

## Firm in Transition

### Topic 1

## Soft Budget Constraint (SBC)

Lubomir Lizal

CERGE-EI

## Soft Budget Constraint

### Soft Budget Constraint

opposition is Hard Budget Constraint

- Introduced by Janos Kornai
- Model of enterprise under CPE

Dynamic process of filling up the gap between revenues and costs.

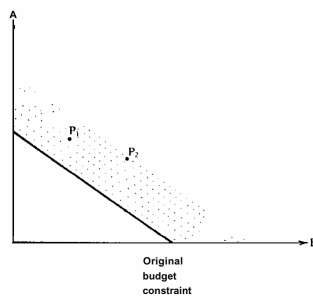
Subjective probabilities of possible external assistance depend on

- collective experience
- past behavior
- beliefs of the future change of the assistance

CERGE-EI

## SBC

The 'softening' of the budget constraint



Household

Cannot exceed its budget line

- HBC

Enterprise

Can go beyond the budget line to P1 or P2

- SBC

CERGE-EI

## SBC Analogy

- Highway speed limit
  - speed limit is 130 km/h
- What happens if your police-metered speed is:
  - 131 km/h
  - 134 km/h
  - 140 km/h
  - 150 km/h
  - 170 km/h
  - 200 km/h

CERGE-EI

## SBC Types

- Four types of SBC
  - 1) Soft subsidies
    - Bargained for, lobbying, covers costs overruns
  - 2) Soft taxation
    - Relaxed rules of taxation, may not pay certain taxes, lowering tax rate according the needs, tailor-made
  - 3) Soft credit
    - Lending w/o collateral, repayment is not enforced, no bankruptcy in case of insolvency
  - 4) Soft administrative prices
    - Prices are set by bureaucracy, flexible to go up with increased costs or other economic changes

CERGE-EI

## SBC and HBC Comparison

- Example: Credit analysis
  - 1) Loan of € 60 000 at 3% p.a.
    - Collateral of shares in amount of € 50 000
    - Mortgage on the factory premises up to € 80 000

*Hard loan = HBC*
  - 2) Loan of € 80 000 at 15% p.a.
    - No collateral
    - Free to re-negotiate
    - No obligation associated with the debt

*Soft loan = SBC*

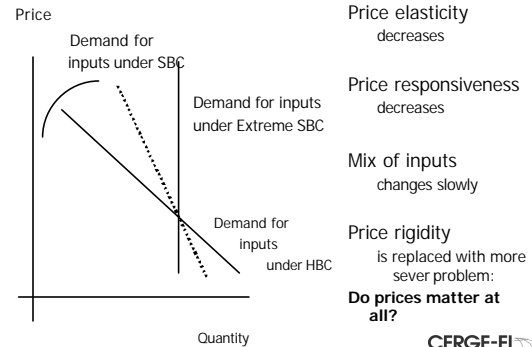
CERGE-EI

### SBC vs. HBC

- SBC
  - The terms might not be favorable, however, terms, prices, quantities, subsidies, taxes, etc. are not fixed, everything can be re-negotiated in any time
- HBC
  - The external economic conditions are given and cannot be negotiated. Terms are enforced with the final threat of bankruptcy

CERGE-EI

### Impact of SBC



CERGE-EI

### SBC and Efficiency

- Allocative efficiency
  - relies on the adjustment caused by price changes
  - we cannot achieve allocative efficiency if the input&output do not adjust to price signals
- X-efficiency
  - weaker performance is tolerated
  - X-efficiency is lowered

CERGE-EI

### Dynamic Adjustment

- How do firm reacts to new conditions?
- HBC
  - immediate adjustment in quality, cutting costs, new products, new means of production...
- SBC
  - seek for assistance to overcome externally imposed changes of the market
  - Firm tries to keep the status quo (stagnation)
  - State is an insurance company against all types of risk
    - Insured person has lower incentives to take precautions against the unfavorable conditions

CERGE-EI

### Excess Demand

- No matter managerial objectives, the SBC firm:
  - has expansionist tendencies
  - higher demand for input no matter their costs
  - create excess demand for certain inputs since the demand is unconstrained under SBC (for the financial point of view)
- Consequences?
- Walras Law does not hold:

CERGE-EI

### Walras Law

- Excess Supply = Excess Demand
- Example: Investment
  - Total demand for investment is constrained by risk aversion toward failure.
  - The higher the probability of failure, the higher price has to be paid for the investment to those providing resources.
  - Under SBC this self-adjusting principle does not work
  - Society has limited resources =>
  - Hidden or obvious redistribution towards less efficient projects.
- Economy of SHORTAGE

CERGE-EI

### **Life-time of Firm**

- In Socialist or Centrally planned economies:
- Firms operate under SBC
- Long-term loss making (or inefficient) firm can survive as long as the central authority wants it alive
  
- => No bankruptcies