

Could we build a bridge between Austrian Economics and New Institutional Economics? - A Pre-History of Soft Budget Constraint

Cláudio Djissey Shikida (*)

Abstract

The concept of soft budget constraint is recent in economic analysis. It has become increasingly important in economic theory, for its role as a system of incentives. However, soft budget constraint plays also an important role in the history of economic thought, where it can be traced back until Mises's writings on economic calculation and property rights, both derived from the debate of the economic calculation in socialist regimes. In this sense, soft budget constraint can be viewed as a bridge between Austrian Economics and New Institutional Economics. Since Mises, like other Austrian economists, is virtually ignored in Brazilian courses of Economic Thought, this article intends to show his importance as a forerunner of the concept of soft budget constraint, and will try to link these two theoretical views of economic systems.

(*) PPGE-UFRGS

e-mail: cdshikida@ig.com.br

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[not for quotation without permission]

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1. Introduction

"The differences between mainstream neoclassical economics and the new heterodoxy of neo-institutionalism and evolutionary theory may gradually be vanishing. If that is the case, increasing appreciation of the Austrian insights into the problem of socialist economic organization should be expected to emerge". [FOSS, N.J., 1994 : 81]

Recently, in the economic literature, we have seen the frequent use of the concept of "soft budget constraint" (SBC). In a sense, this is a simple application of an old idea to new problems, like almost anything in economic theory. Shortly, SBC means that a particular economic agent doesn't respect his budget constraint.

This concept is due to Janos Kornai, and its origin is in his studies of socialist economies¹. Examples of studies in this field are Raiser (1994), Kraft & Vodopivec (1992), Kornai (1996), Anderson, Korsun & Murrell (1997) e Goldfeld & Quandt (1988).

Another kind of study focuses the problems of the relationship between institutions and economic growth, and is under the New Institutional Economics' (NIE) theoretical branch. Here, Barry Weingast and associates are the main researchers². Essentially, these authors look for a necessary condition for the functioning of a federalist system in order to promote prosperity without "excessive" state predation of private wealth.

This article follows the NIE' s tradition but with an eye on Austrians insights. The objective here is to contribute with a discussion on the historical roots of the concept of SBC and to suggest a way to link Austrians and NIE through these lens.

But so much for an introduction. Before going on, it is necessary to define, more precisely, what is New Institutional Economics, Austrian Economics and SBC. Then, the SBC will be proposed within these two somewhat distinct theoretical views of economic phenomena. Finally, conclusions will follow, revealing some optimistic views.

2. New Institutional Economics and Austrian Economics

This section is based on two simple questions. The first is: what is New Institutional Economics? The second, obviously, is: what is Austrian Economics? We will try not to give definitive answers to these two questions. But we will try to obtain a broad definition of the two concepts and, following this, we will try to find in the recent concept of "soft budget constraint", the theoretical bridge between the two non-mainstream lines of economic theory.

Let me begin with New Institutional Economics (thereafter, NIE).

"The alpha and the omega of the NIE are institutions and economic performance. Institutions determine economic performance and economic performance determines institutions. This is nothing new. What is new are the conceptual spokes such as transaction costs, property rights, credible commitment, and agenda control, that are used to determine the simultaneous causal links between institutions and economic performance".
[ALSTON, L. J., 1998 : 2-3]

¹ In the opinion of the author of this paper, It could be said that Kornai (1992) represents a "second generation" study in the studies of "socialism". The "first generation" could be traced to the debate of economic calculation in whose were involved three branches of economic theory: Austrians, neoclassical and marxists. For details, see Foss (1994), chapter 4. This kind of study has been stimulated by the historical change initiated with the sovietic Perestroika and the final collapse of the socialist world in the 90s.

² See, for instance, Qian & Weingast (1999).

Similar emphasis in the definition through the Coase's transaction costs is found in Langlois (1994). The concept of "transaction costs" is no more a strange one in the traditional economic literature, neither "property rights"³ nor "credible commitment" (and "agenda control"). The proponents of NIE sometimes prefer to define it as a kind of "extended neoclassical-economics" in the sense that it represents a theoretical effort to incorporate old criticisms to the theory.

Perhaps the critical point concerns the importance of "institutions". But, what are "institutions"? They can be understood as "(...) the informal norms and formal laws of societies that constrain and shape decision-making"⁴. In this sense, "institutions" can be thought as constraints (or liberators) to the action of individuals⁵. They can be "religion", "gender", "race", "geographical localization", "corruption level", etc. The inclusion of several - apparently - non-economic variables to the economic models is a very difficult issue at the theoretical level, but it has become an important source of empirical research. La Porta, Lopez-de-Silanes, Schleifer & Vishny (1998), for example, apply a large database of non-economical variables in their study about the quality of government. They use, e.g., religion, legal origin, interest groups and corruption in order to verify what determinate the "quality" of government, measured through several variables.

However, the use of econometrics in this field has to be viewed with caution. Endogeneity of several variables (or the definition of what is endogenous) and reverse causality are issues that seem to be worse when we talk of NIE and the "institutions" that it brings to the research agenda.

It's important to note that the NIE - as well Austrians - has adopted the *methodological individualism* in its analysis⁶. The distinguishing point is that NIE proponents try to include "cultural" variables in the economic problems, as described above.

In summary, that is NIE. A final remark, however, is necessary here. NIE isn't a *totum* of homogeneity. As a - relatively - new field of research, NIE doesn't present a complete "economic-expanded model" as, for instance, mainstream microeconomics. Nevertheless, this isn't a real problem because NIE proposes itself to be an extension of the traditional economics. So much for NIE. We should move to the next question: what is Austrian Economics?

Austrian economics is not a completely integrated body, with researchers working on different fronts⁷. In general, Austrian economics is characterized by *subjectivism*, which implies that methodological individualism would be the right way to understand economic phenomena. In this sense, Austrian economics share a common point with NIE: both try to work with the imperfections added to the traditional view of economics⁹.

Perhaps what distinguishes Austrian economics from mainstream economics and NIE is a methodological issue. For example, Austrian economics lacks formal models, like those present in mainstream economics and in NIE. Another distinction is that Austrians are (almost?) unanimous in the defense of free markets, while NIE's authors don't necessarily embrace it. Methodological individualism seems to play a different role in Austrian economics, probably because of the "dispersed knowledge" notion that is added to the traditional concept of "scarcity". If the knowledge about the economics is dispersed (and scarce), then any form of planning would distort market signals. Therefore, the notion of dispersed knowledge seems to be fundamental to the argument favoring free markets in the Austrian literature.

³ Foss (1994), correctly, in my view, claims that Mises was one of the forerunners of the property rights approach to economics. See the similarity with the modern Beckerian economics when Mises talk that "(...) marriage (...) has come into existence entirely as a result of the contractual idea penetrating into this sphere of life (...)". [MISES, *apud* FOSS (1994) : 90]

⁴ See Alston, (1998), p.3

⁵ See Clague (1997), sections 2, 3.

⁶ It is also adopted by the "mainstream neoclassical microeconomics".

⁷ As we aren't so much familiarized with Austrian economics, this part of this section probably will suffer for more imprecision. So, comments to this part of the paper will be incorporated in the future.

⁸ See Boettke (1994).

⁹ See Iorio (1997) and Boettke (1994) for example. The first is, maybe, the first "Austrian economics textbook" in Brazil and the part of this section about Austrians is strongly based in it.

The market mechanism, properly understood as a process that reveals prices to consumers and firms, plays a key role in Austrian economics, being the central theme in the so-called "socialist debate". The point of view developed in this paper suggests that the Austrian notion of market mechanism provides a link to NIE¹⁰. This will be made twofold. First, in the next section, as a history of economic thought argument, and second, as an extension of institutional economics studies in section 4.

3. Soft Budget Constraint: a possible bridge between NIE and Austrian Economics?

As we've said in the introductory section of this paper, SBC is a relatively recent concept, that was developed by the Hungarian economist Janos Kornai to understand the problems of central planning in the socialist world and, recently, has been adapted by some NIE's economists to understand failures of government in "federations's structures".

SBC can be characterized - according to Raiser (1994) and Kornai (1996) as:

- a) Failure to pay suppliers;
- b) Breach of contracts;
- c) Failure to pay taxes;
- d) Sales are not enough to cover costs.

The four items above basically infer the possibility of the companies breaching a contract. The same companies can cheat suppliers either by putting off, at their own discretion, the payment for production input or simply by not paying them. Moreover, there is a high degree of arbitrary decisions on taxes the companies are subject to, that is, the greater the chances of "relief" in taxation, the softer the constraint of the company will be. Another way of minimizing the hardness of such a constraint is achieved by allowing flexibility for the regulated sectors of economy. In the case where prices are administered, the easiness with which they are re-adjusted, completely independent from the performance of the company, can result in an even worse performance of the company (it means that the firm will always prefer to follow the path of prices adjustment instead of operating in terms of quantities).

The characteristics described in the items (a)-(d) above, are based on two factors: breach of contract and maintenance of conditions that favour the receipt of the company. Such conditions can be re-negotiated; however, it is vital that such a re-negotiation is strongly linked to the horizon of actions of the companies. It is worth mentioning that the "freshening up" of such favourable conditions must be great enough for the firms to invest, without worrying about the generation of self-income, According to Kornai:

"What is really important is the psychological effect of the constraint: with a hard budget constraint, a deficit causes fear, because it may lead to extremely serious consequences. Profit-maximization refers to the internal goal-setting of the decision-maker in the firm; the softness-hardness of the budget constraint refers to the external tolerance-limits to losses". [KORNAI, J., 1986 : 8]

Here, it is possible to notice the expectational character of softness in the constraint. Another characteristic of SBC is the "paternalism" implicit in the relationship between the state and its firm.

¹⁰ Lavoie (1994) points another concepts that are common to some NIE's economist. Shortly, there are the models derived from Chaos's theory. In this sense, "path-dependence" would be a concept common to some NIE's economists and Austrians that wish to create economic models. However, this point would not be analysed here.

It induces a *moral hazard* problem because - in the example of the state owned firm - the manager doesn't has incentives to work in an efficient way because he knows that the state will be compensate him for his faults.

A good description of this is in the recent paper from Schaffer (1997) that traces the origin of the concept of SBC to Ludwig Von Mises. According to him:

"It is perhaps worth noting here that a version of the SBC made quite an early appearance in the economics literature. In 1920, von Mises wrote: '[I]n practice the propertyless [i.e. socialist] manager can only be held morally responsible for losses incurred. And so ethical losses are juxtaposed with opportunities for material gain. The property owner on the other hand himself bears responsibility, as he himself must primaly feel the loss arising from unwisely conducted business', Von Mises (1920), p.122". [SCHAFFER, 1997 : 29]

The above quotation refers to the debate of socialist calculation and it is the link that probably can be put between NIE and Austrian Economics. That is, one of the consequences of the SBC in a firm (not necessarily a state owned) is the problem of *incentives* to the managers. As correctly stated by Mises, the definition of property rights is very important for a firm's performance. It is very similar to Coase's question about transaction costs and, consequently, to the NIE analysis of property rights¹¹.

To be more specific, consider Kornai's own words.

"The sharpest repudiation of Lange's line of thought during the debate came from Friedrich von Hayek (1935). His main argument was as follows: the real big problem for socialism is not wether it can set equilibrium prices, but what incentives there are to obtain and speedily apply the necessary dispersed information concealed in many different places. (...) Looking back after fifty years one can conclude that Hayek was right on every point in the debate". [KORNAI, J., 1992 : 476]

See, also, this small text, from Mises, where the problem of SBC is clearly stated in terms of a problem of incentives¹².

"The method of trial and error is applicable in all cases in which the correct solution is recognizable as such by unmistakable marks not dependent on the method of trial and error itself. (...) If one wants to call entrepreneurial action an application of the method of trial and error, one must not forget that the correct solution is easily recognizable as such; it is the the emergence of a surplus of proceeds over costs. (...) But the characteristic

¹¹ Maybe the consideration of Mises as one of the "ancient fathers" of SBC isn't totally correct. If you understand Economics as the science of "catallactics" as expressed by Whately (see Rowley (1994) for details) and by Mises, Hayek, Buchanan and Tullock, you see that the only difference of *Public Choicers*, for example, and the mainstream economics is the broadening of the field of study of economics (the so-called "economic imperialism"). The "catallactics" only seems to put in evidence that the most important point of the human action is the system of incentives that exists around the individual. After all, Marshall has said that economics is the science that studies the actions of human beings in ordinary life. A definition not so far from the Mises in *Human Action*, despite of the different ways that both authors gotten in the development of economic analysis.

¹² More specific references about how Mises had insights in the theoretical problem of principal-agent can be found in Foss (1994).

mark of the socialist system is that the producer's goods are controlled by one agency only in whose name the director acts, that they are neither bought nor sold, and that there are no prices for them. Thus there cannot be any question of comparing input and output by the methods of arithmetic ". [MISES, 1996 : 704-5]

And, also, the argument of Hayek, quoted by Kornai (1992):

"The sharpest repudiation's of Lange's line of thought during the debate came from Friedrich von Hayek (1935). His main argument was as follows: the real big problem for socialism is not whether it can set equilibrium prices, but what incentives there are to obtain and speedily apply the necessary dispersed information concealed in many different places (...). Looking back after fifty years one can conclude that Hayek was right on every point in the debate". [KORNAI, J. , 1992 : 476]

Basically, Hayek and Mises want to emphasize their own concept of market as a dynamic institution, in which the price system has a crucial function of signaling. Also, particularly Hayek is very known for his argument of the problem of the use of the knowledge by individuals¹³. Essentially, since information is dispersed in society, its use by entrepreneurs would represent the most efficient form of resource allocation, which would not be possible through the actions of some kind of central planner (which would have to know how to collect the dispersed information).

Another application of SBC is in the NIE's study of federalism¹⁴. Essentially, the most important concept is "Market Preserving Federalism". It was developed in the works of Montinola, Qian & Weingast (1994), McKinnon (1994,1995a), Qian & Weingast (1997), Qian & Roland (1997) and Cao, Qian & Weingast (1997). The importance of this is highlighted, for example, in Hillbrecht (1997):

"The non existence of safe property rights, that is, the absence of a reliable commitment of the State to guarantee them, will reduce economic activity and wealth creation, since the economic risk of investing in some activity is increased by political risk of undesirable interventions on it". [HILLBRECHT, R.O. 1997 : 55]

So, the central government is responsible for the important task to ensure protection to property rights, to avoid the "escape" of capital. Another form of commitment is the adoption, *de facto*, at least, of clauses favouring harder budget constraints in the political units of a federation. Thus,

"Lack of commitment in this form fails to provide 'negative incentives' to economic institutions and agents, who rationally distort their efforts, typically leading to wasteful investment and low productivity. Put simply, the soft-budget constraint eliminates the need for sensible planning since mistakes are not

¹³ See Thomsen (1994) for a brief resume of the role of price system following Hayek. For an example of the socialistic vision of economic calculation, see Nemchinov (1964).

¹⁴ A good summary can be found in Ferejohn & Weingast (1997) with studies related to USA's federalism using the NIE's perspective of the "Market Preserving Federalism".

costly to the decision makers (...)" [MONTINOLA, G., QIAN, Y., & WEINGAST, B., 1994 : 5]

So, what is the importance of SBC (or, to be more correct, the non-SBC) to the institution of federalism as proposed by Weingast and associates? Considering several conditions¹⁵, the non-SBC is a main issue to make Federalism work, that is, to generate the right incentives to economic growth.

The main point about SBC is that, within the context of the study of federalism, it lays on the principle of lack of access to the option of redemption of irresponsible jurisdictions (states and localities). Adopting harder constraints means that all public goods and services supplied by the jurisdiction should be at least goods with concentrated costs¹⁶. Otherwise, the governments of the jurisdictions should allocate every resource in the production of their public goods and, such resources in turn, would or not be collected by the jurisdiction itself¹⁷, as long as its capacity to borrow is limited. According to McKinnon:

“(...) budget constraints on every government should be ‘virtually’ hard, i.e., its capacity to borrow directly - or indirectly through other governments - must be limited.”
[McKINNON, R., 1994 : 5]

Hillbrecht (1997) succinctly presents the measures proposed by McKinnon that budget constraints should be hard. The measures are basically: high rates of interest for the debts of the jurisdictions (this measure could be enforced as a punishment tool, and should go up in case the government in debt breaches the pre-established commitment), the existence of fiscal separation - it is worth mentioning revenue sharing constraint - the non-existence of intergovernmental transfers (matching and non-matching) and the probability of competition among local governments for production factors.

Thus, in this model of Federalism, there should be competition among every subnational government, according to the rules defined by the central government. These rules must be general, and arbitrary intervention should be reduced to the minimum, in such a way that subnational governments are compelled to follow them. Apart from this, the autonomy of the units to devise their own policies concerning their population and companies, added to SBC, will yield competitive policies, although these will be bonded to some sort of intertemporal fiscal equilibrium. As there is no financial assistance for subnational governments, “fiscal incentives” policies to attract investments cannot be drafted randomly, as long as one has in mind, within the bureaucrats’ universe of planning, a need to generate enough self-income to cover current deficit. Following the same line of the model offered by Tiebout (1956), subnational governments will not necessarily have the same levels of public supply once:

"The heterogeneous nature of public policy preferences allows jurisdictions with higher public expenditure and consequently higher tax collection to live alongside with others offering fewer public goods". [HILLBRECHT, R.O., 1997 : 56]

¹⁵ See, for example, Montinola, Qian & Weingast (1994).

¹⁶ Benefits could also be concentrated. However, this may not be the case for many public goods (take, for example, the case of local education that can form citizens of high human capital and who, if they have access to mobility and low transport costs, will be able to move into another jurisdiction). On the other hand, the non-diffusion of costs and financing of public goods and services will curb the over-provision of public goods.

¹⁷ A more extreme point of view, however can be found in Frey: "I would really like to emphasise the aspect that in a Federalist State the inferior levels must act as their own tax authority or the state is not a Federalist one". [FREY, 1995 : 2]

Therefore, federalism, as proposed by these authors, has the property of preference revelation from the *voting-with-the-feet* model, and two additional institutional conditions: the autonomy of each sub-government to enforce policies within their own jurisdictions, and the condition that such policies are subject to competition rules, that is, poor policies will not be compensated by any assistance of citizens from their jurisdictions. On the whole, the possibility of state governments being bailed out would be non-existent¹⁸.

It isn't the objective of this article, however, to discuss all aspects of Market Preserving Federalism. But it is important to note the richness of the NIE's analysis to understanding the problem of the economic development of a nation subject to a "federalism" designed to be an incentive, not a restraint.

But, is the SBC a good bridge between the two theoretical viewpoints?

Probably Kornai wasn't worried mainly with questions of History of Economic Thought. In this sense, some insights of Austrians - notably, in this case, Mises - was out of Kornai's scope of analysis.

Also, austrian economists probably would say that Kornai wasn't well informed about the differences of Austrians and NIE (or mainstream economics). One good point noted by Foss (1994) is that the the problem of agency theory isn't of the "adequate incentives", but one of the "discovery of incentives"¹⁹. That is, following the author, the problem is that someone has to be given the right incentives to discover how is the best action to do. In Kirzner's conceptual framework, we could say that SBC generates a problem to the perception of the public administrator because of the *alertness* that could exist - of course, in a distorted way - for him to suffer from the misperception of the real costs of the production of the governmental services that comes with the SBC.

In this sense, the lack of a hard budget constraint (or, similarly, the syndrome of SBC) can be understood as a distortion in the dynamic process of discovery that the competitive process of jurisdictions - in the case of federalism - could bring to the public manager. That is, it is not only the problem of SBC be a "wrong" incentive, but a more dangerous one, that SBC can misguide the discovery, by the public manager, of the most efficient way to allocate resources²⁰.

Someone could note, with reason, that the concept of distortion of SBC, in the applied example of Federalism, in Austrians perspective, could be named as a "second order one", because the public manager is, in one sense, a distortion in the well functioning of price system, even with we consider the existence of public goods²¹.

However, even considering the theoretical problem of Austrians with neoclassicism (or also with some branches of NIE), wich is related to the tension between free market and state intervention, studies on the origin and development of SBC in the constitution of modern states could be richer if the approach includes a deeper study about how SBC - and the institutional structure that originates it - can be a problem for the public managers in their search for an efficient alocation of resources. Even more, a rent-seeking approach could be thought as a necessary complement of this kind of study, in view of the relevant argument that if SBC is bad for the discovery process, why would someone, rationally, implement it?²² The answer to this question could not be given without a study of the institutions behind the economic system. Also, if someone

¹⁸ It is important to note that this "Market Preserving Federalism" is a kind of normative concept. It is a design of institutions theoretically built in order to promote private wealth without the incentive to the state predatory power.

¹⁹ A point originally due to Israel Kirzner, an Austrian economist of University of New York.

²⁰ See Kirzner (1994) for more details about *alertness* and *discovery*.

²¹ A good explanation of the Austrian view of public goods - the traditional argument for economic intervention - is in Hülsmann (1999). His point of view - and, perhaps, of the most Austrians - could be resumed in this: "Fundamentally, a good can possibly be a public good if it brings about desired or undesired effects on people different from its owner (externalities). Yet, these externalities are clearly not a feature of a good as such, but depend exclusively on the subjective feelings of those other people. Whenever any person other than the owner takes an interest in a good, it becomes *ipso facto* a public good". [Hülsmann, 1999 : 16]

²² One answer would be, obviously, the indifference of the voters. For critical arguments about this, see Caplan (1999a) and (1999b). Probably free-marketers would say that the existence of the State is a cause of this implementation in the sense that State IS a form of distortion in the economic system. But it isn't a very simple question and this answer will not be tried here despite of its obvious importance.

search the roots of the distortions caused by SBC in the natural search of efficient allocative results by public entrepreneurs, someone could use Austrian insights in a richer view of the political market²³.

The NIE approach has done well in explaining why would be good to not have SBC in a federalist system. Public Choicers have said a lot about rent-seeking²⁴. It would be better to have studies about SBC and its role as an obstacle for the discovery process that could enhance the provision of certain public services, despite the pro-free market view of Austrians, of course.

We think that this discussion is relevant in a world where new rules are introduced to the State, mainly with respect to budget balance and the privatization of state enterprises, like the Brazilian case. An approach of this kind certainly would include a more profound understanding of the political transaction costs in the political-economic system. Another great advantage of the dialog between NIE and Austrians would be to have a richer view of the market process and how could it help to modify the structure of the actual Brazilian state.

4. Conclusions

This paper has a hard objective. It intends to show that there is a bridge between Austrian Economics and NIE. In this sense, it tries to contribute to a discussion put by Boettke (1994)²⁵ when he wrote:

"The new political economy associated with scholars such as William Riker, Kenneth Shepsle, Robert Bates, Peter Ordeshook, Barry Weingast and others provides important insights into the nature of political processes and organizations. This school of thought however, is too closely wedded to the core assumptions which define the neoclassical paradigm for modelling human behavior. Basic results of this line of research (...) must be rethought under the alternative perspective of the Austrians". [BOETTKE, 1994 : 612-3]

The author of this paper think that NIE and Austrian Economics are only manifestation of the broad concept of "cattalatic". Economics is the study of human action and the incentives behind them. Also, not only the "rethinking NIE" in terms of Austrian economics is valid, but also the contrary.

The SBC concept can be thought as a bridge between the two sides of the debate. SBC is a concept that is originated in Austrian insights of Mises and has been developed by Kornai in what we called "the second generation of studies about socialism" and has been adopted by mainstream economics in studies related to Industrial Organization (see Maskin (1996)), Federalism and, of course, Comparative Economic Systems. In this sense, there are wide opportunities to cross fertilization of theoretical insights of both sides.

We aren't specialists in Austrian Economics, but we see with optimism insights of both views of economics that could, in the future, bring both nearer than nowadays.

²³ For example, someone could say that the dispersion of knowledge could be a good starting point in studying what could be the optimal size of the local governments. That is, the production of public goods - or its financing - could be understood as a dynamical process of discovery by competitive local governments. The existence of SBC, again, would have a negative normative role in it. See Foss (1998) for the original exposition of this argument in an Austrian perspective of the Theory of the Firm.

²⁴ And Rawski (1997) has tried to join these two aspects.

²⁵ But, see also Furubotn & Richter (1997) in their quotations to the importance to the NIE of studying the Austrian Theory of the Capital or about the relationship of Menger, Mises and Hayek with the old institutionalism.

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