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Economics Letters 86 (2005) 129–134
economics letters
www.elsevier.com/locate/econbase

Transition and enterprise restructuring: the role of budget constraints and bankruptcy costs

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Received 15 March 2004; accepted 19 May 2004
Available online 27 September 2004

Abstract

The focus of analysis is on the impact of financial leverage as a measure of bankruptcy costs on enterprise restructuring, based on budget constraints in the economy. Data of Bulgarian manufacturing firms allow comparison of firm behavior under soft and hard budget constraints as distinguished by the inception of a currency board in 1997. Controlling for change in sales, firm size and type of ownership, statistically significant relationship between financial leverage and firm restructuring through labor adjustments is found to exist under hard budget constraints only.

Keywords: Leverage; Firm employment; Bankruptcy costs; Budget constraints

JEL classification: G33; L25; P34

1. Introduction

The impact of budget constraints on firm behavior in transition economies has been recognized in a number of studies where elimination of labor hording is identified as an important component of enterprise-restructuring policies (e.g., Grosfeld and Roland, 1996; Coricelli and Djankov, 2001). A large theoretical and empirical literature, summarized in Kornai et al. (2003), has identified the causes and

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0165-1765/$ - see front matter
doi:10.1016/j.econlet.2004.05.004

channels of soft budget constraints (SBC). However, the effects of the heavy indebtedness resulting from SBC in transition economies and the influence of corporate capital structure on firm restructuring and economic efficiency have not been fully explored.[1] In the finance literature, research has long been focused on how financial leverage and bankruptcy costs influence operating behavior and efficiency (e.g., Titman, 1984; Perotti and Spier, 1993; Sharpe, 1994; Rajan and Zingales, 1995). The main finding is that higher levels of debt in the capital structure discipline firms and force them to make optimal resource allocation decisions.

This paper analyzes the impact of financial leverage on firm restructuring, based on budget constraints in the economy. The analysis explores an important channel through which the hardening of budget constraints is expected to cause active labor adjustment and enterprise restructuring. The empirical analysis uses data on more than 1500 Bulgarian manufacturing firms over the period 1994–2000. During the first half of the period, SBC were widespread and combined with inconsistent economic policies led to a severe financial crisis, which was followed by the inception of a currency board in mid-1997 and significant hardening of the budget constraints. Thus, data allow us to compare firm behavior under soft and hard budget constraints. Under hard budget constraints, a statistically significant relationship is found between determinants of the level of bankruptcy costs, such as firm size and financial leverage, and restructuring through labor adjustments. Ceteris paribus, the elimination of excess labor is more substantial in smaller and more highly leveraged firms. This relationship is not present under SBC.

2. Analytical framework and hypotheses

The costs of adjusting firm labor force arise through the costs of hiring, training and firing employees, or the quasi-fixed components of the labor input (Oi, 1962; Fay and Medoff, 1985). The presence of such costs ought to induce firms to dampen fluctuations in their labor force relative to fluctuations in demand for their output, a pattern of behavior commonly referred to as labor hording.[2] In the context of former centrally planned economies, an important reason for labor hording has been the pursuit of objectives other than profit maximization, such as full employment and other social and political goals. These considerations are in fact determinants of the SBC, which are identified as the major obstacle to efficient enterprise restructuring during transition (Kornai et al., 2003).

If the costs of deviating from the profit-maximizing employment–sales ratio are high relative to the costs of adjusting labor, firms will choose to restructure. As deviations from the optimal employment–sales ratio are more costly for smaller firms and more highly leveraged firms, these ought to be quicker to adjust to changes in the economic environment (e.g., Sharpe, 1994).[3] Firms that experience relatively high opportunity costs of capital are prone to do less labor hording and to restructure when demand shifts or financial conditions change so as to preserve their capital.

[1] Rizov (2001) reviews theories of capital structure and discusses their implications for firm financial management in transition economies.

[2] Oi (1962) describes the potential costs of adjusting a skilled labor force. Fay and Medoff (1985) review reasons for labor hording, including the value of retaining skilled labor stock in anticipation of recovery, as well as contractual commitments and the adverse implications of labor adjustment for employee morale.

[3] Gertler and Gilchrist (1994) argue that smaller firms are more sensitive to monetary shocks and Carpenter and Petersen (2002) show that smaller firms have a high sensitivity to their own liquidity.