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Kornai on Soft Budget Constraints, Bail-Outs and the Financial Crisis

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In a post a few days ago, (After subverting bank insolvency, our leaders are now about to make a mess of liquidity) , I argued that hard budget constraints were the defining characteristic of a well-functioning market economy. Many/most of the advanced industrial countries were weakening or even undermining the capacity of their financial sectors to intermediate efficiently by permitting a softening of the budget constraints of banks and other financial institutions that were deemed systemically important and/or were too politically connected to fail. I noted that the concept of the soft budget constraint (SBC) came from professor János Kornai, a great economist and a Nobel prize winner (the overlap is by no means perfect - there are type I and type II errors)(CORRECTION: As pointed out in a comment on this post, Professor Kornai has not (yet) won the Nobel prize. My bad, as the teenagers in my family would say. In my defense, he ought to have been awarded the prize already, preferably instead of the large efficient markets cohort that did receive it.)

Professor Kornai's classic book *Economics of Shortage,* analyses a fatal internal contradiction in central planning - how soft budget constraints became a defining feature of a centrally planned economy and were central to its astonishing inefficiency and eventual downfall. In a paper co-authored with Eric Maskin and Gerard Roland ("Understanding the Soft Budget Constrained", published in the *Journal of Economic Literature*, December 2003, vol. 41(4), pages 1095-1136), Kornai argues the wider applicability of the SBC concept to economies other than centrally planned economies. For those with access to JStor, the paper can be found here.

I am pleased and honoured that this blog can bring you the following short note in which professor Kornai explains the relevance of the SBC to an understanding of the causes and consequences of the financial crisis of 2007-2009.

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János Kornai

The soft budget constraint syndrome and the global financial crisis

Some warnings from an East European economist

One strong concern expressed more than once in discussions on the present financial crisis has been this: the interventions by the state are smuggling a bit of socialism into the capitalist economy. This is the side of the debate to which I would like to contribute, as a research economist who has spent several decades examining the socialist system from inside. My subject here is not the post-socialist region, but the rest of the world-though I look upon it with the eyes of one who has himself experienced socialism at first hand.

Back in 1968, when attempts began in my native Hungary to implant "market socialism" into the socialist economic system, the heads of state-owned enterprises were urged to increase their profits. Managers were to do well if their enterprises made money, as they would receive a share of the profits. But there was little cause for concern if the enterprise made a loss and fell into debt: in almost every such case, some kind of rescue operation was mounted. For instance, there might be a bailout funded out of the state budget, or the state-owned bank might extend extra credit, without much hope of the loan being repaid. Losses and debts were unpleasant, of course, but they were not a life-or-death matter for an enterprise.

Managers, based on their experience of repeated rescue operations, could more or less bank on their enterprise surviving. Despite all the stress on the profit motive, the incentive remained fairly weak in reality. Why bother too much about cost-cutting or innovating if there was no threat of insolvency? The financial situation of the enterprise did not place a real constraint on its spending, its borrowing or its expansion. This was the state of affairs that I called at that time a "soft budget constraint" (SBC).

Softness of the budget constraint cannot yet be said to apply in a *singular* case where a firm in deep financial trouble is bailed out. The syndrome appears if such rescues occur frequently, if managers can begin to *count on* being rescued. We face here a mental phenomenon, an expectation in decision-makers' minds that strongly influences their behaviour.

To simplify matters, a contrast is often made between the soft and the hard budget constraint. In fact there are grades between these two extremes. The budget constraint that corporate decision-makers sense may be very soft, moderately soft, quite hard and so on, depending on their subjective awareness of the probability of rescue.

Included in the SBC syndrome is a phenomenon known to insurance theory as *moral hazard*, but the first is fuller and richer in content, describing a social process and a complex economic mechanism. It does not simply involve examining single decision-makers in isolation, doing less than they might to avoid damage because they can count on compensation from their insurers. The analytical apparatus of the SBC entails deeper, more comprehensive examination of motivation, behaviour and mutual effects among the multiplicity of firms, state bodies, financial

When I dealt with this subject initially, I contrasted the typically soft budget constraint on socialist enterprises with the hard budget constraint on classical capitalist firms. Decision makers in the latter can feel they are on their own. Faced with chronic losses and spiralling debt, they can expect no aid, and the story will end in the firm's exit. But even in my early accounts I warned that the SBC syndrome, although it soaked more deeply and generally into the fabric of a socialist economy, can also appear in a market economy based on private ownership. Since then, the SBC theory has been applied by many observers to a variety of economic situations. It has been shown that it needs considering beyond the bounds of the socialist system as well.

Let us turn for a minute to the dawn of capitalism. A debtor unable to pay was threatened by the debtors' prison. Business failure in the early period of capitalism was more than a fatal material blow, for it ruined the bankrupt's moral reputation. The budget constraint in those days was still absolutely hard. The perilous results of loss and indebtedness forced entrepreneurs to be extremely cautious.

But the historical development of property relations and the credit system gradually brought essential changes. The principle of limited liability became legitimated, and joint stock companies based on that new principle appeared. At the same time, the hitherto close connection between the material and moral position of decision-makers and the financial state of their companies became weaker.

As property and management separated, so the relation weakened between the individual destiny, income and reputation of the managers making the practical business decisions on the one hand, and the presence or absence of financial destinies of their companies, on the other. Successive legislation on business failure provided some protection for firms caught up in a spiral of debt. These changes and others not mentioned here contributed to a steady softening of the budget constraint. It never became as soft as it was under a socialist system of course, but a softening tendency can be discerned down the centuries. Early capitalism rewarded success richly and punished failure fiercely. As time went by, the rewards not only remained, but in several countries increased dramatically, while the penalties became lighter. That disproportional change has weakened the incentive for business to pursue efficiency and adaptability to change. It encourages irresponsible decisions on borrowing, investment and expansion.

This historical view is worth bearing in mind when analysing the present global financial crisis. Spreading of the SBC syndrome is at once a cause and an effect of the crisis. I will not say it is the only cause: the situation that led to the crisis was brought about by a complex of factors. But I will say firmly that softening of the budget constraint is one of the *main* causes of the crisis. The general softening tendency has been reinforced in the United States and several other countries by successive bailouts over the last ten or twenty years. Some economists, such as Professor Chenggang Xu, have been pointing for years at a close link between the crisis in East Asia and earlier bailouts. But warnings were sporadic and passed almost unnoticed. As a reminder, here is a timeline of just some of a few recent bailouts.

What I have given so far is not a list of recommendations (I will return to those) - it is a prediction, not a prescription. There is no telling accurately what the scale and frequency of future rescue operations will be, but the worldwide rescue campaign will certainly be broader and greater than any that went before. So like it or not, the propensity to soften the budget constraint will continue, indeed strengthen. Also increasing and becoming more confident will be business leaders' expectations of being rescued if they get into trouble. Similarly, leaders of local governments experience the softening of their budget constraints as well. Banks and other financial institutions can feel especially sure their survival will be underwritten. But there will be good rescue prospects also for loss-making or insolvent non-financial companies holding key positions in the economy and/or having good contacts with the politicians making bailout decisions. The bailout of banks in most cases indirectly implies also the rescue of firms unable to pay their debt.

Before moving from prediction to practical issues of economic policy, let me turn back for a minute to the question addressed in the introduction. Is the part of the world that never lived under the socialist system really shifting towards socialism? The answer cannot simply be yes or no.

Capitalism developed gradually out of the pre-capitalist social environment, by an organic process of growth. As capitalist forms came to dominate the economy, so the influence of business on politics increased. Socialism, on the other hand, did not seep gradually into the fabric of society in Tsarist Russia or post-World War Two China. The communist party became capable under specific historical conditions of seizing political power, taking control of the machinery of state, and then *imposing* the socialist economic system on society by state force. Every means was used, including merciless repression. The developmental process of the socialist system, unlike that of capitalism, began in the political quarter, not the economic.

However many bailouts there may be, however much the budget constraint may soften, there is no danger of socialism returning *in that sense* - which is the most important point. It is meaningless to raise that spectre in the United States, Western Europe or other developed countries, where democracy has sent down deep roots. There may be times when public discontent is stronger and more widespread than in other calmer and more prosperous periods. But only incorrigible revolutionists given to hoodwinking themselves believe such discontent can overthrow the foundations of the system. That prediction indicates a failure to understand the history of the communist system.

		Mutual savings banks	
1981	Netherlands	Mortgage banks: WUH, FGH	
1982	Italy	Banco Ambrosiano	
1983	USA	Bank insolvency during the Debt Crisis	
1984	USA	Continental Illinois National Bank and Trust company	Timber industry
1989	USA	Savings & Loans crisis	
1992	Sweden	Swedish banking crisis	
1993	France	Credit Lyonnais	
	Japan	Japanese banking crisis	
1994	Mexico	Mexican crisis	
1995	UK/France		Eurotunnel
1996	France	Credit Foncier, CIC, GAN	
	Italy	Banco Napoli	
1997	East Asia	East Asian crisis	
1998	Russia	Russian crisis	
	USA	Long-Term Capital Management	
1999	Austria	Bank Burgenland	
	Brazil	Brazilian crisis	
2000	Thailand	Krung Thai Bank	
2001	Argentina	Argentinean crisis	
	Germany		Philipp Holzmann AG (construction)
	USA		Airline Industry
	Turkey	Turkish crisis	
2002	Italy		Fiat (Iveco)
	UK		Railtrack
2003	France		Alstom (engineering)
2004	France		Bull (IT firm)
	Germany	Bankgesellschaft Berlin	
2006	Austria	BAWAG	
2005	France		Imprimerie Nationale (printing)
2007	Germany	IKB bank, Sachsen LB	
	UK	Northern Rock	
2008	Belgium	Fortis, Dexia, KBC	
	France	Dexia, Credit Agricole, Societe Generale, BNP Paribas	
	Germany	West LB, IKB, Bayerische LB, Commerzbank, Hypo Real Estate	
	Ireland	Bank of Ireland, Allied Irish	
	Luxembourg	Fortis, Dexia	
	Netherlands	Fortis, ING	
	Switzerland	USB	
	UK	Lloyds TSB, HBSO, RBS	
	USA	AIG, Bank of America, Bear Stearns, Citigroup, Goldman Sachs, Wells Fargo and 25 other institutions received support in excess of $ 1 bn each	Chrysler, General Motors

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