comparison, and otherwise lie outside the scope of this book". (ibid. p. 43., translated from Hungarian)

This defines the scope of his inquiry, and shows that to Kornai, the phrase "socialist system" does not mean the system that may be imagined as the polar opposite of a market economy but means those countries in their existing and historical forms which were ruled by communist parties.

Kornai declares his methodology right in the beginning of his book: "The main subject of this book is the positive analysis of the historically existing socialist systems." (ibid. p. 44.) This contains everything which needs to be said about method. In the same chapter he writes that his goal is to record and explain regularities that can be observed in the countries that fit his criterium, and to deduce general conclusions from such regularities. These general conclusions deduced from historical regularities build up Kornai's theory of socialism.

2. Kornai's soft budget constraint

Probably the most famous element of Kornai's works is the formulation of the idea of the soft budget constraint. Kornai distinguishes between systems of economic coordination based on how binding effect economic realities have on the behaviour of economic agents. Agents in a free-market economy can generally be described as having a hard budget constraint. This means that the firm or the individual must economise in a way that generates profit, or at least does not generate losses in the long run. In a hard budget constraint environment, agents bear the consequences of their economic losses. Kornai characterises systems like the existing socialist economies as being soft budget constraint environments. This means that:

> […] the strict relationship between expenditure and earnings has been relaxed because excess expenditure over earnings will be paid by some other institution, typically by the State. A further condition of 'softening' is that the decision-maker expects such external financial assistance with high probability and this probability is firmly built into his behaviour (Kornai, 1986, p. 4.).

A soft budget constraint, however, is still a budget constraint. It still suggests that economic agents are informed about the economic realities, only they don't always necessarily have to adjust their activities accordingly. We shall discuss later whether this device can accurately describe the inner workings of a truly planned economy.

3. Different views on economic calculation

Since Kornai studies historically existing socialist systems, to him it would be absurd to demonstrate that central economic planning is impossible. Thus, in his The Socialist System wherever he writes about allocation problems he is mainly concerned with problems of incentives. Although in his chapters on the history of economic thought he mentions Mises (Kornai, 1993, p. 498.) during the main body of the book he mainly utilises Hayek's insights, especially in the chapter on "The problem of information" (ibid. 156.-159.). Here, based on Hayek (1945) he explains that a socialist system which would lack the profit motive would make the utilisation of widely dispersed knowledge extremely inefficient. He states that where information is collected by the state, "the processing of information and the system of incentives necessarily diverge from one another". It is almost always this problem of incentives which is highlighted by present day expositions of socialist economies in Hungary (see Hámori, 2007, p. 169.).

The Misesian theory of socialism is usually not concerned with such problems of incentive. In his view, not even the most dedicated and benevolent citizens could create a completely bureaucratic allocation of goods in the absence of money prices formed on the market. It is here, where Mises can provide us with insights on planned economies.

Kornai' work explicitly mentions the problems of central planning, He clearly states that it is impossible to compare costs and incomes in an economy where we are not faced with market prices, but natural units:

> From the point of view of direct bureaucratic planning the most ideal would be if every command of the planning system was denominated in natural units. But this is impossible […]. In this form, bureaucratic coordination finds itself faced with the basic problem of economising: it is necessary to compare things that are different in quality.

> This cannot be carried out otherwise than by the use of some sort of prices." (ibid. p. 181.)

It is also clear that the prices mentioned here are not the products of the market mechanism (ibid. p. 178.), but are administrative or quasi-administrative prices, that are arbitrarily created by the state. In his words:

> In the market coordination one of the roles of prices is to supply us with information about the relative scarcities of resources and commodities. The [bureaucratic] prices described here do not carry such information. In other words, relative prices in a classical socialist system are arbitrary and irrational. (ibid. p. 180.)

In this point however we stand in contrast with the Misesian conclusions, which show that a non-market (or in other words, arbitrary) coordination of resources *cannot lead* to rational economic calculation. It is clear that a price system that arises from the individual economising activities that take place in a market framework, is a prerequisite of any kind of complex economic activity. In the absence of prices, the costs and earnings of any economising activity are impossible to establish, and impossible to compare. As a result, it is not possible to choose from an almost infinite multitude of alternative modes of production. As Mises writes: "What is called planned economy is no economy at all. It is just a system of groping about in the dark. […] What is called conscious planning is precisely the limitation of conscious purposive action." (Mises, 1998, p. 696.). From this we can conclude that in existing planned economic systems, although the market was repressed to an extensive degree, the administrative prices utilised could not have been *entirely arbitrary*. If these prices were truly bureaucratic, the socialist economies would not only have been inefficient, but could not have existed at all, since they would have encountered a complete lack of information, that would have made the choice between even comparatively simple economic decisions impossible. However, in reality there definitely must have been certain circumstances which made it possible for the classical planned economies not to collapse in the absence of a price-setting market, and which made them able to maintain a relatively sensible course of economic activities even in the face of the strictest structures of planning. We shall deal with such circumstances in the next part of our paper.

4. The indirect market processes aiding planned economies

The real socialist countries did not fit Mises' criterium of a planned economy, namely, they did not organise their economic system based solely on central bureaucratic organisation without markets and prices. As we have said above, such a centrally planned economy could not have existed. However, there were examples of socialist economies where central state control had a decisive role and got close to the Misesian criterium. Kornai calls such systems "classical planned economies", such as the Soviet Union under Stalin (between 1928 and 1953), and Brezhnev (between 1964 and 1982). We can also mention here

Hungary before the economic reforms of 1968, during which time firms were operated through compulsory planning directives. Although these historical periods were characterised by a slow and distorted economic development, the complete aimlessness and planlessness of the Misesian planned economy was averted. Although shortages were constant (Kornai, 2011), industrial and agricultural production did take place, chains of supply were operated, which, in their foundations, were similar to those that could have been called into existence by a market system. Our proposition is that this was made possible only by certain indirect effects of the market mechanism, which are not included in the model of a perfectly planned economy.

5. The preceding price system, as a basis of calculation

The most important support for the planners of a socialist systems must have been the fact that in every country previous to the institution of central planning there existed a more or less free and price setting market economy. We argue that this circumstance could aid the planners in two ways:

The first is that before the conversion to a planned economy there existed a system of prices that could be utilised during the planning process. The prices that existed before the formulation of the first central plans could have been used to create the "accounting weights" of the planning process. From the point of view of economic calculation, it is invaluable that for every capital good and commodity there existed a price from the previous regime (in the inventories of firms, for example), that could help the planners to form at least a vague idea about the scarcity relations between goods. These prices could form the basis which, to some degree, reflected economic realities. Naturally though, this basis lost its relevance very quickly in a constantly changing economic environment, and a supposedly socialist system is not exempt from constant dynamic changes. Thus, the further we get from the original date when the copied price system was actually relevant, the more meaningless these prices become. In the case of Hungary, the first economic plans were drawn up using the prices of 1938 as a basis. When such copied price systems became obviously untenable, the planners attempted to improve on them, in so-called price rearrangements, such as the one in Hungary in 1951, with little success. As Mises wrote: "the problem of economic calculation is of economic dynamics: it is no problem of economic statics." (Mises, 1951, p. 139.).

The second important way in which a previous price system could have helped central planners was that these planners themselves, as most of the other citizens of the socialist community, had a "feeling" for the relative importance of many commodities. This feel for scarcity was also due to the previous market system. We can say, for example, that to us, the idea that every manufactured piece of furniture should be made of tropical wood, or that between every two settlements we should build a TGV-like trainline, would sound ludicrous. We would say to all these projects that they contradict "common sense", even though they do not contradict common sense at all. What these plans are in conflict with is the price system that we got used to. The reason why it is so difficult to imagine the Misesian perfectly planned economy is that we are unable to mentally dissociate ourselves from the information supplied to us by market prices; we cannot even comprehend how absurdly we would guess the relative scarcities of goods in the absence of a price system. Similar circumstances could have had a very beneficial effect on the planners' ability to determine a course of resource-allocation that could resemble an optimal set of choices, and to avoid the complete absurdity of a completely planned system.

6. World prices, as a base of reference

The most crucial tool for dynamic adaptation to economic realities must have been the international price-system that surrounded socialist countries. It appears almost self-evident if we consider for a moment the position of a central planner, that in the absence of a better solution the copying of foreign market prices may bring us closer to the optimal solution. Despite the fact that the country under planning can radically differ from a capitalist country in many ways, it still seems to be a better solution for long term adaptation, than the complete lack of idea about economic reality. This was also the experience of Peter Wiles (1957), who tried to find out the details of the planning process while visiting communist Poland. According to his experience, trade between the countries was carried out this way:

> What actually happens is that 'world prices,' i.e. capitalist world prices, are used in all intra- block trade. They are translated into rubles…and entered in bilateral clearing accounts. To the question, 'What would you do if there were no capitalist world?' came only the answer 'We'll cross that bridge when we come to it.' In the case of electricity, the bridge is already under their feet: there has been great difficulty in pricing it since there is no world market.

These observations only involve trade between the socialist countries, and Wiles mentions that he believes, though it is only a suspicion, that planners use 'world prices' in the case of their national plans as well. This suspicion may be confirmed in many instances, for example in the case of Soviet planning:

> Our economists and planners put forth a plan that greatly surprised the members of the Central Committee, since in it the price of a ton of grain was equivalent to that of a ton of cotton, which also meant that the price of a ton of grain became the same as that of a ton of bread. To the remark of the members of the Central Committee, that the price of bread should be higher than the price of grain, due to the costs of milling and baking, and that cotton should be more expensive than grain *as shown by the world price of grain and cotton*, the authors of the proposal had no coherent answer. (Stalin, 2006 [1952], p. 24–25.)

Or in the case of Yugoslav planning:

> The principle for the supervision of prices is based partly of *world prices*, partly on the costs of production; both firms and the planning authorities – the latter of course in the hope of avoiding the increase of prices – always refer to that element, that is more advantageous for its purposes. (Soós, 1986, p. 141.),

> The director of the chemical company called "OKI" gave an interview to Ekonomska Politika where he said: "We have recommended the authorities the use of price-automatism in the determination of our prices, but they dismissed this proposal on the grounds that the basis for the prices of our commodities is the world price system. In the not-so-distant past, when world prices were on the rise, and we referred to them, they explained to us that the real measure is not the world price system, but the cost-principle!" (ibid. p. 141–142.).

In the case of such reform-socialist economic models as the aforementioned Yugoslav economy in the 1970s, the use of world prices is obvious, since they were used in the official planning and supervisory processes. However, to us, the Stalinist example reflects equally well how helpful capitalist prices must have been in the determination of plans. Even if these prices are not directly built-in to what Kornai rightly called the "system of weights" which constituted the classical socialist system of prices, capitalist prices could have been crucial in the formulation of economic plans, as a base of comparison.

7. The use of pseudo-administrative prices

Both Mises, and Kornai deal with the question – the former from a theoretical, the latter from a descriptive point of view – of what happens if the planning bureaucracy is unable to control the operative units of the economy (firms, industries) in complete detail, and if these units possess a certain degree of autonomy. The incentives and institutional framework involved in these questions are treated thoroughly in Kornai (1993). To us the crucial question is to what degree did the certain measure of autonomy of the firms contribute to the rationalisation of the price-parameters used by the planning authorities?

Kornai (1993) mentions that although the prices used by central planners were arbitrary (which we doubt, based on the Misesian insight that completely arbitrary prices could not have made economic decision making possible), there existed a certain level of bargaining between the firm and the central bureaucracy:

> In practice […] the price-authorities […] had to base their decisions on calculations that have been proposed by firms or (according to the relevant regulation) some supervisory unit of firms. For this reason, in many cases the prices dictated by planners were not real, but pseudo-administrative prices; the price-authority puts its seal of approval on prices are in reality determined by producers. This price is also not formed by horizontal market cooperation, but by vertical, bureaucratic bargaining. (Kornai, 1993, p. 178.).

Though it is obvious, as mentioned above, that a price set by a firm in a socialist economy cannot be equated to a price arising from market conditions, from an allocational point of view it can be an extremely important factor that the producer can effectively act in favour of its self-interest. It is also obvious that the firms mentioned by Kornai do not operate in market conditions, but the mere fact that they, to some degree, “resist” certain elements of the central plan, shows that to a certain level it is in the interest of the managers of the firms to keep the plans more rational than they otherwise would have been. It would be an exaggeration to call this a profit-motive, but we can say, based on Kornai, that the managers had an incentive to keep the firms’ costs low, and their incomes high:

> It is true, firms are not completely indifferent to the costs and benefits of production; after all, the minimization of costs, and the attainment of a certain amount of profit was among the general principles and the specific commands of the plans. We should rather say: their interest in keeping costs low and in attaining profit, their income-sensitivity is quite weak; it is overshadowed by other, stronger considerations. (Kornai, 1993, p. 174.)

This weak profit motive is enough for us to count it as a further quasi-market element. Because although the above-mentioned pseud-administrative prices could not compete with the coordinating ability of real market prices, even this limited drive for profit compelled firm managers to bargain for prices that bared information about the specific local knowledge of managers about economic realities.

Let us suppose, for example, that the planning authorities set a price for a certain commodity, but that it would be too low for the producing firm. With this administrative price the costs of the production of the commodity would outweigh the income generated by the sale of the commodity: the price would generate losses for the firm. If the firm can in some way affect the planning process in a way that a higher price is set for the commodity, it indirectly contributed to the rationalisation of the plans. If at a certain price the firm generates losses, it means that the value of the resources used up during the production process is higher, than the value of the product itself. A firm that generates losses makes society poorer. By having an influence on the pseudo-administrative price set by the planners, the firm was able to influence the plans in a way which squanders the resources of society to a lesser degree.

8. Conclusion: The invisible budget constraint

It is necessary to clearly spell out an important conclusion of the comparison of Mises and Kornai. As we have seen, the inductive method of Kornai leads him to describe socialist planned economies as ones in which incentives lead economic agents to create and maintain an inefficient structure of production. Firms possess a soft budget constraint, where they are not strictly motivated to follow a profit motive, whereas in a market economy, the institutional environment punishes economic actors who only squander resources.

This certainly holds true for existing socialist economies. Nevertheless, we believe that this model does not describe the essence of planned economies. It may describe conditions in a socialist economy which makes use of the above-mentioned indirect market influences and is thus able to utilize prices that have some foundation in economic realities. But we know from the Misesian economic calculation problem that in a completely planned economy that is isolated from the market in every way, complex economic calculation (the comparison of costs and earnings) is impossible. In a completely planned economy not even a soft budget constraint may arise. A budget constraint presupposes prices that enable us to evaluate our wealth and denote it in a common numeraire (money). Without private property and markets, the formation of prices is not possible, and a budget constraint cannot arise.

Instead, we propose a different term. Although in a perfect planned economy the planning authorities would lack the ability to make rational economic decisions, the economic realities which bring about the need to economize are still binding. Though the central planners would be unable to determine whether, for example, a water treating plant, or a synthetic water factory would be more economical, the relative scarcity of the necessary inputs would still exist. For this reason, we believe that as Kornai's soft budget constraint characterises the economic agents of the existing socialist economies, the economic planners of a perfectly planned economy would face an *invisible budget constraint*. This phrase expresses that although scarcity and the wide-ranging human preferences concerning goods and services still effectively constrain the range of actions of a planned economy, and although the economic problem arising from them still needs to be solved, without money prices the planner would be unable to perceive these constraining elements. Thus, although the budget constraint itself would still exist, it would be "invisible" for those involved in the planning process.

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