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A political economy theory of the soft budget constraint

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ABSTRACT

Why do soft budget constraints exist and persist? In this paper we argue that the prevalence of soft budget constraints can be best explained by the political desirability of softness. We develop an infinite horizon political economy model where neither democratic nor autocratic politicians can commit to policies that are not ex post optimal. We show that because of the dynamic commitment problem inherent in the soft budget constraint, politicians can in essence commit to make transfers to entrepreneurs which otherwise they would not be able to do. This encourages such entrepreneurs to support them politically. Though the soft budget constraint may induce economic inefficiency, it may be politically rational because it influences the probability of political survival. In consequence, even when information is complete, politicians may fund bad projects which they anticipate they will have to bail out in the future. We show that, maybe somewhat surprisingly, dictators who are *less* likely to lose power, are *more* likely to use the soft budget constraint as a strategy to gain political support.

1. Introduction

Traditional policy analysis in the tradition of Pigou (1920) and Samuelson (1954) saw policymakers as designing policies to solve market failures, or satisfy normative criteria, subject only to the availability of resources and the nature of preferences and technology. In the 1970s economists began to realize that even well-intentioned planners were subject to other types of constraints. Diamond and Mirrlees (1971) examined the nature of optimal policies without lump-sum taxation, and Gibbard (1973) and Green and Laffont (1979) argued that the incentive compatibility constraints generated by private information had to be respected. Kydland and Prescott (1977) also showed that optimal inter-temporal policies might be time inconsistent, making it difficult for a planner to commit to even a second-best policy. In the 1980s and 1990s economists began to merge such ideas with models where policymakers were self-interested and studied how the interaction between such interests and social welfare led to further deviations from first- or second-best outcomes.

These models have brought us much closer to an understanding of the relationship between market failures and political failures. Yet many puzzles remain. A central, and fascinating one, is that of the "soft budget constraint." Originally introduced by Kornai (1979) in the context of centrally planned economies, the basic notion is that governments and policymakers are unable to impose a "hard" budget constraint on government owned enterprises or government agencies. In consequence such enterprises or agencies have incentives to act in inefficient or profligate ways knowing that they will

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be bailed out if things go wrong. Gregory and Harrison (2005) provide a detailed discussion of the soft budget constraint in the Soviet planned economy.

Since its development, the problem of the soft budget constraint has been recognized to be endemic to most polities, though clearly being worse in developing economies. This recognition emerges from the fact that all scholars note that soft budget constraints in Eastern Europe and the former Soviet Republic proved more long lived that central planning. Maskin and Xu (2001, p. 10) report that "considerable empirical work indicates that the soft budget constraint syndrome continues to play an important role in virtually every transition economy, even those that have already undergone many years of reform".

Why do soft budget constraints exist and persist? The central argument in the literature is that soft budget constraints arise because politicians cannot commit not to refinance bad projects ex post and cannot distinguish bad from good ex ante. Given that a project is launched, it will be refinanced as long as benefits cover costs. Previous costs are sunk. Entrepreneurs know this, and submit bad projects for financing in the first place. This is the key argument in Dewatripont and Maskin (1995), which has become the canonical model of soft budget constraints. This approach follows the literature which built on Kydland and Prescott (1977) where policymakers were thought of as well intentioned and thus downplays any political reason for the existence of soft budget constraints.

Such an approach to understanding the soft budget constraint is interesting. But it is also useful to extend such an approach, because the overwhelming amount of evidence strongly suggests the role of political motivations in explaining soft budget constraints. For instance, political scientists who have studied this topic, argue that the main reason for soft budget constraints to persist is that soft budget constraints serve the interests of politicians—this is precisely the reason they are not dismantled. This literature leaves unanswered, however, the question of exactly why the interests of politicians manifest themselves in such a way.

In this paper we develop a fully political economy model of the soft budget constraint. Our starting point, following Alesina (1988), Osborne and Slivinski (1996), and Besley and Coate (1997), is that politicians cannot commit to policies that are not ex post optimal. This inability to commit to arbitrary policies hampers the ability of politicians to exchange policies for support, since voters do not necessarily believe political promises (unlike in the basic Downsian model where perfect commitment is assumed). Such a political setting is the natural one if one accepts that the problem of the soft budget constraint is a problem of commitment. Instruments which solve this credibility problem are therefore potentially attractive politically. We argue that the key thing about the soft budget constraint is that, in effect, it is a credible way of transferring income to potential supporters: because a policymaker *cannot commit to enforce a hard budget* constraint, *he can commit to make transfers* to citizens.

Nevertheless, this in itself does not make a soft budget constraint politically rational. Instruments which allow all politicians to make credible commitments to policy are not necessarily attractive unless they improve the position of one politician relative to another. For example, politicians would like to be able to offer income redistribution to groups to win their support. In order for this offer to change the expected outcome of a political fight, such redistribution has to satisfy two conditions; (1) it must be optimal ex post for politicians to enact, and (2) it must be something that all politicians cannot offer.

Such asymmetries arise in many natural ways. Politicians differ in their valuation of welfare of different groups, in their ability to undertake different policies, in their regional attachment, and in their interaction with different groups. For instance, Dixit and Londregan (1996) argue that (p. 1134) "Such differences can arise when each party has its core support groups of constituents whom it understands well. This greater understanding translates into greater efficiency in the allocation of benefits: patronage dollars are spend more efficiently". Although in reality there may be many reasons for politicians having different costs or benefits in transferring resources to different groups, the exact modelling of these asymmetries is not crucial for our argument. We therefore simply adopt the familiar mechanism of Dixit and Londregan (1996) where politicians have lower net costs of transferring resources to core supporters than to other groups.

In this paper we argue that it is the combination of these two things that leads to the prevalence of the soft budget constraint. Politicians are happy to finance projects which are known to be bad in the sense that revenues do not cover costs and which they anticipate that they will find it optimal ex post to "bail out". This is because such "bail outs" redistribute resources to people or groups to whom they would otherwise find it difficult to redistribute to credibly and to whom other politicians cannot credibly redistribute resources. We refer to such groups as the core supporters of a politician. We show that the key difference between such bad projects and good projects is that all politicians can commit to refinance good projects ex post and thus although they may redistribute resources to potential supporters, they do so symmetrically and therefore do not give any politician a strategic advantage.

In many countries where soft budgets constraints are prevalent the quality of democracy is questionable at best or they are pure dictatorships at worst. Thus it is crucial to investigate how the extent of democracy itself influences the attractiveness of the soft budget constraint as a political strategy. Our starting point is the observation by Bueno de Mesquita et al. (2003, p. 28) that to understand the political survival of dictatorships the key is to investigate how they are able to generate sufficient support to cling to power: "Make no mistake about it, no leader rules alone. Even the most oppressive dictators cannot survive the loss of support among their core constituents." A main difference among democracy and dictatorship, however, is that dictators actively use the state apparatus to ensure that even if they are supported by less than half of the population they remain in power. Thus while the minimum winning coalition under democracy is half of the voters, the minimum winning coalition in a dictatorship may be considerably lower. To be able to