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Abstract

This paper explores the relevance of soft budget constraints (SBC) to development studies by examining the parastatal sector. The political ingredient of the SBC is discussed by focusing on two examples: 1) religious and military foundations in Iran; and 2) Fannie Mae and Freddie Mac. It presents two main findings. First, the SBC of the parastatal sector can be understood as the political economy of a predator state or state's rent-seeking activity. Second, the state sector is more prone to the SBC compared with a decentralized competitive market, but it might be subject to a harder budget constraint in comparison with the parastatal sector.

Keywords: soft and hard budget constraints, parastatal sector, predatory state, religious and military Foundations

Soft Budget Constraint and the Parastatal Sector

Mehrdad Vahabi (University of Paris 8)

1. Introduction

The soft budget constraint (SBC), initially conceptualised by Janos Kornai (1979, 1980, 1986, 1998a,b), describes the attitude of firms within a socialist economy where a paternalist state never lets any firm go bankrupt and always bails out a loss-making firm. Kornai provided an *exogenous* or Institutional theory of the SBC, according to which the cause of the softness is not explained by the internal interests of the softening institution (namely the state), because the state is assumed to be paternalist and not predatory¹. Since Kornai's pioneering work, a vast body of formal literature has been published about the SBC, offering an *endogenous* explanation of the phenomenon.

The term 'endogenous explanation' means an analysis of the SBC as an outcome of the internal interests of the softening institution (the state or another organization playing the role of Principal). From this perspective, the degree of budget constraint is a matter of strategic behaviour of rational maximizing agents. Dewatripont and Maskin (1995) conducted pioneering work in this field, arguing that the SBC syndrome pertains wherever a funding source, for example, a bank or government, finds it impossible to keep an enterprise to its fiscal budget, i.e., whenever the enterprise can exact *ex post* a bigger subsidy or loan than

¹ The distinction between "predatory" (dominating) and "paternalist" power is clearly acknowledged by many authors. For example, Wartenberg (1990) distinguishes between domination and beneficent power. According to him, one instance of such power is paternalism, as in legislation requiring the wearing of seat-belts, where A, seeking to avert harm or promote some benefit to B, may act against B's current wants or preferences, thereby limiting B's freedom to act. For Wartenberg, this type of power is different from other types of beneficent power which he dubs "transformative". He provides different illustrations of "transformative" power such as mothering, apprenticeship, teaching, parenting, and therapy. For a detailed discussion of "paternalism" and its difference with "predatory" or dominating power see Lukes, 2005, pp. 84-95.

would have been considered efficient *ex ante*. In this sense, the SBC problem extends well beyond socialist economies, because the extent to which loss-making firms or projects are terminated or refinanced is also very relevant in developed, emerging, or developing capitalist economies (Maskin, 2006).

Eminent representatives of the two Institutional (exogenous) and formal (endogenous) branches of the SBC literature advocate a unified theoretical framework (Kornai, Maskin and Roland, 2003). The unified framework predicts the softening of budget constraints due to asymmetrical information between the Centre (Principal) and Agent, and time inconsistency. *Time inconsistency* of the Centre lies at the heart of the SBC syndrome: if the Centre were able to *commit credibly* not to subsidise the firm *ex post*, the firm would make more efficient *ex ante* decisions. Accordingly, Kornai's *exogenous* explanation of the SBC as a result of state paternalism becomes a specific case of time inconsistency and a lack of credible commitment.

The theoretical justification for the unified framework is open to discussion. Tensions between the exogenous and endogenous explanations of the SBC notwithstanding (Vahabi, 2011b), the two branches share at least two commonalities. First, analysis of the SBC is conducted within a dichotomous vision of the state versus private sector. Second, a pure decentralized market economy is considered to be a benchmark of the hard budget constraint (HBC) and efficiency. Consequently, nationalization tends to soften the budget constraint whereas privatisation and decentralization tend to harden the budget constraint.

The practical implication of this result was extremely important for both the developing countries experiencing the post-socialist transition and those embarking on macroeconomic adjustment and structural reforms during the last two decades.

The SBC was particularly pressing in Romania, Russian Federation, China, Albania, Azerbaijan, Tajikistan, Belarus, etc. (Kornai, 2001; Li, 2008). Five main groups of instruments which led to the SBC in the post-socialist transition were: 1) fiscal subsidy; 2) soft taxation; 3) soft bank credit (non-performing loans); 4) soft trade credit (the accumulation of trade arrears between firms); 5) wage arrears. The Washington consensus held that the 'Holy Trinity' of liberalization, privatisation and stabilization would suffice to produce an efficient market. The advocates of the SBC theory emphatically argued that the hardening of the budget constraint should be given equal priority with these.

Many empirical studies demonstrate the existence and deleterious effect of the SBC syndrome in the public sectors of non-socialist developing countries (Kornai, Maskin and Roland, 2003, pp. 1129-1130). The relevance of the hardening of the budget constraint was also highlighted theoretically for all the developing countries by many authors (Raiser, 1994; Anderson, 1995) and decision makers in international institutions (World Bank 1997, 1999; EBRD 2000, 2001). A considerable degree of government intervention in many developing countries, the particular importance of parastatals in industrial production, and the explicit goal of improving the working of markets during structural adjustment made Kornai's hypothesis a useful background against which the success or failure of many economic reforms could be studied.

Interestingly enough, the SBC was maintained in many developing countries which adopted structural and adjustment reforms and introduced a privatisation policy. However, the "privatisation" was nothing but the transfer of property rights to the parastatal sector which often was controlled by the military or religious elites. One salient illustration is the Islamic Republic of Iran.

The 'Adjustment Program' and the 'Stabilization Program' were initially introduced as the first and second quadrennial programs during the two periods of presidency of Ali Akbar Hashemi Rafsanjani (1989-1997). The two programs contained a "privatisation" policy. Accordingly, the fourth Majlis (1992-1996) of the Islamic Republic of Iran passed a law in 1994 authorizing the government to sell the state enterprises in different ways. The law stipulates that *Isargaran* (sacrificers), namely those who devoted themselves to the war, prisoners of war, and relatives and members of those who were killed in the war have the priority to own privatised enterprises. In this way, the 'privatisation' trend consists in transferring state enterprises to the religious Foundations (Bonyads) or to the parastatal sector (Adeli, 2004, pp. 474-75). In the same vein, the July 2006 intervention of the Supreme Leader, Seyyed Ali Khamenei, in favour of privatisation was preceded by the conclusion of two important contracts with Bonyads and *Sepah* (the Revolutionary Guard) for the construction of Lines 6 and 7 of Tehran's subway that amounted to a total sum of two and a half billion dollars. Finally, the Tehran Stock Exchange (TSE) is principally a market for the parastatal sector. Jbili, Kramarenko, and Bailen (IMF, 2004, p. 44) noted "Most listed companies [in TSE] are parastatal enterprises with a varying degree of direct and indirect government ownership" (the phrase in brackets is added). The persistence of the explicit and implicit SBC is one of the main features of the parastatal sector that has extended in the name of privatisation.

This paper explores the SBC in the parastatal sector. The parastatal sector is a sort of chameleon; it is neither 'private' nor 'public' and enjoys the advantages of both state and private sectors. This explains why a dichotomous vision of market versus state is inappropriate for analysis of the prevalent SBC in the parastatal sector. Clarifying the SBC in this sector requires exploring the political aspects of the SBC.

Most SBC models postulate a benevolent (paternalist) state; only a minority assumes a malevolent or predatory state. However, even this minority assumes an *efficient* predatory state² in which the Coase theorem (Coase, 1960) is applicable. But what about the parastatal sector in a predatory state that systematically chooses inefficient policies? Extension of the Coase theorem to politics precludes such a scenario (Vahabi, 2011a). However, religious and military foundations (Bonyads) in Iran and Milbus (military business)³ in many Middle-Eastern and African countries exemplify the SBC in the parastatal sector under inefficient predatory regimes. Furthermore, even within a democratic regime, rent-seeking activity of public authorities is not excluded. The Federal National Mortgage Association (FNMA or “Fannie Mae”) and the Federal Home Loan Mortgage Corporation (FHLMC or “Freddie Mac”) in the U.S. are emblematic examples of the SBC in the parastatal sector under a democratic regime.

In this paper, I will examine the peculiar features of the SBC in the parastatal sector, focusing on two examples: 1) religious and military foundations in Iran; and 2) Fannie Mae and Freddie Mac. I will demonstrate that the SBC of the parastatal sector can be understood as *the political economy of a predator state or rent-seeking activity*.

This result has important practical implications. Hardening of the budget constraint in the parastatal sector requires nationalizing parastatal assets, transparency, and democratic control

² Following Buchanan, it is difficult to reconcile ‘efficiency’ with predation. The efficiency criterion is inapplicable in cases of coercive power: “To the extent that potential traders are coerced, either by prohibitions on their ability to make enforceable contracts or by the imposition of non-compensated transfers, no conclusions about value-maximizing resource use can be drawn because the rules permit no test” (Buchanan, 1987, p. 158). Although in this paper I use the term ‘efficient’ (or ‘inefficient’) predatory states in reference to the existing literature, I do not adhere to the theory that underpins this distinction.

³ I adopted Siddiqa’s definition of Milbus as “military capital used for the personal benefit of the military fraternity, especially the office cadre, which is not recorded as part of the defence budget or does not follow the normal accountability procedures of the state, making it an independent genre of capital. It is either controlled by the military or under its implicit or explicit patronage.” (2007, p. 5)

over this sector's activity. In a symbiotic vision of the market and the state, nationalization might be a source of HBC. This finding mitigates one of the major predictions of the standard SBC literature, according to which nationalization usually works to soften the budget constraint.

The remainder of this paper is organized into four main sections. Section 2 explores the political aspects of the SBC and demonstrates that the assumption about the nature of the state is fundamental in explaining the origins and persistence of the SBC. Section 3 is devoted to soft budget constraints in the parastatal sector under an authoritarian regime, or under a systematically *inefficient* predatory state. I will elucidate this point by analyzing religious and military foundations under the Islamic Republic of Iran. Section 4 focuses on the SBC of the parastatal sector under a democratic regime. It also discusses the sources of the SBC in behemoths such as Fannie Mae and Freddie Mac in relation to the recent subprime crisis. Section 5 identifies the SBCs in the parastatal sector as the political economy of predatory or rent-seeking activity, and shows that hardening of the budget constraint might be achieved through nationalization. Section 6 presents conclusions.

2. Political aspects of the SBC

At least two conceptually separable elements are involved in the essential SBC problem: one is related to *economic power* relationships and the other is associated with *political power relationships*. The first involves the exercise of economic power due to a monopoly position in the market, or asymmetrical information between agents. The second refers to particular formal authority relationships between superiors and subordinates in a vertical or hierarchical structure.

Kornai, Maskin, and Roland (2003) highlighted the importance of adverse selection and moral hazards in generating soft budget constraints in both socialist and capitalist economies. However, asymmetrical information is not the only problem leading to the SBC. The second problem is a political one at the heart of the SBC syndrome; it is related to the differences in goals between the government and firms. Stigler's theory of the market capture highlights the effects of lobbying on economic performance (Stigler, 1971).

These two problems cannot be completely separated in reality, so in many models the SBC is defined both in relation to the asymmetrical information structure and the asymmetrical objective functions. Nevertheless, they can be conceptually separated. When considering the asymmetrical objective function, the nature of the government becomes crucial.

In their analysis of the size of nations, Alesina and Spolaore (2003) distinguished between three different types of government. The first is a *benevolent* government that maximizes a collective utility function. Here, politicians are assumed to be ideal social planners who maximize social welfare. The second is a *democratic* government, which can be described as a government of free citizens who can vote for government policies and political borders. In economic jargon, public policies are determined by the utility function of the median elector. The third is a *predatory* government, or what the authors labelled 'Leviathans'. Here, "decisions are taken by rent-maximizing governments who care about their own welfare, and that of their close associates, rather than the welfare of their citizens. Following a tradition that goes back to Thomas Hobbes (1651), we will call such governments 'Leviathans'" (p. 69). Because Leviathans do not follow the elective principle, they are exposed to insurrection threats, a point that was particularly stressed by Acemoglu and Robinson (2000). They interpreted the extension of voting rights to larger fractions of the population as a consequence of a problem of insurrections for absolute monarchs in the 19th century.

Accordingly, predatory governments or Leviathans maximize their rent-seeking utility function under the constraint of the non-insurrection condition.

The SBC literature excludes the democratic state but includes two other types: the benevolent (paternalist) and the malevolent (predatory) states.

In the benevolent (paternalist) case, softness cannot be explained by the internal interests of the government, so the softness explanation would be *exogenous*. Three types of models may be grouped into this category: 1) the Kornai and Weibull (1983) model of the SBC as *ex post* bailouts; 2) the externality models (Segal, 1998; Daveri and Panunzi, 1997; Wildasin, 1997); and 3) the insider control model (Li, 1998).

All these models focused on *ex post* bailouts or *ex post* state intervention. However, an *ex ante* state intervention may also lead to the SBC. If an economic unit obtains some subsidies, tax reliefs, preferential loans, etc. before the start of the financial period, its budget constraint is soft in a preliminary sense. Based on this observation, Szabó (1988) distinguished between the *preliminary (ex ante)* and the *incremental (ex post)* softness of a budget constraint. The exogenous explanation of the SBC focused on ‘incremental’ rather than ‘preliminary’ softness⁴.

Some studies of state subsidies have rejected the paradigm of benevolent government in favour of a positive theory of government or a ‘malevolent’ (predatory) government maximizing the interests of governors under the constraint of non-insurrection. The most notable of these studies is Becker’s (1983) paper, which developed a theory of competition for subsidies among self-interested pressure groups. These groups choose the level of rent-seeking activity, which determine transfers through an exogenously given (‘black-boxed’)

⁴ It should not be forgotten that socialist and capitalist economies include some *strategic* sectors or *strategic priorities* in producing some products or services, leading to a preliminary softness of budget constraint.

political influence function (Vahabi, 2011a). This second assumption leads to an *endogenous* explanation of the political aspect of the SBC syndrome. The Public Choice Theory develops this *endogenous* explanation of the SBC.

The political aspect of the SBC is particularly relevant when softening of the budget constraint becomes a matter of strategic behaviour of the rent-seeking Leviathans. In this case, the *ex ante* SBC is as significant as the *ex post* SBC. Anderson (1995) noted the political origins of soft budget constraints in the Middle East, arguing that because of the political importance of non-market, concessional, or politically-motivated external financing in the Middle East after the Second World War, regimes in this region came to participate in the international system in much the same way that managers of state-owned enterprises operate in socialist economies.

The importance of these political considerations regarding the relationship between states notwithstanding, economists have tried to capture the political element of the SBC in the particular relationship between the state and firms. Boycko, Shleifer, and Vishny (1995, 1996) focused on this aspect of the SBC problem.

In their analyses of the relationship between politicians and managers, Shleifer and Vishny (1993, 1994) and Boycko, Shleifer and Vishny (1996) illustrated the Coase theorem by stressing the role of *corruption* in raising efficiency. When side-payments in the form of bribes are allowed, managers and politicians choose the outcome that, from their joint perspective, is the most efficient. Bribes divide the surplus between managers and politicians according to the Nash or some other bargaining solution. In this sense, corruption can be compared to *reputation* in providing a mechanism for contract enforcement. However, as Shleifer (1994) argued, in transition economies the horizons of politicians are often too short to develop a reputation for efficient bribe-taking.

It should be noted that in this case, corruption is to some extent exempt from *renegotiation*. Because corruption is illegal in most societies, both the giver and the receiver of a bribe risk going to jail. This type of analysis of property rights as both control and cash flow rights has largely contributed to the understanding of some informal institutions such as corruption; it *endogenises* the political aspects of the SBC and tries to show that the inefficiency of public firms is related to the agency problem with politicians rather than with managers. “We believe that managerial discretion problems are usually minor relative to political discretion problems. Privatisation works because it controls political discretion” (Boycko *et al.*, 1996, p. 318).

Hence, the softness of the budget constraint is a strategic choice of politicians who maximize a particular kind of ‘political function’, whereas managers as profit-maximizers are more prone to maintain a HBC. It should be stressed that in this line of analysis, although *the state is assumed to be predatory, it is an efficient predatory state because the political Coase theorem is applicable* (Vahabi, 2011a).

A theory about an ‘efficient’ predatory state or a ‘Political Coase Theorem’ (PCT) has important practical implications with regard to privatisation. In the early phases of market reform during post-socialist transition, privatisation of state property had pride of place. Borrowing from the Coase theorem, one major argument for the rapid privatisation in Russia was that the achievement of initial property rights was less important than the establishment of property rights and free exchange. Advocates of speedy privatisation, inspired by the Coase theorem, were convinced that the inefficiencies and injustices in the initial stages of property distribution would eventually be automatically corrected as long as the market for property rights functioned properly. “The Coase theorem shows how efficiency can be restored, but only if property is protected and contracts are enforced (Boycko, Shleifer and Vishny, 1995,

p. 27).” After a sequence of exchanges, property rights will be reallocated to the party who offers the highest bid, i.e., the most efficient owner.

Rapaczynski summarized a similar line of argument about the rapid privatisation in all post-Soviet economies (PSE): “Governments’ intent on fostering a market economy should thus make sure to put an effective legal system in place, one in which property rights are unambiguous, secure and freely alienable. Even if the state gets some of the initial endowments wrong, it is often added, the Coase theorem instructs us that the parties, if free to contract, will correct this by appropriate private agreements” (1996, p. 89). This prediction has now been clearly proven false.

State failure and a lack of market infrastructure prevented the correction of flaws in the initial distribution of property rights through Coaseian bargaining mechanisms. As a result, inefficient forms of corporate governance have persisted far longer than predicted by the Coase theorem.

Table 1 identifies the nature of the state in various SBC models.

Table 1. Benevolent and Malevolent (predatory) states and the SBC.

Type of SBC	Cause of SBC	State type	Authors
<i>SBC ex post</i>	Paternalism	Benevolent state	Kornai and Weibull, 1983
<i>SBC ex post</i>	Externalities (too big to fail)	Benevolent state	Segal, 1998; Daveri and Panunzi, 1997; Wildasin, 1997
<i>SBC ex post</i>	Insider control	Benevolent state	Li, 1998
<i>SBC ex post</i> and <i>SBC ex ante</i>	Rent-seeking	Efficient predator state (application of the Coase theorem, 1960)	Boycko <i>et al.</i> , 1995, 1996; Shleifer and Vishny, 1993, 1994

My theoretical framework assumes a predatory state, as do the endogenous models of the SBC. Nevertheless, I introduce two major modifications:

- 1) My framework assumes that predatory states and lobbying are inefficient, because the Coase theorem (1960) is not applicable with regard to the relationships between the state and the ‘parastatal’ sector (Vahabi, 2010a, 2011a).
- 2) My framework is based on a symbiosis of state and market, in which a parastatal sector develops. This sector has a chameleon-like character (neither public nor private but with the advantages of both state and private sectors). It has an indeterminate status, with multiple Agents and Principals pursuing contradictory objectives.

The next section presents the peculiar features of the parastatal sector under an inefficient predatory state.

3. Parastatal sector under an authoritarian regime

Since the 1980s, parastatal sectors have emerged in many Middle-Eastern and African countries. A parastatal sector has a chameleon-like character and has a SBC under an inefficient predatory state. Examples abound: religious and military foundations in Iran (Vahabi, 2010b; Mohajer and Vahabi, 2011), health and agricultural sectors in Malawi (Chirwa, 2002); the military sector or Milbus in Egypt, Pakistan, and Turkey (Siddiqa, 2007); and many other sectors throughout the Middle East (Celasun, 2001) and Tanzania (Skoog, 2000 and Fischer, 2006).

Kuran (2001, 2003) explored the relationship between religious foundations and Waqf within the Islamic system of public goods provision. Acemoglu and Robinson (2005), North (1995), North, Wallis, and Weingast (2009) studied the importance of the military sector under authoritarian or 'natural states'. In the same vein, I identified the peculiar features of religious and military foundations in the Middle East and particularly focused on the Iranian *Bonyads* (Foundations) in post-revolutionary Iran, which involve the SBC (Vahabi, 2010b; Mohajer and Vahabi 2011). I found that property rights in the parastatal sector are indeterminate; here, 'indeterminate' properties refer to booty from warfare and looting, or property confiscated during a revolution. Although this kind of property can be transformed into 'public,' 'personal,' 'private,' 'combinatorial,' or other types of ownership, their initial status remains indeterminate. For 'indeterminate' properties, entitlement to property rights depends on the discretionary power of the coercive authority. Appropriative allocation leads to indeterminate property.

Bonyads are considered 'para-governmental' (Saeidi, 2004), or 'parastatal foundations' (Maloney, 2000). Many Bonyads exist; the most prominent are Bonyad-e Mostazafan va Janbazan (BMJ, Foundation of the Oppressed and Self-Sacrificers) and Bonyad-e Shahid

(Martyrs' Foundation)⁵. The BMJ was set up after the confiscation of the assets of the late Shah and 53 industrialists exiled in the aftermath of revolution, in conformity with Khomeyni's injunction that referred to these assets as 'spoils' and specified that 'they must be kept and controlled separately from state properties' (Saeidi, 2004, p. 484).

The size and scope of the BMJ is similar to that of a government (*New York Times*, Jan. 8, 1995). With holdings worth 12 billion U.S. dollars, the BMJ constitutes the largest non-state sector in the Iranian economy, second in size only to the National Iranian Oil Company⁶ (Smith, 1997; Maloney, 2000). Due to complete opacity, no accurate information is available about Bonyad's activities, but an economic report published by the French Embassy estimated that its various branches contribute 7–10% of the Iranian GDP (Ambassade de France, Mission Economique, 20 June 2006).

The BMJ operates like a holding, with many enterprises extending into almost all sectors of the economy: mining, housing, manufacturing, trade, shipping, transportation, airline, tourism, agriculture, food industry and soft beverages, etc. Recently, it has been strengthening its position in the energy (including hydrocarbon) and communication (as the second-largest Iranian mobile operator, etc.) sectors. However, the institutional status of this giant holding has chameleon-like characteristics. It can change at will, acting as a private economy when buying privatised firms, but going 'public' to control such 'strategic' businesses as the national shipping line, enshrined in the Iranian constitution as a publicly-owned agency.

⁵ This Foundation was established a month after the 1979 revolution to support the surviving relatives of the martyrs and disabled veterans of the revolution and later the families of the martyrs of the eight-year war with Iraq. For a more detailed report, see *Encyclopedia Iranica*, 1987, pp. 360-61; Maloney, 2000, pp. 151-2; Saeidi, 2004, pp. 488-490. For some recent official data regarding its activities as well as a similar Bonyad, the Imam Khomeyni Relief Aid Committee, see Sazman Modiryaat va Barnameh Rizi Keshvar *Salnameh Amari Keshvar 1383* (The Annual Statistics of the Country) 2004, pp. 551-2, 565-571.

⁶ Saeidi (2004, p. 493) noted that the total budget of the foundations was estimated at nearly half the government's national budget, 6000 billion rials, at the end of the 1980s.

This chameleon-like position is the result of its indeterminate property structure: it is neither private nor state-owned. In terms of legal status, the Foundations have been described as public, non-governmental organizations. This classification is somewhat paradoxical, but it does reflect their ‘indeterminate’ nature. With no governmental discretion over their expenses, no shareholders, no public accounts, and no well-defined legal status, they have been operating autonomously from the government. However, as professed ‘charitable’ organizations, they have been benefiting from tax exemptions (IMF Staff Country Report, 1998, p. 26), preferential bank credits, subsidies, and special ‘quasi-budgetary redistribution’ (Coville, 2002).

Despite the historical defence of the *waqf*⁷ (Islamic religious endowment) by the ulama, the Foundations as ‘charitable’ organizations are not attached to any religious institution. Of course, they are absolutely loyal to the supreme leader and to local religious leaders who act as their representatives, but they are unconnected to the clerical Shiite hierarchy and the traditional religious networks: “the Bonyad-e Mostazafan operates, for all intents and purposes, outside the scope of both the traditional religious power structure and the government” (Maloney, 2000, p. 157). The *waqf* continue to command vast amounts of resources in the Islamic Republic; and the Bonyad-e Astan-e Qods, which manages the endowments related to the shrine of Imam Reza at Mashhad, owns property all over the country⁸. In contrast to the Shah’s regime, the Islamic Republic has guaranteed the independence of *waqf* from the government; but the Foundations maintain their autonomy from both the government and the traditional religious hierarchy.

⁷ For an analysis of *Waqf* as a credible commitment device to give property owners economic security in return for social services, see Kuran (2001).

⁸ For a historical account of Astan-e Qods-e Razawi, see Mawlawi, Mostafawi, and Sakuurzada, 1987, pp. 826-837.

What are these Foundations, and to whom do they belong? They own ‘confiscated’ properties (‘spoils’ in Khomeini’s terminology) that could have been transformed into private or state properties, but were not. Contrary to the dominant view, the state sector in post-revolutionary Iran does not resemble the omnipresent state of the USSR. It would be easy to compare Iran to post-Soviet Russia, where the dismantling of an entrenched system of power and the concomitant rise of new political and financial magnates (powerful transitory ‘financial-industrial groups’) empowered an array of puissant clientelist networks, but unlike their Russian counterparts, the Iranian Foundations have not transformed into private monopolies.

Their permanent position as an ‘indeterminate’ form of property is a result of the extension of parallel institutions even into the Iranian economy under the Islamic Republic. “These organizations represent the dual power structure in Iran which reinforces the financial authority of religious leaders without accountability” (Saeidi, 2004, p. 479). They constitute the *authoritative* resources of theocrat leaders: they favour and empower the parallel military and paramilitary groups belonging to theocrats, and enrich the military and religious elites, and thence reproduce the authority of the Supreme Leader and theocrats (Mohajer and Vahabi, 2011). They enjoy an almost unconstrained capacity of intervention in the Iranian economy and in political competition between different factions, and may be described as ‘a state within a state’ (Scheuer, 1994).

In the presence of oil resource wealth, a weakened state, less foreign aid, and pressure for economic liberalization, religious and military elites found it optimal to deinstitutionalize the state and formal bureaucratic mechanisms in favour of a parallel “shadow state” under their own control. Parastatal sector is the result of this deinstitutionalization of the state and its SBC stems from the predatory activities of elite groups on the state resources

The close relationship between the BMJ and the Iranian security apparatus and its institutional authority was confirmed by the appointment of Mohsen Refiqdust, the former commander of the Revolutionary Guard (*Sepah*), to lead the Foundation in 1989. Due to non-accountability and total opacity with regard to its activities, widespread corruption in the BMJ and its diverse branches involving Refiqdust's brothers and many other directors led Refiqdust's replacement by former Defence Minister Mohammad Foruzandeh in July 1999 (see *The Economist*, Sep 25, 1993; *The New York Times*, Jan 8, 1995; *Financial Times*, Jul 17, 1997; Saeidi, 2004, pp. 495-98).

When Foruzandeh took up his post, he announced that 80% of its 350 companies were losing money. However, the state bailed out all of these enterprises. This *ex post* SBC was complementary to the *ex ante* SBC that had benefited the Bonyads. The colossal sum of the *ex ante* SBC was mainly guaranteed through bank credits, preferential exchange rate for U.S. dollars, and tax and custom tariffs exemptions.

During Refiqdust's direction, the organizational connections between the Revolutionary Guard and the BMJ developed substantial involvement in weapons procurement and production. For example, "the Bonyad's heavy presence in legitimate mining and chemicals production allegedly camouflage IRGC [the Revolutionary Guard] chemical weaponry plants. In addition, German intelligence sources contend that the MJF [Bonyad] has utilized a network of sham enterprises to acquire inputs for the Revolutionary Guard's defence industry (...) In addition, the foundation apparently undertakes international endeavours that transgress the traditional definition of trade - the MJF is commonly cited as a generous supporter and active political patron of the Lebanese terrorist organization" (Maloney, 2000, pp. 159-160).

Close examination of the Foundations in Iran reveals that they promote 'destructive creation' which is the exact opposite of Schumpeter's 'creative destruction'. Schumpeter (1951,

Chapter VII) referred to the process of capitalist development as ‘creative destruction,’ meaning the destruction of old products, past processes of manufacturing, and archaic forms of organization through the introduction of new products, ways of producing, and organizational methods. Destructive creation is the opposite of ‘creative destruction,’ and refers to the production of destructive means and the necessary infrastructure and skills related to such means so that authoritative resources and relationships can be reproduced.

The main characteristics of the parastatal sector, which is permeated by the SBC, can be summarized by five features:

- 1) Property rights are indeterminate, which allows the development of personal ownership of the assets by predators, particularly the religious and military elites.
- 2) Parallel institutions, a fragmented political order, or a situation of a ‘state within state’ constitute the *sine qua non* political condition for the development of this sector.
- 3) The multiplicity of Agents and Principals results in opacity with regard to the identity of decision-makers concerning the disposal of parastatal assets.
- 4) This sector is based on the inseparable character of politics and economics under an authoritarian regime.
- 5) Enhancement of this sector is closely associated with the populist quasi-budgetary policies of revenue redistribution that aim to attract support from marginal and deprived layers of the population.

In summary, the parastatal sector is contradictory to the impersonal rights of all citizens. It is a major impediment to the development of a genuine private sector as well as to the

institutions of a welfare state such as social security. *The SBC of parastatal sector is the outcome of the political economy of an inefficient predatory state.*

4. Parastatal sector under a democratic regime

According to Kornai (1993), the SBC is closely related to the predominance of state property, whereas private property has a natural affinity to HBC. Capitalism is considered to be the counter example of the SBC.

In contrast to this vision, the American model of capitalism, with its enduring New Deal institutions, is replete with examples of the SBC. The institutions in question are neither purely private nor wholly public. *They are, rather, hybrids, even chameleons:* “private economic activities supported, leveraged, guaranteed, and regulated by public power; public institutions aided, abetted, and buttressed by private money. They are elements of an American social welfare state but dressed up, in characteristically American fashion, in the guise of a market system” (Galbraith, 2009, p. 104).

Galbraith estimated that these institutions in health care, higher education, housing, and social security together compose nearly 40% of the total consumption of goods and services in the United States. Taking into account the state’s intervention in the military, agricultural, and other sectors, the government is responsible for more than half the state’s economic activity. In other words, the market and the state are intertwined even in the so-called neo-liberal model of capitalism. The main issue is how the prevalent SBC in these sectors is run and to what extent the private sector is taking advantage of it.

For Galbraith, these sectors are run by a ‘Corporate Republic,’ which is a predator state. Although this assessment is controversial, the parastatal sector or what is commonly called ‘Government Sponsored Enterprises’ (GSE) played an undeniable role in the recent subprime

crisis. Congleton (2009) particularly highlighted the roles played by the Federal National Mortgage Association (FNMA or 'Fannie Mae') and the Federal Home Loan Mortgage Corporation (FHLMC or 'Freddie Mac') in the financial crisis.

After initial periods of federal support, all of these government-sponsored enterprises (GSEs) became more or less private entities. None had formal backing from the U.S. Government, although they were partly managed through government appointees and subjected to different forms of government oversight than other financial firms.

According to Congleton (2009, p. 291), "Most investors consequently believed that, if need be, U.S. taxpayers would back up the GSEs after they were "privatised," which proved to be correct in September 2008. The implicit backing of taxpayers allowed the FHLB, Fannie Mae, and Freddie Mac to borrow money at rates lower than other banks (about 0.4% less, according to Congressional Budget Office estimates). The GSEs also faced somewhat different regulatory constraints than ordinary investment banks. They were, for example, exempt from most state taxes and regulations, which provided an implicit subsidy of approximately a billion dollars. *These implicit subsidies to housing were not on the federal government's balance sheets, nor were the risks associated with the implicit guarantees of the federal government*" (emphasis added).

These institutions largely benefited from huge amounts of *implicit* subsidies or what Kornai dubbed the *ex ante* SBC before the crisis. According to Crippen (2001), the value of the implicit subsidies between 1995 and 2000 varied from \$6.8 to \$15.6 billion. Fannie and Freddie remained major players in the mortgage market even as they approached bankruptcy in 2007–2008. As expected, they were bailed out in the summer of 2008. The newly created

Federal Housing Finance Agency reported that “as of June 2008, the combined debt and (MBS) obligations of these GSEs totalled \$6.6 trillion, exceeding the total publicly held debt of the U.S. [government] by \$1.3 trillion. The GSEs also purchased or guaranteed 84% of new mortgages”⁹. They were also the beneficiaries of the *ex post* SBC.

Analysis of the origins of the *ex ante* and *ex post* SBC in this sector reveals the political economy of the recent financial crisis. In fact, the SBC can be explained by a trilateral consensus among regulators (politicians), interest groups, or lobbyists, particularly the senior managers at Fannie and Freddie and median voters.

A) Regulators or politicians

Following the 1992 law regarding ‘affordable housing,’ the Department of Housing and Urban Development (HUD) was placed in charge of the GSEs. HUD encouraged the extension of loans to ‘underserved areas’ and for ‘low- and moderate-income housing.’ Accordingly, both Fannie Mae and Freddie Mac increased their loans and created a new market in ‘sub-prime’ (e.g., sub-standard) mortgages and mortgage-backed securities. This policy was implemented under both Presidents Clinton and George W. Bush for a simple reason: they could subsidise housing without the need for additional congressional approval or funds. Regulators or politicians could gain more votes from American citizens (median electors) by allowing them to realize their dream of being a homeowner, without facing any formal responsibility in front of the Senate or Congress regarding how loans were provided. *The ‘off-budget’ character of this parastatal channel of financing the housing was the source*

⁹ Source: www.fhfa.gov/Default.aspx?Page=4

of its softness. To put it another way, the parastatal sector could be used as an informal institution to avoid the restrictions and regulations of formal institutions such as the Senate and Congress.

B) Interest groups or lobbyists

The corporate governance of Fannie and Freddie reveals the inseparability of politics and economics in the way they are run. The President of the United States selects about a third of their boards of directors (5 of 17 for Fannie Mae and 5 of 18 for Freddie Mac); the rest are elected by stockholders. Among the most prominent lobbyists are the GSEs themselves and organizations representing commercial banks and realtor groups.

Until recently, the standing regulator of Fannie and Freddie, the Office of Federal Housing Enterprise Oversight (OFHEO, a department of HUD) was significantly politicized and deprived of sufficient ability to ensure efficient control. The politicized character of the regulator contributed to the lack of transparency and non-controllability of senior directors of Fannie and Freddie. According to a report published by the *Washington Post*, several high-paid top officials of Fannie Mae, including its CEO, were ‘encouraged’ to resign as a consequence of the OFHEO and the SEC investigations. The SEC and OFHEO subsequently fined Fannie Mae \$400 million in 2006 for manipulating its accounts from 1998–2002 to enrich its senior management (Day, 2006).

C) Median voters or American citizens

Home ownership is the major form of wealth accumulation for American citizens or median voters. Kennickell (2006, Table 11a) estimated that about two-thirds of the net wealth owned by Americans in the lowest 95% of the wealth distribution was home equity. Before the housing bubble burst in 2006-2007, the median voter (who is a home owner) was not interested in knowing how the subprime market was eased by Fannie and Freddie and how dangerous the consequences could be in case of a financial crisis. There was not much concern about the lack of control and transparency of 'off budget' channels financing the housing sector. This trilateral consensus was terminated with the burst of the housing bubble and the subprime crisis.

5. SBC and political economy of rent-seeking activity

In the preceding sections, I discussed the SBC in the parastatal sector under both authoritarian and democratic regimes. How do these cases diverge and what are their commonalities?

The two cases differed in three main ways.

First, the existence (or absence) of a state of law or a Weberian state that has monopoly over violence is a crucial difference between the two cases. The parastatal sector (Foundations) in Iran developed under Velayat-e-Faqih¹⁰ and not a Weberian state. Its very existence can be understood as an authoritarian resource for the domination of Shiite clergy and their military apparatus (*Sepah* or the Guardian of Revolution). The parastatal sector under a predatory state

¹⁰ The institution of Velayat-e-faqih or guardianship of the jurisconsult is Ayatollah Ruhollah Khomeini's legacy to Shiite political theory and praxis. "The jurisconsult, or supreme leader, is a highly esteemed cleric chosen by his peers on the eighty-six-member Assembly of Experts in recognition of his knowledge of fiqh, or Islamic jurisprudence, and his other religiopolitical credentials. The Supreme Leader's role is to guide Iranians (and, in theory, other Muslims) toward the just government of God. His powers are wide ranging. He is the Commander-in-chief of Iran's armed forces, may veto the President's decisions, and is charged with protecting the government's Islamic character" (Bakhtiari, 2005, p. 114).

is a 'state in a state,' run by elite groups who have access to coercive means. This sector is not subject to any law, because the formal state cannot credibly commit itself to enforce the law on violent enforcers.

Fannie and Freddie are institutions that developed under a state of law. A state of law does not accept political privileges for elite groups that are not universal. Thus, the autonomy of 'politics' and 'economics' is acknowledged with regard to the universality or impersonality of rights for every citizen (North, Wallis and Weingast, 2009). In fact, increased political accountability, at least in the short run, may induce politicians to choose less transparent instruments to maintain public support. The 'off-budget' practices under a democratic regime reflect this type of *implicit* or concealed SBC. Desai and Olofsgard (2006, p. 385) demonstrated that "democratic transitions can also expand the proportion of implicit subsidies in the total". Conversely, in an authoritarian or theocratic regime, the political privileges of elite groups (particularly the clergy and army) are translated in terms of economic privileges and *explicit* SBC.

The second distinction is related to the use of coercive means. The parastatal sector under a predator state increases the extent of military penetration into society and economy. Foundations (Bonyads) and Milbus develop profit-making through the privatisation of security. The members of other elite groups in the country accommodate the military's interests for mutual benefit. This is a case of collective over-plundering, a concept that can be explained better using Mancur Olson's theoretical framework of stationary and roving bandits (Olson, 2000). By engaging in collective over-plundering, the roving bandits impose negative externalities on the society, resulting in a depletion of resources. This will reduce *in fine* the share for bandits themselves.

Stationary bandits eschew this scenario by protecting society against roving bandits in return for economic gains. The military and civil elites come to terms through negotiations for mutual interests. However, this leads to an extension of military power in economic and social spheres. Examples of this kind of coalition abound¹¹. The parastatal sectors under democratic regimes do not promote the extent of military sector in society and economy.

Third, parastatal sectors under authoritarian regimes include almost every type of activity, regardless of size. Foundations are giant holdings that own small, medium, and large enterprises in almost every branch of economy from the food industry to petroleum, cell phones, and the automotive industry. In contrast with this vast and multi-sectoral penetration, the parastatal sector under democratic regimes is justified in the case of large economies of scale that are ‘too big to fail’ (Stern and Feldman, 2004; Mishkin, 2006).

This is not to claim that under democratic regimes, the SBC and its associated inefficiencies derive from the indivisibilities or externalities (‘too big to fail’). Demsetz (2011) correctly noted that the only source of inefficiency in the presence of indivisible goods and services is the strategic behaviour of agents (free-riding). My point is that the parastatal sector under a democratic regime has an *economic* rationale, notably large negative externalities in terms of social impact. Under an authoritarian regime, the existence of this sector obeys a *political* rationale.

These major divergences notwithstanding, the SBC in parastatal sectors under both democratic and authoritarian regimes arises from at least three common sources.

First, parastatal sectors under both types of political regimes enjoy both forms of SBC, namely *ex ante* and *ex post* SBC.

¹¹ See Saddiqa (2007) for a discussion of Milbus in Pakistan and other Middle Eastern countries.

Second, parastatal assets have an indeterminate status and a chameleon-like position between ‘state’ and ‘private’ sectors. The inseparability of politics and economics provoke asymmetrical objective functions between principals and agents. Political considerations often override economic efficiency maximization. To put it differently, the political ingredient of the SBC prevails.

Third, parastatal sectors promote parallel institutions, particularly formal and informal ones. Even under a state of law, group interests and lobbies can develop a coalition of ‘private’ businesses and ‘public’ officials as described in Stigler’s capture theory (1971). The parastatal sector blurs the frontiers between ‘private’ and ‘public’ to a greater extent. It provides fertile soil for the emergence of informal institutions due to the multiplicity of agents and principals with asymmetrical objective functions. When multiple principals are involved, it becomes difficult to identify who decides what. The ‘off budget’ procedures in the cases of Fannie Mae and Freddie Mac are good examples. The emergence of *eminence grise* is one result of informal institutions. While formal procedures and legal rules require transparency and accountability, informal rules and institutions encourage opacity and non-accountability. The lack of controllability is also strengthened by the politicized character of regulatory bodies that are in charge of GSEs.

In sum, the SBC in the parastatal sector reflects the political economy of an inefficient predatory state or rent-seeking activity within a democratic regime. How then can the budget constraint be hardened in this sector?

This issue requires analyzing the source of the softness. To date there is no consensus on which factors are responsible for the prevalence of soft budgets. As noted earlier, the SBC problem involves two aspects: economic and political. Exogenous and endogenous theories of the SBC that focus on the *economic* aspect usually recommend ‘privatisation and

decentralization'. Because the prevalence of soft budgets is attributed to government ownership, the HBC is related to a competitive decentralized private sector.

A second approach highlights the *political* aspect and considers the 'policy burden' (for example, maintaining employment) to be the main source of SBC (Lin, Cai and Li, 1998; Robinson and Torvik, 2006). The policy burden hypothesis predicts that privatisation will not eliminate the SBC problem if legacies of pre-reform policies are maintained. For instance, if enterprises are supposed to maintain full employment and provide other social security requirements, then the SBC will not be overcome by privatisation (Li, 2008).

Because the main source of the SBC in the parastatal sector is political, privatisation is not a solution for hardening the budget constraint in this sector. Analysis of the parastatal sector under an authoritarian regime reveals that nationalization of this sector is a first step toward defining property rights and clarifying the identities of Principal and Agent. This initial phase of nationalization contributes to transparency and monitoring of the parastatal sector without which no genuine privatisation can be carried out.

The state sector is more prone to the SBC compared with a decentralized competitive market, but it might be subject to a harder budget constraint in comparison with the parastatal sector.

Two radical reforms are required to transform the parastatal sector under an authoritarian or a theocratic regime:

- 1) *Establishment of a state of law, separation of state and religion, and democratization of political life so that a predatory state can be dismantled or controlled.* It should be emphasized that in regions like the Middle East in which religion and politics are not separated, religious foundations have a strong economic basis. Secularism is not only a political reform but also a major economic reform.

2) *Nationalization of the parastatal sector so that property rights can be clearly defined.*

The hardening of the budget constraint requires the nationalization of parastatal assets, transparency, and democratic control over activity in this sector.

Following the subprime crisis, hardening of the budget constraint warranted the nationalization of Fannie Mae and Freddie Mac. Although the presence of a state of law controls a state's predatory tendencies, the inseparability of politics and economics, the indeterminate character of property rights, the dual (formal and informal) structure of decision-making in the parastatal sector still lead to opacity and non-accountability. In the presence of a politicized regulator, strong lobbies, 'off budget' practices of public authorities, and a lack of appropriate bankruptcy procedures, nationalization of this sector has become the only panacea. The implicit insurance of Fannie and Freddie through off-budget guarantees without much oversight or review has already cost U.S. taxpayers more than one trillion dollars.

I fully concur with Congleton (2009, p. 297) that: "the Congress needs to create a GSE regulator with authority on a par with that of banking regulators, with a free hand to set appropriate capital standards, and with a clear process sanctioned by the Congress for placing a GSE in receivership." This regulator should be depoliticized.

6. Conclusions

Development studies would gain a broad conceptual framework by acknowledging the relevance of soft budget constraints to macroeconomic stabilization, structural adjustment, and privatisation in developing countries. Understanding the political ingredient of the SBC

may enable us to derive a set of conditions necessary for the sustainability and success of fundamental economic reforms.

By critiquing the dichotomous vision of exogenous and endogenous theories of the SBC, I explored the parastatal sector within an alternative theoretical framework based on a symbiosis of market and state.

My analysis produced two main findings. First, the SBC of the parastatal sector can be expressed as the political economy of a predator state or state's rent-seeking activity. Second, the dichotomy of SBC (related to state sector) versus private sector (associated with HBC) should be blurred. The budget constraint might be hardened through nationalization under specific circumstances.

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