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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 institutions and politicians: the whole cast of the play. The SBC syndrome breeds irresponsibility and disdain of risk, and opens the way to excessive investment hunger and expansion drive among managers. This in turn makes financial troubles more frequent and

rescue demands more strident, in other words, softens the budget constraint. The SBC syndrome becomes a self-inducing, self-reinforcing process.

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.

Examples of larger public bailouts in developed countries, 1980 - 2008

Year	Country	Financial sector	Non-financial sector
1980	USA	First Pennsylvania Bank Mutual savings banks	Chrysler
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

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.

However, the danger of revolution is more threatening in countries where there is no democracy or democracy is not deeply rooted. That applies especially where people have never known what it is like to live under a socialist system, and influential politicians and intellectuals have naïve ideas about socialism. There mass discontent may lead to explosions and even a socialist takeover of power. That is a possibility, perhaps in some Latin American countries, perhaps elsewhere. And where that danger really threatens, economic policy-makers and business will do well to attempt to assuage the causes of the discontent, even at the expense of some future efficiency and economic success. These threatened regions are not the ones where radical hardening of the budget constraint should be attempted.

Let us return to the region of developed, democratic countries. They need not fear the introduction of a socialist *system*—I see any violent overthrow of the existing political structure as quite unlikely. But I do think it possible for phenomena that were among the main attributes of the socialist system to appear and consolidate under the capitalist system. *In that sense only* has it been and will it be possible for there to appear and strengthen in a private property-based market economy a softening of the budget constraint seen hitherto as typical of socialism or the transition from socialism to capitalism.

What does *not* follow from the positive analysis and prediction so far is any simple, normative statement of the following kind: end the rescues and harden the budget constraint at any price. Larry Summers, in an article, stood up against the “moral hazard fundamentalists”, and I agree with him. My intention here is not to preach a fundamentalist sermon. I distance myself strongly from those who advise under these conditions that all banks, financial

institutions and firms unable to ride the crisis should be allowed to fail. I will also refrain here from declaring what financial institution or firm should be rescued and under what conditions, confining myself to a few notes and observations.

I have the feeling that the public polemics are becoming bogged down in a debate about immediate remedies for an immediate problem. I see this is inevitable and has to be the focus of attention, but it may be useful at least to meditate on a comparison of socialism with capitalism and think in terms of centuries of history.

I am no political decision-maker. My task as a researcher and analyst is like that of a medical consultant. There is a diagnosis to make and possible therapies to explore. The SBC syndrome can be compared to a disease for which there is no complete cure. The patient must be told. But it is possible to live with the disease and mitigate its results. Several treatments can be considered. The doctor in such cases has a duty to report objectively on the effects of each alternative therapy, recounting its effects and its side-effects. That duty is shirked by economists who give a one-sided explanation of rescue operations and other means of state economic intervention.

There are some widespread economic views that foster illusions. That is like a doctor promising full recovery to a patient who has no chance of one. Such miraculous expectations are beginning to attach themselves to regulation. It is untrue that the whole problem arose because regulation was relaxed, though that was a significant factor. Tighter regulation would not stop softening of the budget constraint from leading to excessive hunger for credit, irresponsible risk-taking and a rush to expand. It was shown by experience under socialism, especially in its later, more sophisticated phase, that not even the best *regulation* can make up for the appropriate positive or negative, remunerative or punitive *incentive*. Those of us who lived under a socialist command economy learnt that even the craftiest regulation can be evaded. Every regulatory trick is soon parried. Hungary could export in large numbers people with a talent for getting round the rules. There is clearly a need for better regulation as one therapeutic tool, but let us not expect too much of it.

I find the debate short on objectivity. Those arguing (justifiably) for rescues talk solely of the need and usefulness of them, saying nothing of the detrimental effects I have described in this article. The doctor I have put forward as an example has a duty to perform when recommending steroid treatment to a patient with acute inflammation: to point to the many dangers of a treatment whose side-effects compound as the treatment is prolonged. Yet the doctor may say he recommends it in this case nonetheless. We economists should demand the same of ourselves.

I see similar bias on the other side of the debate. Concerns are rightly stated or often overstated. Yet nothing is said of potentially catastrophic spill-over effects if the collapse of some financial institution or company cannot be prevented.

The debate is driven by political and ideological divides. Left or right, conservative or liberal, Republican or Democrat—for many these underlying stances decide in advance which of the opposing arguments they heed and to which they turn a deaf ear.

I am not well enough informed of the details of the increasingly frequent bailout schemes, but I sense that they share one shortcoming. They do not apply sufficiently the principle that those responsible for bringing the financial trouble on the company or institution should pay a heavy personal price. If the budget constraint is no longer really hard—if the principle of “winner gains, loser loses” no longer applies spontaneously—we should at least try to simulate its effect to some extent. The culprits who have brought trouble on the bank or the company should not continue drawing lavish pay or receive massive handshakes if they

leave and find similar lucrative jobs elsewhere, without their reputations being seriously damaged. In some cases steps in that direction have been made in the US and France, but those can be considered as sporadic exceptions only. Those sensational episodes were rather to prevent the offensive arrogance to pay huge bonuses. No proposal has been raised, however, that those responsible in the trouble should personally share the losses of the bank or the firm the same way as having shared the profits in good times.

One of the great problems with socialism was that the careers of members of the economic elite, whether they rose or fell, did not depend on their economic achievements, but on connections and political subservience. We should not resign ourselves to seeing this well-known aspect of socialism spread further in the market economy. Legal proceedings, legislation and individual interventions by the officials and institutions of state regulation should ensure a closer link between good or bad economic performance and success or failure in managers' careers. Far stricter norms of behaviour need to be imposed on business participants and professional bodies and communities, and on the press that shapes public opinion. That will not eliminate softening of the budget constraint, but its side-effects will be less damaging.

