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ECONOMIC PLANNING IN MARKET ECONOMIES: SCOPE, INSTRUMENTS, INSTITUTIONS

by

Domenico Mario Nuti

BADIA FIESOLANA, SAN DOMENICO DI FIESOLE

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ECONOMIC PLANNING IN MARKET ECONOMIES: SCOPE, INSTRUMENTS, INSTITUTIONS

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European University Institute,
Florence.

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1. Scope

The appropriate balance between "plan" and "market" has been debated ad nauseam in relation to the USSR, Eastern Europe and China, while for capitalism it is the only question still debated today when capitalist planning is discussed at all. Yet the answer to this question is relatively easy.

The experience of Soviet-type economies shows that the most determined attempts at centralised control of the whole economy through direct command and detailed physical allocation lead to elemental spontaneous processes which can be no less anarchic than those of pure capitalism. Instead of establishing social control over accumulation, Soviet-type economic and political centralisation leads to an over-accumulation bias, which at first yields fast growth but then persists well past the exhaustion of labour reserves and causes falling utilisation of plant and excess demand for labour and intermediate inputs. Systemic commitment to price stability prevents excess demand for labour and goods being translated into higher (or high enough) prices; shortages and queues ensue, disrupting the supply system and aggravating the built-in microeconomic inefficiency of the centralised system; cycles appear, as retrenchment from over-accumulation is forced upon central powers by domestic and external constraints, or as popular dissatis-

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faction with economic performance is dealt with by alternate bouts of liberalisation or further centralisation. It is clear that economic planning should go no further than major macroeconomic variables while markets should be allowed to determine detailed output structure and relative prices by the actions of competing firms unencumbered by central controls, while taxes and subsidies can be used to convey to firms public choices about environmental protection, desirable patterns of income distribution and any other relevant factor neglected by markets.

At the same time the experience of capitalist economies has shown that the sphere of markets should go no further than output proportions and relative prices (with the same provisions for public preferences), while only economic planning might control major economic variables, to prevent some or all of the macroeconomic evils: unemployment, stagflation, inflation and external imbalance on a large scale. In the macroeconomic sphere markets can make any kind of expectations come true if widely held, or they can act perversely (e.g. lower wages possibly lowering the level of labour employment through adverse feedback on demand), or "turbulently" (as officially recognised by British government circles when sterling recently plunged to dollar parity). Even when they do work, markets often are much too slow or incur economic and social costs which cannot be tolerated. Increased reliance on markets is a poor response to macroeconomic imbalances.

The lesson of Soviet-type and British-type economies, therefore, is that economic planning should cover no more and no less than macro-variables such as employment, aggregate income, investment share and its broad allocation, public consumption and criteria of income distribution, the balance of international payments flows for trade and capital; while markets should cover no more and no less than the structure of output (by sectors and enterprises) and relative prices; with policy instruments, instead of direct orders, being used to make markets fit with the plans. This view is firmly rooted in the socialist tradition, from Dobb to Nove, and the controversies from "right" and "left" seeking to stretch the scope respectively of market and plan beyond these limits can now be regarded as settled, in view of the recent spectacular failures of both Soviet-type overstretched planning and British-type overstretched markets. Macroplanning with micromarkets is the current model

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of the Hungarian economy, which has so distanced itself from the Soviet model as to request, in recent negotiations with the EC (though now stalled) the incorporation in a treaty of the statement that Hungary now has a market economy, satisfying the requirements of GATT. It is also the model towards which China and Poland are striving and, at least in the view of Gorbachev's boldest interpreters, so is the Soviet Union. With the addition of workers' self- management and group ownership, it is also Yugoslavia's basic model.

Once we have settled the question of the appropriate scope of market and plan, however, we are not much wiser as to what we should actually do. This type of macroeconomic planning is indistinguishable from ordinary public policy, of the kind theorised for instance by Tinbergen and Johanssen: the government "objective function" is maximised for levels of desirable targets obtained by means of policy instruments (fiscal and monetary policy, public enterprises, direct controls), up to the point where the trade-offs between targets in the government preferences are the same as, or closest to, the trade-offs obtainable through alternative policy-mixes. If this is not how it is, it is how it should be. What is the difference, then, between this and, say, Nove's "feasible socialism"? How could the failures of public policy in economies intermediate between the Soviet and British types, which are no less conspicuous than the failures of central plans and competitive markets, be suddenly avoided just by sticking the label "planning" or "socialist planning" on public policy?

It can be argued that the difference between traditional public policy and economic planning is one of degree, and that quantitative difference makes for qualitative change in both character and performance. Economic planning, especially socialist planning, will have a longer time horizon, a different ranking of targets and of the relative degree of their fulfilment (for instance, it will attach greater importance to employment than to price stability), will employ policy instruments to a greater extent than the ordinary public policy of a non-socialist government, as well as use a model of the functioning of the economy with features borrowed if not from Marx, Kalecki and Keynes at least from Pigou, Malinvaud and Drèze, instead of Friedman, Lucas and Sargent. This is a plausible view and certainly there is, to say the least, much room for improvement in public policy management

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everywhere. But there is not yet a significant success story, let alone a consistent success record, for this kind of planning either East or West. By and large, the macro problems of unemployment, stagnation, inflation and external imbalance have persistently proven to be almost intractable, targets being either conflicting or otherwise beyond the reach of policy instruments within the accepted range. From the evidence so far available we must conclude that, unless something new happens in the world, or is brought into the theoretical picture, economic planning as "active" public policy cannot be expected to perform the miracles that "less-active" public policy does not perform, that "feasible socialism" à la Nove has already come and gone, and there is not much hope for the future of socialism as economic performer. At times of tranquillity there would seem to be not much to choose between markets and plans because they both work, whereas at difficult times we can only trade-off the drawbacks of plans with the drawbacks of markets, also with little to choose between them.

So, a more positive and optimistic outlook requires the introduction of new policy instruments and new institutions to match the ambitions of economic planning and of socialist values. It is true that in the last twenty five years a fair amount of institutional innovation has taken place in both major systems. In capitalist countries this has taken the guise of indicative planning of the French type, neocorporatist social pacts and modifications of the work contract. In socialist countries parallel innovation - apart from the reform moves to drive their economies away from the command model - consists of Yugoslav type self-management, GDR-type vertically integrated firms, and performance-related compensation schemes. All these developments fall outside the range of conventional public policy instruments, except as part of the catch-all category of "qualitative" instruments, and are aimed at attacking the intractability of macroeconomic problems. All these new institutions are perfectly harmless; unfortunately, they are also not very effective.

Indicative planning was supposed to provide a transparent, consistent and consensual picture of future developments, to which all would conform out of self-interest; but the participants in this exercise often cheated; even when they did not cheat, their views about the future could not be well

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summarized by single-valued and firm expectations, and even if they all agreed on a possible and desirable scenario they could not agree on their own individual part in it; planning contracts were never real contracts; stabilisation plans, i.e. ordinary public policy measures, took over from indicative planning, followed by even more conventional drastic austerity measures. Neocorporatist pacts were short on implementation and turned into unilateral gifts by the workers. Proposed and implemented changes in the work contract range from the introduction of wage indexation at times of accelerating inflation to its abolition when inflation decelerates, from synchronised collective bargaining to tax-based wages policy, from work-sharing (i.e. the collectivisation of unemployment) to Weitzman's proposal for replacing wages by a variable share in the revenue of their enterprise. All these labour contract modifications amount to devices to hold down real earnings without being seen to do so; as workers can only be cheated once, all the time imaginative new tricks have to be invented to keep wages low.

On the socialist side, Yugoslav-type self-management seems more the result of (and dominated by) group ownership, a form of property which has no known justification, than a direct attempt at workers' participation in decision-making. There is no doubt that self-management can make a very valuable contribution to the planning environment through greater economic democracy and can be a tangible counterpart of economic concessions in a social pact; it is still an open question, however, whether self-management can have a positive direct impact on economic performance. Vertical integration of GDR firms has reduced the informational and organisational problems of its centrally planned economy to the size of a sector but has no particular virtue in the Hungarian-style economy; moreover, the flexibility exhibited by the GDR economy is more likely to come from the umbilical cord linking it to the FRG rather than from its vertical industrial structure. Performance-linked formulas for the determination of earnings bestow rewards or punishments mostly on workers who have not had any responsibility and therefore deserve neither.

Newer policy instruments and newer economic institutions than these will have to be devised to support the high ambitions of socialist planning (the discussion of necessary <u>political</u> preconditions for planning - East or West -

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goes beyond the scope of this paper). The suggestions and reflections that follow are tentative and incomplete thoughts, put forward in the brainstorming spirit of the Cambridge Conference.

2. New instruments

The intractability of macroeconomic problems such as unemployment, inflation, foreign payments deficits, is due primarily to the pervasive presence of a network of conflicts between different persons, classes and groups (or even between coexisting roles of the same persons, classes and groups). These conflicts have three frequent characteristics:

i) the dispersion, variability of roles and anonimity of the large number of agents involved in the conflict (e.g. I would sacrifice some of my wage if, as a result, fewer people were unemployed but only if a number of other people did too; nobody is signalling this intention and neither do I; even if all of us like-minded people got together we would have to find a number of willing firms and negotiate with them the terms on which our wage sacrifice is transformed into higher employment; too many agents are involved).

ii) the intertemporal nature of most conflicts, which introduces the possibility that the best resolution of a conflict might involve a sequential and therefore uncertain settlement of conflicting interests, which is not implemented because of that uncertainty. (Those of us willing to sacrifice our wage levels to reduce unemployment have got together and negotiated mutually acceptable terms with a number of firms; but since we are sacrificing our wage now and the increase in employment will come some time later, and the delivery of later larger employment is uncertain, in the circumstances we will not sacrifice our wage levels).

iii) the actual pay-offs of alternative strategies encourage a non-cooperative stance by partners in conflict (e.g. it is in the interest of firms not to employ in the future people they would not otherwise wish to employ, whether or not I and my well-meaning friends have sacrificed current wages for that purpose).

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Neither markets nor plans are good at resolving these conflicts, familiar from literature on prisoners' dilemmas, isolation paradoxes, moral hazard, etc. In order to resolve these conflicts, markets would need multilateral, intertemporal, contingent contracts, of a kind and on a scale that has proven - so far - uneconomic or inconvenient to stipulate, let alone enforce. Planners cannot resolve these conflicts either because policy instruments affect mostly the present, unconditionally with respect to possible settlements of conflicting interests between a large number of parties.

It is conceivable, however, that a new class of policy instruments be used by planners: namely, future contingent instruments (FCIs), i.e. legally binding unilateral commitments, on the part of the government, to adopt at a future given date or dates a given instrument of economic policy (say, a tax or a subsidy), and/or given parameter or parameters for that instrument (or package of instruments), conditional on a given state of the economy (say, a given level of employment, or the growth rate of income); such commitments would be irrevocable within a specified period of time, with a guarantee that they would not be nullified by subsequent offsetting measures within the time specified. Within this time limit such commitments could be binding for successive governments, just as any government is already bound, for instance, by the national or international debt incurred by its precedessors.

At present there is only one rudimentary instrument of this kind, namely indexation (for instance, of governments loans, or wages in the public sector, or tax thresholds) with respect to the price level. This is equivalent to the choice of a numeraire different from money, whereas the proposed range of FCIs could be linked to any index of macroeconomic performance.

The advantages of the proposed instruments are:

i) the replacement of uncertain expectations about government future intentions, which often nullify the effectiveness of current measures, by firm beliefs (as firm as beliefs in the state can be, at any rate, when its commitments are backed by the judiciary and are no longer changeable at the whims of the executive);

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ii) the possibility of adopting not just a present policy stance but a firm time pattern of policy measures, designing a path towards a configuration of macro-variables by the government. The path need not be inflexible, for alternative courses can be announced, contingent on the value taken by exogenous as well as endogenous variables.

iii) the provision by the government of a guarantee of last resort in the case of social pacts containing conditions about the value of macroeconomic variables, with a preannounced set of measures designed to reward adherence to such pacts.

Let us suppose, for instance, that the government wishes to raise investment and employment, while workers would be willing to sacrifice wages but are distrustful of the uses to which their forsaken wages will be put by their employers. The government can guarantee this kind of pact by effectively indexing, through tax concessions, the lower level of wages to the rate of unemployment, simultaneously announcing that in a given number of months (equal to the expected average lag between investment outlay and employment) a capital tax will be levied also geared to the future unemployment rate unless this is on a preannounced target consistent with the reinvestment of the wage cuts. (A similar proposal put forward in 1983 by Fitoussi and Nuti in Italy raised interest in Trade Union circles). Alternatively, the government could announce that next year in the event of unemployment reaching a critical level it would immediately step in with a given large-scale public works programme; this might by itself restore investors' confidence and lead to an improvement that might make that intervention unnecessary; this is not just an ordinary announcement effect, since it is reinforced by the envisaged binding nature of government commitments.

It might be interesting to compare this type of policy instrument with the apparently similar framework of Debreu's general equilibrium model with intertemporal and contingent markets. Debreu-type contracts are private, bi- or multilateral and contingent on a state of the world (i.e. they are devised to eliminate not market uncertainty but environmental uncertainty) whereas FCIs are public, unilateral intertemporal promises, contingent precisely on macroeconomic features of market uncertainty.

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Unilateral commitments, like unilateral disarmament, make cooperative strategies much more attractive if they can be made contingent on concomitant commitments by other conflictual partners as well as on external events, with a strong guarantee that the contingency clause will be respected if the contingent event is lagged. Thus, for instance, the classic prisoner's dilemma would be satisfactorily resolved if the validity of a prisoner's confession could be made conditional on a similar confession by the other prisoner.

In international relations we could imagine a country unilaterally committing itself to freer trade conditionally on acceptance, by its trading partners who take advantage of its new liberalism, of stiff protectionist measures if payments flows are seriously disrupted. If this type of commitment spread the chance of concerted reflation would greatly improve.

Because of their unilateral nature, such commitments do not require the prior agreement of a large number of potential contractual partners, yet the spreading of such types of commitments can facilitate the stipulation of a multilateral pact with private as well as public parties. For instance, the declaration by a city that the territory within its limits is a nuclear-free zone - such as is sometimes made - is an irrelevant moral stance of no consequence; but, if a city makes a unilateral commitment to make its territory a nuclear-free zone conditionally on a city of proportional size in the potential enemy country also being made a nuclear-free zone and a number of cities in both countries make this conditional unilateral commitment in pairs, bilateral disarmament will be all that much nearer. By the same process, conflictual parties (private as well as public) could make progress towards a pact even if the object of the contract (as in the example of peace) is indivisible; while if the object is divisible the reciprocal acceptance of conditional unilateral commitments will fulfil the contingent condition and lead to immediate improvement.

It would be naive to expect miracles from this range of policy instruments, though clearly they avoid the limitations of more conventional instruments in dealing with multi-party, intertemporal and contingent conflicts. New institutions will also be needed, in the strict sense of public

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agencies with separate legal personality undertaking policy tasks different from the production of ordinary goods and services.

3. New institutions

The main problem areas in the macroeconomic performance of market economies are unemployment, low income growth and external payments deficits. (Inflation is not half as bad as is widely believed and, in any case, if the other three problems are reduced it should be possible to control inflation through incomes policy and FCIs, if monetary policy does not suffice). New institutions (i.e. public agencies) are therefore needed to deal with employment, investment and international trade. Let us imagine that three new public bodies are set up: the National Employment Corporation, the National Investment Corporation and the International Trade Corporation. What features must they have to contribute significantly to employment, growth and external balance?

First of all they would have to operate through the market, i.e. buying and selling and renting and letting and lending and borrowing, instead of issuing prohibitions and commands; otherwise the well-known drawbacks of the Soviet-type model would rear up. It follows that they should not have the structure of Ministries, they should have a profit and loss account (though they may receive grants from the state budget), and they should not have the monopoly of whatever they do (which would interfere with the efficiency of markets and also reintroduce the drawbacks of centralised planning).

Second, they should act directly on the level of employment, investment and trade, because their existence is justified solely by the inadequacy of indirect instruments of intervention.

Third, they should not involve an open-ended commitment (such as that incurred by health services in modern welfare states) and their responsibility should be, respectively, that of maximising additional employment, investment

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and net exports (or volume of trade) over and above what would have occurred without their intervention, within the budgetary constraints of their net revenues, plus own endowment when they are set up and recurring grants from state budget (grants could follow the pattern of FCIs, i.e. be indicated in advance by the government contingently on the performance of the economy in these crucial areas). The three corporations should therefore not be bound to the fulfilment of preset targets, unless they accept this responsibility in negotiations with the government on the amount of resources entrusted to them. These principles already narrow down very considerably what these corporations could do:

The National Employment Corporation would hire workers at the minimum national wage for each skill and occupation and rent them out to firms at the best competitive rate (whether lower, or temporarily higher) they can obtain in the market; if there is no demand for the services of some of its workers it can rent them out free of charge to Local Authorities. Any firm hiring workers at a rate below the going wage from the NEC is forbidden to lay off any other workers, so that NEC workers are the "margin" for firms. In this way the marginal cost of labour to firms is lowered without lowering the average wage, thereby avoiding perverse feedbacks of labour cost on demand. The same result would be obtained with a wage subsidy on additional employment under the same restrictions on firing and on a given budget on a first-come first-served basis; but the subsidy would have to be preset and would not respond to market conditions as frequently as under the proposed arrangement. The NEC could be given, as well as a basic budget, an amount per worker hired corresponding to cost of unemployment to the government (forsaken income tax as well as unemployment subsidy per worker). The scale of NEC operations is dictated by its government grant, as well as by its own ability to rent out workers on good terms. The actual additional employment generated by NEC would be visible and countable; its cost per worker (net of unemployment cost) would be monitored and regarded as its performance indicator, though changes in this indicator would be related to changing external circumstances or scale of operation and supplemented by direct scrutiny of NEC activity. (Something resembling this institution has been suggested in Italy under the label "Labour Service" in policy discussions, but with a

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vague mixture of functions ranging from job creation to job brokerage, neither of which are vested in the corporation proposed here.)

The National Investment Corporation would be a cross between military procurement agencies in capitalist countries and Soviet-type Machine Tractor Stations. Like military procurement agencies NIC would have a budget out of which to acquire equipment, through tender or negotiated purchases in the market, in this case plants expanding productive capacity of any good or service. Like MTS of Soviet memory, NIC would then rent plant out or sell it to firms or individuals at whatever rental or sale price can be obtained in the market. NIC would specifically be forbidden to operate plant itself, which would alter drastically the nature of its activities, the size and required expertise of its staff; though of course NIC could recommend (but not automatically obtain) that a public enterprise should be set up especially for that purpose (and indeed the possibility of this happening would enable NIC to obtain a better price in the market for the rental or sale of the plant). To avoid duplications, NIC would announce its plans in advance, indicating clearly whether these are intentions or firm commitments. NIC performance would be judged by its profit, or loss, relatively to the total resources with which it is endowed and also to the scale of its capacity creation. If the switchover to the proposed system is made from a command economy, NIC should replace all centralised investment other than public infrastructure.

The International Trade Corporation would act as an additional import-export company, empowered to enter long term contracts with both domestic and foreign companies (or even foreign governments in the case of trade with centrally planned economies or developing countries), as well as undertake international borrowing and lending as necessary. It has often been said that planned trade expansion, not protectionism, is the best way to cope with external constraints, but, in spite of the like-minded attitude of several countries, the institutional machinery for expanding trade in a planned fashion is lacking. ITC would import goods on long term contracts, for cash or barter, sell them domestically at spot prices (or, if it can,

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also on long term contracts); order and buy goods domestically for export, either to obtain currency to pay for its imports or to balance barter exchanges. Dealing in lots of commodities, it could act as broker in multilateral and intertemporal barter. Its trading programmes would be announced for future years, so that capacity for export could be especially developed and contracted, or domestic capacity expansion slowed down to absorb planned imports. Domestic sales of imported goods would be at competitive prices whatever the international price paid by ITC, so nobody could complain of dumping practices; even if ITC undersold domestic producers it would do so having announced its intentions in advance, to give domestic producers the time to soften the blow. ITC performance would be judged by its profit, or loss, relatively to the total resources with which it is endowed, and to total turnover and net exports. By and large this Corporation would be like a Soviet-type Import-Export company, except for the important differences that it would not have the monopoly of international trade, it would act on its own initiative following market signals in an effort to raise the volume of trade and (if possible) net export earnings instead of executing a trade plan, and it would deal in several commodity groups.

If the scale of operation of the envisaged corporations was too large for a single unit, more than one could be set up, with the same criteria. The corporation(s) in each area of responsibility would therefore pursue directly one each of the three most elusive targets of planning in market economies. The envisaged machinery would allow government and the public to monitor the costs and benefits of the pursuit of each policy objective, avoiding both the undershooting typical of capitalist economies using ordinary instruments of public policy, and the costly overshooting typical of the socialist economy using central planning. Moreover, the full cost of the realisation of public policy targets can be revealed (over and above the cost of indirect policy instruments attributable to them in the state budget and other public sector accounts), in a way which is not revealed in centrally planned economy where prices used for aggregation are not market clearing prices and priority sectors get a preemptive claim on deliveries equivalent to an infinitely expandable budget (Kornai's "soft

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constraints"). Looking at costs, the public might decide to lower their sights and choose to trade-off targets in favour of a different mix.

It may be difficult to envisage the operation of an economy in which such "residual" state intervention directly acts on crucial macrovariables; but it is even more difficult to envisage how an economy without at least the first or the second of these institutions can hope to conduct economic planning instead of just taking pot shots at macrotargets with the conventional instruments and institutions of economic policy. This is perhaps not that important for capitalist economies, where by and large people have almost given up the notion of planning and therefore there are no expectations to be disappointed. It is, however, very important for socialist countries, which have been making repeated attempts at freeing themselves from the strictures of the command system but expect of markets - regulated as they might be through policy means - the delivery of macropolicy goals which markets can very rarely deliver; in their case, the discovery of the failures of markets and the inadequacy of usual policy means may drive them back to the command system (as indeed has already happened repeatedly, as witnessed by the frequency with which attempts at reform are introduced and gradually withdrawn).

4. Transition

Even if the planning model sketched here, or any other model of planning in any economic system, were to be universally recognised as the best of all possible models, it would not follow at all that the transition from the extant model to the ideal one would be smooth, costless or even desirable.

The changeover to a new economic system is most likely to occur at a time of crisis, i.e. the new system (especially if markets are activated in command economies) is most likely to operate in the least favourable conditions, especially in the possibly weak form in which a new system may have to be introduced. The changeover is also likely to be paralleled by the rise to power of new political groups and, therefore, the simultaneous

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affirmation of pent-up aspirations previously repressed, which are bound to compete with standard macroeconomic targets. Large redistributional claims are likely to be put forward and it may be politically necessary to validate them in order to retain newly found power. Fear of change might lead to a drain of resources (people, skills, but above all liquid capital).

The broad implications of these circumstances are fairly clear but the empirical and theoretical study of them is non existent. The political movement favouring the introduction of macroeconomic planning in the market economy or the marketisation of a command economy will need, ready on the eve of taking power, if not an actual plan at least an institutional blueprint, complete with draft legislation, as well as fingertip command of information about the state and the trends of the whole economy and its external connections. Impatience can be ruinous and, initially, only modest improvements in the achievement of desired targets can be expected, announced and implemented. The normality of everyday life will have to take priority over long-term targets. Redistribution will have to be achieved by redeploying wealth, not through the distribution of paper claims unmatched by goods in the market. Political concessions having a low resource cost will have to be granted instead of acceding to costly aspirations. Steps to stem capital flight will have had to be taken in anticipation of taking power (because the same anticipation will be shared by financial circles). External supply sources and outlets both in finance and trade relations may have to be partially switched if a substantial systemic change is envisaged; alternative partners then must be available, already committed to expanded relations preferably by earlier contingent agreements.

It is a most disheartening law of contemporary political and economic history that no political movement favouring systemic change (whether wishing to introduce planning in a capitalist economy, or - like Solidarnosc - wishing to marketise the command system while retaining macroeconomic control) has ever got anywhere near power having the slightest idea of how to proceed afterwards, let alone with an institutional blueprint or a plan. (Only <u>total</u> marketisation is a simple, effectively self-implementing move with the total abolition of

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central control). And if any such political movement took power tomorrow anywhere in the world it would not be in any better position than its failed predecessors. This is why it is most important to discuss as widely and in as much detail as possible not only the uncharted territory of feasible socialisms, but also the feasible paths that might lead there.

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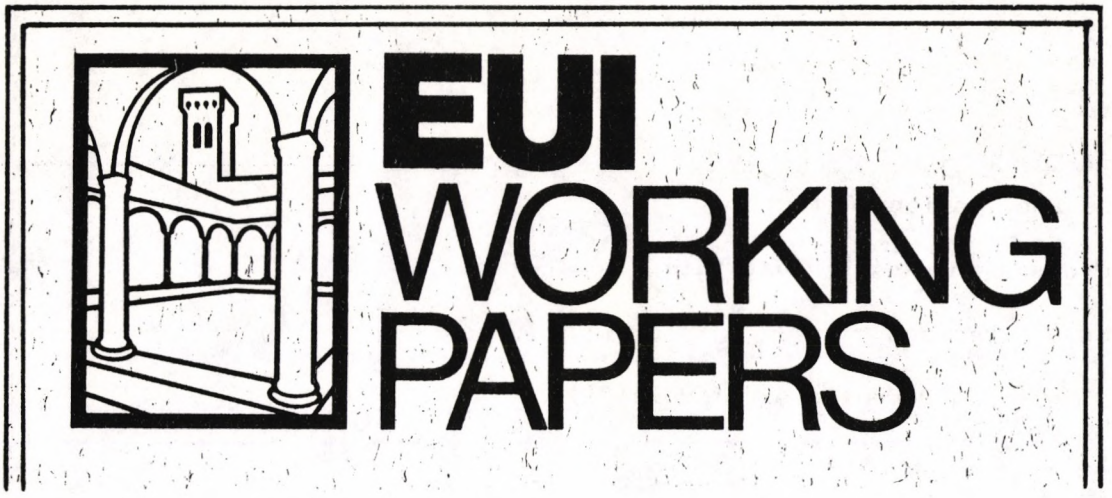

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