Open-End Budgeting

Through Suppressed Inflation

By P. CRAIG ROBERTS

In a modern industrial economy there are so many factors of production and so many possible combinations of them to produce so many possible products that it is administratively impossible for any man or group of men to decide centrally how to allocate the resources to the best possible uses. Furthermore, it is highly unlikely there would be any agreement as to the best possible allocation. Therefore, the market is used in which resources are allocated to where they earn the highest return. This is the only signal there is of their productivity and of their most important use and the only standard by which to judge if they are being used efficiently.1 Of course, this is not true if

1 The Soviet Union and the communist governments of Eastern Europe have learned this from practical experience over the same time period that their theoretical economists rediscovered economic theory. On this greatly significant latter fact see Robert W. Campbell, Marx, Kautsky, and Newkirk: Stalinism versus Reality,” Marxist Review, October, 1941, pp. 402-418.

Professor Alex. Novy has pointed out for some time the inconsistency between the assertion that prices play no allocative role in the Soviet Union and the alteration of prices because it is desired through this means to affect resource allocation. The trouble with Soviet prices, according to Professor Novy, is that they do not reflect or measure relative needs, structures or productivities and thereby these results in a grossly inefficient allocation. Such a situation is most amusing. The “planned economies” cannot operate without money or prices. Yet they cannot allow price movements to reflect actual productivities and productivities since this would completely expose the ideologically necessary patterns of central economic planning. Professor Novy, perception as he is relative to many other students of Soviet economic processes, does not see the important meaning here. Novy is more interested to point out that due to monopoly points and administered prices, western market prices are not so efficient themselves. This only

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sheds, however, that market economies in the general sense are characterized by the use of money and prices to allocate goods and resources and not by the relative degrees of their efficiency in reflecting scarcity and productivities. The original notion of central economic planning which led the Socialist Debate and the Russian Revolution required the complete absence of money and prices. The distinguished sociological and philosophical geniuses, Michael Polanyi, has pointed out in vain for decades to economists and scholars that Soviet “planning” works only by resisting almost every essential feature of private capitalism—the very features like profits, price work, inequality of wages, and production for a market, which had been the reasons for the overthrow of private capitalism.” (Time and Tide, April 6, 1946, p. 317.)

The vast hierarchical planning bureaucracy in the Soviet Union serves primarily to prepare detailed economic forecasts and not actual plans. The fact that “plans” are changed day by day, week by week, month by month, demonstrates as clearly as should be necessary that the initial forecast or “published Plan” exercises no meaningful control over economic processes. The limited historical perspective of present-day authorities on the Soviet Union will eventually serve to discredit them as experts. In fairness, however, it can be admitted that vast follies are difficult to recognize and more difficult to account for.
has been mobilized for full-scale war for any length of time. The mobilizations of both world wars were short-run projects. If such mobilization was to continue for a decade or two and if there was near-normal technological change during that time, it would be safe to say that the centrally administered productive relations would bear no meaningful relationships to one another.

THE MARKET is a polycentric administrative system; its efficiency depends upon the degree to which prices and profits—the signals upon which the administrative process rules—reflect relative scarcities and productivities. The static theoretical model of pure competition was developed in this century and was until recently generally accepted as an ideal standard by which to judge allocative efficiency. This model has withstood (whether for justified or unjustified reasons) many kinds of assaults. More recently, however, some economists have followed in the steps of earlier non-economist socialists and have attacked the model for not explaining either the allocation of public goods or the correct allocation of resources between private and public sectors, and it has been held responsible for not pricing or costing either the bad behavior of individuals who pollute water resources or the pleasure one gets from viewing a rose garden for which someone else paid the cost. This is misguided criticism since the model was never meant to explain either the allocation of public goods or the correct allocation between public and private sectors, nor was it meant to explain the use of resources which have no market price or prevent us from freely looking at our neighbors’ rose gardens. The criticism actually only points out the failure of economists to devise such a theory. The result, however, of this criticism of the market for failing to embrace enough of our life (criticism often supplied by the same critics who otherwise criticize the market for embracing too much of our life) have been the artificial extension of the market (both in the stand-

...and theory of public finance and in actual policy) to force it through the government budget to create art and adjust social costs. Moreover, there has been an even more significant confusion resulting from illegitimate criticism. The intellectual concept of the Economic Man did not serve to discredit an insufficient theory, but to discredit reality in two ways. Accepting the theory as an adequate reflection of men’s aspirations and motivations, Western culture was criticized for reflecting the theory and being characterized by selfish individualism. Accepting the theory as an ideal standard by which to judge allocative efficiency, actual market economies have been criticized for not reflecting the theory. A theory which was never meant to be more than an illustrative metaphor to shed light on the kind of coordination achieved in the economic use of resources in a market economy, a theory which made “ideal” assumptions in order to better illustrate this coordination and to do so in a rigorous way, has unleashed all sorts of moral and social revulsion against reality—revulsion which these days often misapplies to scientific clothing. This is a complex story and one which is embarrassing to the scientists in the economic profession. Only one aspect of the story has direct interest for the discussion of economic policy to be offered hereon. The wrath expected against the comparative ineffectiveness of real-world administered prices and monopolistic profits has apparently led some people to regard these signs as operationally worthless, and the discussion over the actual efficiency of the price system has tended to side-track realization that the polycentric movements of these signals have continued to result in technological change and economic growth.

A second factor which has tended to obscure the importance of polycentric price and profit movements in generating economic growth stems from the Keynesian formulation of the ancient realization that such movements did not produce growth if there was a dearth of money. The powerful focus on total effective demand has apparently led some economists to believe that increasing total spending is sufficient in itself to produce economic growth. The validity of this belief depends upon how economic growth is defined and upon the length of the time period over which growth is to be attained.
If growth is defined in terms of taking up slack in existing capacity, the policy is sufficient in itself. If productivities remain constant and technology does not change, the policy is sufficient in itself. Likewise, over an intermediate time period, which would have to be defined relatively in terms of the inherited and inherent strengths and productivities of a society, growth can be produced by inflationary validation of a disorganized price system. However, though this is not a popular area of discussion, the long-run result of such a policy should be apparent to any economist.

A third factor which has not led to keeping in the forefront the importance of polycentric price and profit movements in producing economic growth stems from the fact that economists have given most of its efforts to studying the allocative function of price and profit movements within theoretical models (built upon the assumption of fixed resources and technology) in the welfare terms of maximizing the allocation of, and production from, given resources. However, in the dynamic context of economic growth, fixed resources are not a meaningful or governing consideration. In the context of growth the meaning of full employment is obtained. It only has meaning in terms of relative optimists at successive points in time, since at any time more resources exist than can be employed if only because they will not be discovered until tomorrow. In the United States there are more physical resources than any yet possible level of employment of the present population can bring into the economy. (To state this fact is not to argue that it is in our interest to bring these resources into the economy. However, for the present discussion we are going along with the dominant emphasis on economic growth.) There are many vacant locations available for brick plants and many pits of clay which are not dug. Yet pressure of real demand for bricks on the existing capacity of brick plants would lead to the construction of new capacity, the exploitation of previously unused clay deposits, and to real growth in the economy. The rise in prices in order that temporarily fixed brick supplies or maximum rates of supply might be maximally allocated is not inflation. For industries operating at or near full capacity, not only do their costs go up, and not only are price rises necessary to allocate temporarily fixed resources to their most productive use, but, more importantly, price rises which result in increased profits are the necessary signals to expand capacity; the increased profits may supply the investment funds for the capacity expansion, and, regardless, the excess profits are temporary—even under conditions of oligopoly, quite possibly the capacity expansion results in lower real prices, and it certainly results in real growth. If labor is the factor against which real demand is pressing, the result is technological development which also leads to real growth.

Thus, the most important allocative function of polycentric price and profit movements is to produce economic growth based on the interplay of relative productivities and individuals tastes and preferences. The fact that economists have not been able to construct successfully such a dynamic model is not sufficient justification for neglecting in policy this allocative importance.

The macro-economic models have neglected resource allocation altogether, even to the extent that many textbooks have reduced price analysis to a bag of tricks. Also as a result of the aggregate economic models, economic policy makers have apparently gotten into a habit of thinking of the entire economy as being a neat, objective, rational, and equilibrating system. A system which obeys the same laws at any point in time, which operates at equilibrium levels, if at all, would be an economy which is not part of a growing economy. The instant reality is that the boundaries of most economic models are close to the reality of the growing economy. The instant reality is that an allocation problem which involves the determination of how much of a commodity is to be produced is a real problem at any point in time. The instant reality is that the allocation problem is never solved in the past; the allocation problem is the problem of the future, of the growing economy, of the growing system. The instant reality is that economists have not been able to construct successfully such a dynamic model.
economy in terms of a time period, usually annual, as if somehow all firms, industries, and sectors were moving along at the same pace, step by step, in unison. This, of course, does not happen, and this simple fact has at least as much implication for actual policy as do the conclusions of theoretical aggregate models.

The pressure of real growth on capacity does not manifest itself ubiquitously. Generally all sectors will not be experiencing this pressure to the same degree at the same time. Likewise, generally neither all industries within a sector nor all firms within an industry will simultaneously feel the pressure of real growth. We know this from economic history, which, quite irrespective of theories of balanced growth, shows imbalance. Therefore, while one firm, industry, sector, or several firms in various industries, or several industries in various sectors may be characterized as follows, the entire economy will not be.

Let us take a firm, industry, or sector for the short-run period during which capacity is fixed. (See diagram below) The supply curve indicates various possible rates of supply between a minimum and a maximum for that capacity. As real demand increases, so will the rates of supply and price. Such price rises, of course, are not inflation.

However, the rate of increase in real demand may outstrip possible rates of output, and the consequent inelastic supply will result in pure price rises. We know such price rises have an allocative function. If we assume the supply is of a resource input, we know it will tend to go where its marginal productivity is highest.

Yet the shaded area does represent considerable pure excess profit, and irrespective of whether the error is made of calling the price rise that produces it inflation, it is tempting to call it "profiteering" or, more mildly, monopson behavior. Therefore, a policy might be made of fixing (formally or informally) the price at P1, consciously or subconsciously giving up welfare maximization via allocative efficiency. After all, the economy is not really so efficient anyway, and welfare -- well, what is that?

Perhaps such a policy would actually stop inflation, but it would have to be "cost-push inflation", since price controls only suppress "demand-pull inflation." Of course this might be a rather inequitable way of stopping "cost-push inflation" since these days business prices are usually a step behind labor prices, but business prices can be informally fixed (which saves a lot of administrative trouble) via anti-trust threats (from which labor monopolies enjoy exemption). If the policy is to be equitable the price fixing will have to go further and establish some relationship between unit cost and price, and the administrative requirements of this task would require that productive relations or production functions be fixed as well as prices; thus, technological change would occur less autonomously and thereby probably less swiftly. But what is equity, and who is interested in that kind anyway?

The policy would stop something else also. It would stop (perhaps it would just delay -- but such a delay is like a recession in terms of the unproduced goods lost forever) the supply curve from shifting to S2 by suppressing the natural and necessary signal for capacity expansion. But why did not the firm, industry, sector anticipate the rate of
increase in real demand? Why did it wait until demand was at \( D_s \) or even at \( D_s \), before undertaking capacity expansion? If it was really hot growth industry it might not have waited, but are growth industries usually characterized by capacity outpacing demand?

Perhaps the firm simply felt uneasy in a situation of uncertainty (due to the absence of foresight of the actual future), and wanted to be sure. Is this unjustifiable? Or perhaps it needed the pure excess profits in order to bid the capital necessary for expansion away from other areas in the economy or just to pay for it at constant or falling cost. Whatever its temporary sins, there would be repentance in the long run due to lower real price and a relative maximization of welfare in the sense that we used to understand.

**What, however**, if at the same time there is pressure of real demand on expanded capacity, there is concurrently government deficit spending, which at levels of full or near full employment, quite irrespective of whether there has been an excessive commercial expansion of money and credit, injects excess monetary demand into the economy? Then the whole economy would be into the third segment of the familiar curve. The general price level is rising more rapidly than real output.

In such a situation the only cause of real inflation is the excess monetary demand furnished by the government's deficit finance. Thus, it is a simple matter to eliminate the cause of inflation by eliminating the deficit spending, or by cutting it to very low levels which serve to maintain the pressure of just a little excess monetary demand on capacity as an inducement to continual real growth. In some situations this inducement might be better maintained by monetary policy, since fiscal policy leaves even less room for finesse, especially a fiscal policy of continual shifting of tax rates. (But perhaps the ultimate motivation is really non-economic.) However, rather than eliminate or adjust the cause of inflation there seems to be a preference for adjusting the economy to the cause of inflation by price control. What are some possible causes for the emergence of the partly conscious, partly unconscious cultivation of a public policy of suppressed inflation?

Firstly, there are some men who are intellectually influential and some who are practically influential and some who are influential in both areas who, to a significant degree, veer to the left. Such men might, for instance, simply prefer more welfare or welfare increasing at a faster rate plus inflation to less welfare or welfare increasing at a slower rate and no inflation. Since due to the present attitudes of the public rapidly expanding welfare programs cannot be financed solely out of taxation, they must be partly financed by deficit spending, that is, by inflation which expropriates real income primarily from those in the weakest economic position with respect to a rising level of prices. Such an indirect procedure is both less noticed by commentators and falls on those who are least able to organize effective political opposition. The fact that the price is paid to a large degree by those whom the programs are said to be designed to aid gives a convenient Orwellian obfuscity to the re-
ality of the situation. In effect, the programs are primarily designed to serve an ideology and not a people. Secondly, irrespective of any ideological satisfaction, the government finds the welfare programs politically advantageous and will finance them anyway it can. Thirdly, there is the doctrine of functional finance, which, following the usual theory, policy time lags that cause the government to result in out-of-date policies, is now with us as old, new orthodoxy, and whose meaning read from the empirical evidence is that deficits in any economic situation are of no harmful consequence. Thus, the old ideas of the "new economics" contribute to this model of a mutually sustaining confidence. As the eminent philosopher-scientist Michael Oakeshott has pointed out, all demagoguery must have a scientific basis; otherwise it is recognized as folly. Fourthly, the policy is necessary as a counter-balancing remedy to the Keynesian inflationary remedy for discoordination in the price system.

If there is a concurrent deficit-financed excess demand inflation and the pressure of real demand on capacity, how can we be told which price rises (or what percentage of any given price rise) are the result of excess monetary demand and would only lead to open inflation if not suppressed, and which price rises are the result of the pressure of real demand on capacity and are necessary signals for real growth? In most instances it would not be possible to differentiate. Thus, the logical result of the logical application of a policy of cultivating suppressed inflation is a welfare loss from misallocation plus a forced stagnation of productive capacity. In order for such a policy not to result in stagnation, it would be required that the Russian technique of ordering yearly or quarterly percentage increases in all production across the board be adopted. But this results largely in anti-economy growth in the production of firms and sectors which bear no meaningful relationship to one another (and which gives us all sorts of welfare problems). It is hard to find a basis from which to recommend such a way of running an economy, particularly since the Russians themselves are abandoning it.

But perhaps functional finance is not a long-run prospect. It might have only a passing function. If everyone gets worried about inflation, we can in this instance raise taxes to cure it and let people get used to the idea of tax changes for the maintenance of stability. This way we can usurp the traditional role of monetary policy in checking inflation and move into a counter-cyclical tax policy.

Why do this? Is the profession agreed as to its superior merits? It is the last fascination of the "New Economics," and politically it gives an open end to the federal budget.

The ideologies see no limit to their welfare aspirations. The social engineers who have no reliably definable ideology, but are simply fascinated with the experimentation which new welfare concepts and modern political power open to them, see no limits to their time. The entrenched party becomes permanently entrenched. The Congress is relieved of having the burden of any responsibility for whatever the actual "budget" turns out to be (Congressmen then being more disposed of minor factors, heads of government agencies having the propaganda of dispensing the major ones). The budget is left to the executive, the ideologues, the social engineers, and "scientific economics."

Now we can really increase growth since income can now really be redistributed to increase effective demand, the "new economists" never having paid enough attention to economy. History to know that increasing current consumption, quite irrespective of the Keynesian model, is usually at the expense, and not benefit, of future production.

Well, anyhow we are so rich we do not need an more production of market goods--utility and other disgusting indulgences. We shall use the situation to have more public goods. But why is the government's ability to spend more important than that of the rest of the economy? Because it is spending for all the people. But all the people together would have been spending for all the people together want and they know what they want better than the government does. Yet, all the people together would have been spending for it. The government is spending for all the people.