On the Causes of Soft Budget Constraints: Firm-level Evidence from Bulgaria and Romania

Greetje Everaert[(a)] and Antje Hildebrandt[(a),(b)]
(a) LICOS, Centre for Transition Economics, K.U.Leuven,Belgium
(a),(b) Oesterreichische Nationalbank, Austria*

July 2003

The transition towards market-based economies in central and eastern Europe offers a natural experiment for testing the widely held view in economics that competition and private ownership contribute to improved economic performance. One crucial point of the transition to a market economy is the hardening of budget constraints of firms. The concept of soft budget constraints (SBCs) was introduced by Kornai (1980) and refers to the situation where loss-making firms are bailed out or refinanced. In Kornai's (1980) view, bail-outs of loss-making firms reflect a paternalistic government attitude. The government wants to preserve employment and the survival of firms even when they incur losses. Closely related to the paternalistic explanations of SBCs are political economy models of SBCs. Shleifer and Vishny (1994) argue that the political influence of entrepreneurs automatically gives rise to bribes and subsidies. More recently, several theoretical explanations for the presence of soft budget constraints have been put forward. The existence of SBCs is explained by institutional conditions such as state ownership, centralisation of credit and lack of competition. The purpose of this paper is to empirically test these theories on the causes of soft budget constraints. Do privately-owned firms in more competitive industries

*Foreign Research Division, Otto-Wagner-Platz 3, A-1090 Vienna, Phone: (+43-1)404 20-5229, email: antje.hildebrandt@oenb.at (Corresponding author)

suffer less from SBCs? To what extent can sociopolitical motives such as employment account for the incidence of SBCs?

In attempting to explain the presence of SBCs, we use an unbalanced panel data set, consisting of company account data for Bulgarian and Romanian manufacturing firms, covering the period 1995-1999. Our sample comprises 1536 Bulgarian and 2293 Romanian firms.

Our results suggest that the probability of finding soft budget constraints importantly depends on the degree of competition within the sector and on the ownership structure of the firm. We further find that sociopolitical concerns about employment increase the probability of soft budget constraints, but only when firms are loss-making. Thus, our empirical results largely confirm the hypotheses that competition, privatisation, and firm size matter in explaining soft budget constraint, as suggested in the theoretical models on the causes of soft budget constraints.

Since Kornai (1980), the adverse effects of soft budget constraints have been well-documented in the literature. SBCs are believed to hamper innovation, the restructuring of firms and an efficient resource allocation and free trade. Consequently, the hardening of SBCs is at the heart of the reform process in transition countries. Moreover, our conclusions should draw the attention of policymakers to the importance of raising competitive pressure in transition economies and continuing privatisation reforms to reduce the prevalence of SBCs. The hardening of budget constraints continues to be a top priority in the transition process.