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Policy burden, privatization and soft budget constraint

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We propose a new cause for the pervasive syndromes of soft budget constraint (SBC) in socialist and transition economies, that is, the policy burdens on enterprises result in the SBC problems. The policy burdens induce low effort input of firm manager and thus the low efficiency of production. And with the policy burdens, increasing market competition will make the SBC syndromes arise more likely. Privatization will not necessarily harden the budget constraint of the enterprise. On the contrary, when a SOE still bears the policy burdens, privatization will only aggravate the SBC problems. Because in this case, a private enterprise will demand more *ex post* subsidies from the government, than a SOE under the same condition. Our results help to explain many stylized facts in transition and socialist economies. *Journal of Comparative Economics* **36** (1) (2008) 90–102. China Center for Economic Research, Peking University, Beijing 100871, China; MF003, Manufacture des Tabacs, MPSE, Toulouse Université des Sciences Sociales, 31000, Toulouse, France.

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1. Introduction

A well-known phenomenon in socialist and transition economies is that, when state-owned enterprises (SOEs) incur losses, the State normally cannot restrain from bailing them out by providing additional subsidies or credits, which is known as the soft budget constraint (SBC) problem. Soft budget constraint, a term coined by Kornai (1980), is connected to various problems in socialist and transition economies, such as shortage and low efficiency of SOEs. And due to the negative consequences of SBC, hardening the budget constraints of enterprises has been a principal objective of the economic reforms in transition economies. However, the reforms of Eastern European economies (EEEs) in the 1990s have proved to be unsuccessful in eradicating the lasting SBC syndromes, even after the SOEs had been massively privatized in many of those countries (World Bank, 1996, 2002).

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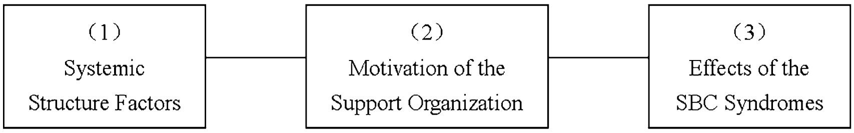
As for the SBC syndromes in socialist and transition economies, there has been a huge amount of literature, most focusing on the consequences of SBC, such as moral hazard or adverse selection problems of firm managers.[1] But about the institutional causes for the formation of SBC, there still exist debates, and little detailed work has been done on these topics.

In this paper, we propose a new hypothesis on the causes of SBC, that is, the policy burdens on enterprises results in SBC problems. And privatization will not necessarily harden the enterprises' budget constraints, if they continue to undertake the State's policy burdens; rather, privatization will probably exacerbate the SBC syndromes under certain conditions. The results of our model provide important implications for understanding many stylized facts in socialist and transition economies, as well as in fledged market economies.

Before expatiating on our theory, we first provide a short review of the literature. As Kornai et al. (2003) summarize, understanding the SBC syndromes entails bearing in mind a complex chain of causality, which is depicted in a schematic form in Fig. 1. Block (1) represents the political and social factors that generate the motives behind the formation of SBC. Block (2) represents the motives that create the SBC syndromes, such as the motivation of the State or creditor to refinance loss-making enterprises. Finally, block (3) represents the consequences of SBCs.



Source: Kornai et al (2003)

Fig. 1. The SBC syndrome: the chain of causality.

Many studies on SBCs focus on the relationship between block (2) and block (3), as mentioned above, and to some degree they have reached a consensus on how SBCs can influence the working of an economy. Dewatripont and Maskin (1995) is a seminal paper in modeling this relationship, from which a large amount of related literature has been developed. In their paper, they formulate the SBC in the context of dynamic commitment inconsistency and effectively capture the main ideas of Kornai (1980) on the SBC syndromes. In their two-period dynamic game, they state that the state could have incentives to refinance an inefficient and uncompleted project, because the marginal benefit of refinancing exceeds the marginal cost of abandoning it, which means refinancing is an *ex post* efficient decision for the support organization.

But little detailed work has been done on the relationship between block (1) and block (2), such as the root causes for the SBC syndromes. Also, one important and unanswered question is why socialist economies are more vulnerable to SBC than fledged market economies. Or, in other words, what are the institutional factors that contribute to the pervasive SBC syndromes in those economies?

Kornai (1980) attributes the causes of SBC primarily to political constraints—that is, to the paternalism of socialist governments. Dewatripont and Maskin (1995), however, have shown that paternalism is neither a necessary nor a sufficient condition for SBC. They suggest that the highly centralized system of socialist economies is the primary cause of SBC, because in a decentralized system, such as in market economies, the transaction cost of refinancing will be so high that refinancing is *ex post* inefficient, and will thus harden budget constraints. Qian and Roland (1998) propose a similar idea: they suggest that China's more decentralized fiscal system increases competition among different regions, and thus the opportunity costs of refinancing bad projects are very high, which could partly explain China's success in economic transitions.[2]

Another influential theory on SBC is that the public ownership of socialist economies is the cause for their pervasive SBC syndromes. In the model of Li (1992), public ownership means that refinancing decisions are made jointly by

[1] And a comprehensive and excellent survey of the literature can be found in Kornai et al. (2003). There is also a symposium on the SBC in Anon (1998).

[2] The validity of their statement depends on the tightness of the financial system. In effect, under existing financial arrangements, banks are owned by the central government. For economic development in their region, local governments can assist local enterprises to borrow excessively from state banks to finance their investment projects. If the state banks accumulate a large amount of non-performing loans due to many of those projects turning bad, the central government is obliged to rescue the banks. Therefore, under a decentralized fiscal system and a centralized banking sector, local governments can treat the funds in the state banks as a common resource, resulting in a situation resembling the tragedy of common.