Irrelevance of the Soft Budget Constraint for the Shortage Phenomenon

A. BAJT
Ekonomski Institut Pravne Fakultete, Ljubljana, Yugoslavia

Abstract

Kornai's thesis that shortage results from demand expansions bred by the soft budget constraint, derives from his implicit assumption that price regimes of input and output firms are different. Since any firm is both an input and an output firm, which discards the assumption as logically untenable, excess demand can only turn up because of lower than contracted inputs of labor and management that are not offset by an adequate downward adjustment of earnings. Expansions of demand that appear to be autonomous, are incited by uncertain deliveries of inputs, that is, by inefficiency (of output firms) as well. A by far the largest part of excess demand can be explained by state preferences for fast growth. As planners are more successful in generating investment, and the ensuing consumer, demand than in expanding production, shortage is inevitable regardless of the character of the firms' budget constraints.

I. Introduction

In his 'Kornai’s soft budget constraint and the shortage phenomenon' Gomulka states that

Budget constraints are softer when and where tolerated economic inefficiency is greater, and it is relatively high efficiency losses, not chronic shortages, that are probably an unavoidable characteristic of the economic systems which are influenced particularly strongly by socialist principles (1985, p. 2).

This statement presents an almost complete turnaround in the 'soft budgets breeding shortage' paradigm and calls for a fundamental reconsideration of the prevailing theoretical stereotypes of socialist economics.

Of course, there is no need to argue that the soft budget constraint breeds inefficiency. If firms expect they would be provided financial help when in trouble, to the effect that instead of going bankrupt they are bailed out (this appears to be the most faithful reproduction of Kornai's definition of the soft budget constraint – Kornai, 1985a, p. 50; 1986, p. 11), managerial activity becomes lax both internally and externally, leading to low labor inputs and poor output quality, and low selling and high purchasing prices, respectively. The softer the budgets the higher inefficiency. The correlation appears so strong that Gomulka (1985, p. 4)
uses the amount of efficiency losses as the measure of the budget constraint softness.

The purpose of this paper, therefore, is to show what misled Kornai to believe that it is the soft budget constraint that generates shortage on goods markets and to propose more adequate answers to the problems tackled by him. In the next section we expose Kornai's concept of the 'soft budget constraint breeding shortage' paradigm, enrich it with the Gomulka's 'excess of budget flexibility over price flexibility', and discuss reasons why it cannot stand criticism. The third section is to identify an implicit assumption that diverted Kornai from inefficiency to shortage as the main characteristic of socialist economies, and to show the mechanisms by which the former is generated, under what conditions it leads to financial troubles and how it results in shortage of labor. In the last section we show that it was mistaking of investment demand for investment production that made Kornai to believe in the soft budget constraint generation of the run-away demand for goods.

II. The soft budget constraint and its irrelevance in explaining excess demand

In Kornai's view, the soft budget constraint leads to shortage by generating a 'run-away demand' for inputs (Kornai, 1986, p. 11), demand running 'away to infinity' (Kornai, 1985b, p. 151), that is, demand "not simply too large, but as a first approximation ... infinite" (Kornai, 1979, p. 809). Together with input prices that in spite of inflexibility frequently go up, larger demand brings financial troubles to firms (Kornai, 1985a, p. 50) – illiquidity, indebtedness, higher costs. To avoid bankruptcy, they negotiate financial assistance with the respective state authorities. Since as a rule they get it, demand 'running away' and shortage are perpetuated.

By such a description, the post-reform system is assumed to be prevailing in socialist economies. Interfirm output-input relationships are based on contracts rather than central plan. Key prices only are determined by the state and even these are negotiable. The basic wage rates are set centrally, but there is plenty of room for their adaptation to specific situations. Only investment still remains a firm province of the state. In the central plan period there was no place for the soft budget constraint. When needed, additional finances were provided to firms automatically.

In order to reach a full understanding of the 'soft budget constraint breeding shortage' paradigm, we first (i) sharpen the concept of the soft budget constraint by making use of the Gomulka's 'excess of budget flexibility over price flexibility'. This enables us to grasp its expectational nature and to estimate direction in which softness of the budget constraint