

Defining Market and Socialism

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There is an argument that one cannot distinguish an economic system precisely, that there exists a continuum that expands from a pure free market to a completely planned economy, and encompasses many shades of a regulated economy and a series of market socialisms along the way. According to this view it could even be claimed it is not possible to define the boundaries of economic systems because the policies which create the continuum are various and can be combined in a myriad of ways.

The extreme position of this view would conclude then that there is little to be learned by looking at an economy that has some mish-mash of these disparate policies, neither for economic theory nor for policy analysis, as the confusing of so many divergent means (policies) will cloud the reason for the observed ends (outcomes of policy).

What this argument overlooks is that there is a unified economic phenomenon which these policies converge to create, both at the firm level and at the economy-wide level. These policies are established with a purpose and certain combinations of them together produce a distinct effect. There are critical points at which a combination of features - laws, regulations, institutions - which each affect one or another economic factor together produce an emergent economic phenomenon.

There are two distinct critical points at which there can be perceived a shift in an economic system. One is at the firm level and the other is at the economy-wide level. The former must precede the latter. Both critical point are defined as the point when policies converge to ensure that the necessary conditions for a market to function with respect to this entity are no longer in place. So, for the firm the critical point is when the necessary conditions for the firm to act as a firm is expected to act in the market are not available; for the whole economy it is when the necessary conditions for the whole economy to function as a market economy no longer exist. Once the latter emerges in an economy viewed on this spectrum, it must be considered a socialist economy. This is a defining factor of the economic system, as will be shown.

At the firm level in a market economy there is indeed a continuum of government intervention. Some relief is provided by government, for example bankruptcy laws, low interest loans, even subsidies for failing firms. However, there is a break when a firm (or individual) actually faces a soft budget constraint¹. Kornai describes what is meant by a soft budget constraint and defines clearly the policy requirements that combine to produce this state.

This is the critical point where the firm (or individual) goes from more or less profit maximizing behavior due to necessity, to behavior inconsistent with the desire to stay profitable. At this

¹ See Kornai, Economics of Shortage, 1980

point the firm or individual does not act in a manner that takes profitability into account and instead bases his decisions on other factors such as leisure, pride and convenience. This is the critical point which determines whether profits are a primary factor to consider or are irrelevant. The behavior of the firm changes because the necessary conditions for the firm to behave as a profit maximizing firm in a market economy are no longer in place. Individual firms may continue to act as if they are profit maximizers even with a soft constraint, but the structure of incentives are such that it is no longer necessary to do so.

The same is true at the economy level. There is a critical point when the economy as a whole is determined by the critical mass of firms which have a soft budget constraint. At this critical point, the economy becomes a socialist economy. There may exist a market economy which contains individual sectors with firms that face a soft budget constraint - nationalized industries, government owned firms, etc. However, in an economy with many firms facing such a soft budget there will be a critical point where so many firms act contrary to market behavioral assumptions that the entire economy experiences a shift.

At this critical point the firms which are not reacting behaviorally to the soft constraint, firms that would like to profit maximize for non-market reasons or incentives, are no longer able to because prices no longer carry the necessary information. This critical point is reached because firms facing a soft budget constraint no longer consistently minimize costs (necessary for competition in input markets and price signaling there) nor do they engage in price competition as profit maximizing firms do (distorting prices in their own sector) and neither do they innovate and take risks and engage in other market activities which help to discover demand, encourage supply to respond to it and thereby bring prices into equilibrium.

When enough firms modify their behavior, prices lose their significance. The remaining firms are then unable to profit maximize because the prices that they must use to do so - for example to calculate their costs - are no longer reflective of actual market conditions. The distorted prices spiral out of control - or snowball - as they are passed around the economy, input into calculations through transactions between suppliers and producers of consumption products, employers and workers, consumers and producers or banks, etc. As each slightly distorted price (for example an input that would not be purchased except that cost was not a consideration for the firms which bought it) is then used to calculate another price (the product that the firm is selling is raised to cover the cost of the input) the effect is magnified.

Note that this critical point can be reached without actual price setting by any central authority - all that it requires is a soft budget constraint for a critical mass of firms. However, when a soft constraint is imposed on most firms in the economy, it will likely come with some explicit price setting - which immediately escalates the distortion - probably exponentially. Rather than the above inflationary effect which at the beginning might just dull the distinction between the quality of products and hide some shifts in supply and demand, price setting results in prices which are actually arbitrary and reflect nothing of supply conditions or of demand.

The authority which saved the failing firm (as per the soft budget constraint) has now chosen as a way of helping it not just subsidies but a price which will help the firm to succeed. This implies that the price which was discovered in the (already distorted) market was not sufficient. By

definition this means that the new price is not reflective of actual prevailing conditions. This price is only reflective of some political decision or preference of the planning authority. Now use of this price in calculation will lead even more quickly to an economy-wide problem of calculation due to non-substantive prices. At the critical point no price can be trusted.

When the critical point is reached some prices may seem to be reflective of some conditions - within the relevant sector for example - but even those may carry some false information based on a single distorted price for some input. All prices are ultimately affected and hence all firms are affected. Thus, no firm is able to profit maximize because they cannot calculate using prices which are not reflective of realities of supply, demand and input costs. This is therefore the turning point whereby the economy becomes a socialist economic system.

This is the unified economic phenomenon which defines the boundary of the socialist economic system. It is not based on disparate policies which can be combined variously and which provide for a continuum of undefinable economic states - a clearly defined set of factors produces a soft budget for firms and when a critical point is reached to a boundary point where the economic system of the market is replaced by the economic system of socialism.