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OPINION

Myths of Soft Budget Constraints

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BERLIN and KUALA LUMPUR, Sep 15 2020 (IPS) - In recent decades, many contemporary macroeconomic and financial problems have been blamed on 'soft budget constraints' (SBCs), with the term becoming quite popular in the economics lexicon, financial media and political discourse.

Soft budget constraints
Originally coined four decades ago to purportedly describe the economic roots of problems in centrally planned 'socialist' economies, it was soon also invoked for ostensibly dirigiste developing countries accused of 'macroeconomic populism' and 'industrial policy'.

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It has since assumed a double life, invoked on one (microeconomic) hand to discipline large enterprises not maximising shareholder value by investing too much for the medium and long-term, and on the other (macroeconomic) hand to control 'irresponsible' governments running budget deficits.

First formulated by Harvard economist Janos Kornai from Hungary to explain economic behaviour in 'socialist' economies said to be characterised by shortage, the term was soon widely used in the literature on economic transitions from centrally planned 'socialism' to market capitalism.

The original claim was that state-owned enterprises (SOEs) in socialist countries were not allowed to fail even when unprofitable. According to him, such SOEs were almost always bailed out with financial subsidies or by other means. True, SOEs in socialist economies never went out of business as there were no bankruptcies.

But although such legal bankruptcy provisions were undoubtedly lacking, SOEs were often disciplined by other means in such ‘centrally planned’ economies: national budget provisioning under central planning was almost always strictly limited, managements could be changed, or enterprises required to reform.

Nevertheless, poor enterprise management and losses were blamed on SBCs. With enterprise losses assumed to result in national level budgetary indiscipline, SBCs at both levels were presumed to be related.

Hence, permanent government budget deficits, debt accumulation, high inflation and other macroeconomic imbalances were presumed to be associated with pervasive enterprise level SBCs and losses.

Global neoliberal economic ascendance from the 1980s increasingly invoked SBCs to explain economic problems at both micro and macro levels in non-socialist economies, such as the financial difficulties of US auto giant Chrysler in the 1980s and various macro-financial crises since.

Shortages and SBCs

The SBC notion was directly linked by Kornai to the ‘shortage economy’, another notion associated with him from the 1980s, with both portrayed as characteristic of centrally planned socialist economies.

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When a government covers the losses of all unprofitable SOEs with a national fiscal SBC — a practice presumed to be widespread — both wages and profits exceed the value of output, causing both consumer and investment demand to exceed supply in such ‘shortage’ economies.

As enterprises are not constrained from increasing demand for resources, shortages emerge. Shortages are inevitable if prices are controlled and cannot rise to clear markets. But SBCs do not inevitably lead to shortages as market price increases can eliminate them.

Due to SBCs, enterprises are presumed to increase investment and production until they encounter non-financial resource constraints in the form of shortages. But no explanations have been offered as to why these should necessarily occur, either in theory or in practice.

Rather, this claim is based on the presumption that SOE managers are primarily, if not solely interested in maximizing output or growth rates. This presumption is widely believed by economists to be realistic, although there is no systematic evidence that this was indeed the case.

Selective industrial policy

Enterprise level losses over several years were also presumed to be due to SBCs, rather than the result of a deliberate policy of selective encouragement of and support for particular sectors, technological initiatives and enterprises.

In fact, such support for strategic industries and enterprises was not widespread, let alone pervasive, and did not cause major government budget deficits. Such selective industrial policy is thus easily, but misleadingly depicted as a classic cause of enterprise-level SBCs.

Such selective subsidization may or may not succeed in accelerating progressive structural transformation, but was certainly neither an intrinsic or pervasive feature of centrally planned socialist economies, and even more misleadingly, a major cause of pervasive SBCs.

In East Asia, promotion of export-oriented manufacturing and new high-tech industries contributed to successful catch-up growth and structural transformation. But such targeted subsidization conditional on meeting performance criteria did not involve national level or macroeconomic SBCs.

The problem in the USSR and East European countries was not subsidization per se, but rather, indefinite, even increasing protection through higher domestic prices for manufactures — as part of import substituting industrialization policy — perpetually protecting manufacturing SOEs not effectively compelled to become more competitive.

Budget constraints in ‘socialist’ economies

In the Soviet Union after the Second World War, from the 1947 monetary reform until the 1987 Gorbachev perestroika reforms, budget deficits and debt were kept low and transparent. Open and hidden annual inflation rates remained in the single digits, often lower than in Western countries.

In fact, budget constraints in ‘socialist’ economies were ‘stricter’ than in most developing countries, and no less ‘hard’ than in many developed countries. SBCs in ‘socialist’ economies were not all-pervasive, as often claimed, but selective, e.g., involving subsidization of some enterprises or industries at the expense of others.

Budget constraints under central planning were mostly much stricter than in market economies at similar levels of development. SOE losses could contribute to government budget deficits, but were mostly modest under ‘socialism’, with both open and hidden inflation relatively low.

Various political factors shaped macroeconomic policy choices during the 1990s’ transitions. Previously ‘hard’ budget constraints ‘softened’ dramatically in many East European countries and former Soviet republics, resulting in fast growing budget deficits and high inflation.

The new combination of weak states facing rivalrous powerful interest groups caused governments to ‘kick the can down the road’, with deficits, debt, inflationary financing, overvalued exchange rates as well as domestic fuel and energy prices below world levels.

Hence, SBCs were just one type of economic policy, rare in ‘socialist’ countries, but found in many developing countries, especially in Latin America and Sub-Saharan Africa, and ironically, in transition economies, especially in the former USSR, from the 1990s.