



Munich Personal RePEc Archive

**Introduction of soft budget constraint to
analyze public administration reforms.
Some evidence from the Hungarian
public administration reform**

Rosta, Miklós

Corvinus University of Budapest

2015

Online at <https://mpa.ub.uni-muenchen.de/68473/>
MPRA Paper No. 68473, posted 21 Dec 2015 15:08 UTC

Introduction of soft budget constraint to analyze public administration reforms
Some evidence from the Hungarian public administration reform

Miklós ROSTA

Corvinus University of Budapest
miklos.rosta@uni-corvinus.hu

Abstract

Public management reforms are usually underpinned by arguments that they will make the public administration system more effective and efficient. In practice, however, it is very hard to determine whether a given reform will improve the efficiency and effectiveness of the public administration system in the long run. Here, I shall examine how the concept of the soft budget constraint (SBC) introduced by János Kornai (Kornai 1979, 1986; Kornai, Maskin and Roland 2003) can be applied to this problem. In the following, I shall describe some steps of the Hungarian public administration reforms implemented by the Orbán government from 2010 onward and analyze them, focusing on which measures harden and which ones soften the budget constraint of the actors of the Hungarian public administration system. In the literature of economics, there is some evidence-based knowledge on how to harden/soften the budget constraint, which improves/reduces the effectiveness and hence the efficiency of the given system. My conclusion is that the concept of SBC can significantly contribute to public management studies by deepening our knowledge on what public administration reforms lead to a more efficient and effective public administration system.

Keywords: Soft budget constraint, public management reforms, Hungary

Introduction

The goal of this study is to introduce the soft budget constraint (SBC) as an analytical tool in public management studies. The SBC syndrome became a household word in economic studies¹ in the wake of Kornai's works on the characteristic traits of the socialist system; the concept itself gradually made its way into other fields of the social sciences too, such as sociology², political sciences³, regional studies⁴ and international relations⁵ as well as in analyses of certain public services such as health care economics.⁶

The concept itself is applied in many ways. It is used for explaining the differences in the efficiency of private and public enterprises, the debt spiral in regional public administration, the emergence of the 2007/8 economic crisis, the problems in the efficiency of organizations

¹ I found 126 studies that used the concept of SBC in the 20 leading economic journals (with the highest 5-year impact factor).

² Cf., e.g., King & Sznajder (2006). I found 12 studies that used the concept of SBC in the 20 leading sociology journals (with the highest 5-year impact factor).

³ Cf., e.g., Tjerbo & Hagen (2009). I found 30 studies that used the concept of SBC in the 20 leading political sciences journals (with the highest 5-year impact factor).

⁴ I found 58 studies that used the concept of SBC in the 20 leading regional studies journals (with the highest 5-year impact factor).

⁵ Cf., e.g., Schultz & Weingast (2003). I found 51 studies that used the concept of SBC in the 20 leading international relations journals (with the highest 5-year impact factor).

⁶ Cf., e.g., Piacenza & Turati (2014). I found 18 studies that used the concept of SBC in the 20 leading health care economics journals (with the highest 5-year impact factor).

offering public services as well as for the various problems in the efficiency in economic policies such as tax policy measures, investment decisions, corruption and organizational sociology issues and the poor allocation policy of the European Union. The SBC syndrome is principally used in the context of its impact on the efficiency of the central government's operation. Interestingly enough, while the concept has been extensively applied in studies on public services, there seems to have been little interest in its possible application in analyses of the transformation of the state structure, i.e. in public administration reforms, aside from fiscal federalism and decentralization. In this article we demonstrate that SBC can be used for a better understanding of the overall goals of public administration reforms and for predicting their impact on the effectiveness and efficiency of public administration.

This study is organized as follows: First, I shall discuss the concept of SBC, followed by an overview of the impact of SBC on public administration organizations. In the same section, I shall demonstrate why politicians tend to contribute to the emergence of an SBC syndrome, despite the voluminous literature on its harmful effects. The next section covers the reform measures that can soften or harden budget constraints, illustrating these with examples taken from the post-2010 public administration reforms in Hungary. The last section concludes.

What is SBC?

The concept of SBC was introduced by János Kornai (1979, 1980, 1986, 1998, 2014) and his colleagues (Kornai, Maskin and Roland 2003). Initially, Kornai used this term for describing the socialist system. The SBC syndrome essentially means that an organization (such as a state enterprise or a local government) can realistically expect to be bailed out by another organization (e.g. a ministry) if it faces bankruptcy. The SBC syndrome emerges when the organization to be bailed out has the expectation that it will be bailed out and on the basis of which it changes its behavior (spends more than the budget constraint would allow). However, the bailout of one particular organization does not imply that a country's economy is characterized by SBC. The main issue is whether there exists a tradition of bailouts in a particular society – in other words, whether behavioral patterns typical of SBC have evolved.

SBC can be described as a social relationship between interacting organizations. We can identify two actors in this relationship: one in need of the bailout, the other willing to provide support. The two actors are not equal: their relationship is vertical because the organization requiring the bailout is at the mercy of the one providing the support, i.e. the former has a weaker, while the latter a stronger lobbying power. Many actors can be in need of a bailout, including profit-oriented companies (banks, multinational companies, sports clubs),⁷ public institutions offering public services (e.g. Hungarian hospitals in the last decade),⁸ local or regional governments (e.g. local governments in Hungary in 2012),⁹ private citizens (household forex debts in Hungary)¹⁰, countries (Greece)¹¹, non-governmental organizations, or even large-scale investment projects (e.g. underground railway construction in Hungary)¹². The central government is the prime rescuer, but banks and international and regional organizations (IMF, EU) and their foundations can also take on this role (Kornai 2014).

The two actors interact with different motivations. The organization in need of the bailout exceeded its budget constraint owing to the expansion drive after which, obviously, it starts looking for a supporting organization otherwise it would go bankrupt. The propensity to expand can also be noted in the central government's organizations, namely the ability for

⁷ Fogel, Morck and Yeung (2008), Storm and Nielsen (2012).

⁸ Kornai (2009), Levaggi and Montefiori (2013).

⁹ Cf. Baskaran (2012).

¹⁰ Bohle (2014).

¹¹ Katsimi, Moutos, Pagoulatos and Sotiropoulos (2014), Benczes (2011).

¹² Cf. Inderst, Mueller and Münnich (2007).

excessive bureaucracy (Downs 1967). State actors are also spurred to expenditures over their budget constraint because politicians have a predilection for softening budget constraints to increase their popularity, which is best illustrated the budgets of election years (Shi and Svensson 2006).

The motivations of the rescuing organizations can be quite complex. The central government can decide to rescue a particular organization for a variety of reasons. It can fear, amongst others,

- that the social cost of the bankruptcy of a large organization will be higher than the cost of the bailout,
- that the bankruptcy of a large organization will spill over to other sectors and cause economic recession,
- that the bankruptcy of a local or regional self-government will deprive the citizens living there of basic public services,
- that the bankruptcy of a large organization can precipitate a regional micro-crisis, which in turn would enhance inequalities that could lead to social tensions (Kornai 2014).

The ideal of solidarity and equity can also induce the central government to decide on a bailout. It can hardly afford to let citizens receive lower-quality health care services in certain regions because this would run counter to the ideal of horizontal equity. Another oft-voiced argument in support of bailouts is the protection of national interests: in these cases, the bailouts rescue organizations that enjoy a special nimbus or reputation, or perhaps a brand name, or their activity is crucial to national defense. In addition to the above, the creation of a clientele can push political decision-makers towards softening the budget constraints of certain organizations from public funds. These organizations are usually directly linked to the political decision-makers' person or their party. Finally, decision-makers can be tempted to soften the budget constraint if they can increase their own personal wealth, implying a close relation between SBC and corruption (Broadman and Recanatini 2002). We can also supplement this list with motivation of the politicians to hold in check the organizations of the public administration. The aim is not to strengthen the control over public administration but to establish a system in which loyalty and unconditional obedience are the key success factors.

According to Kornai (2014, 32-33), the SBC syndrome encourages wanton spending and reduces the price and cost sensitivity of decision-makers. Moreover it alters the outlook of the managers of organizations, whereby they devote less attention and energy to the organization's basic tasks (e.g. to quality and cost-effectiveness in the case of public services), and instead concentrate on fostering relations with potential rescuers (politicians) and use a part of their resources for serving them loyally. To the end of this process SBC undermines social morals and leads to a process of redistribution that many find unfair or inequitable.

Even though governmental decision-makers are aware of these hazards, they are incapable of truly committing themselves to hardening budget constraints. This is generally described as time inconsistency, and countless studies discussing SBC have been devoted to this issue (Dewatripont and Maskin 1995). In our viewpoint, however it is highly questionable whether politicians are candidly committed to pursue hard budget constraint because they would lose an effective tool to enforce loyalty from public administration.¹³

¹³ The literature of time inconsistency argues that while decision-makers appear to have serious intentions that organizations on the verge of bankruptcy that request help will not be financed any further, they are unable to keep their promise and repeatedly bail out organizations in trouble. Even though decision-makers' repeated bailouts aggravate the SBC syndrome because it socializes organizations that they will

What are the effects of SBC in public administration?

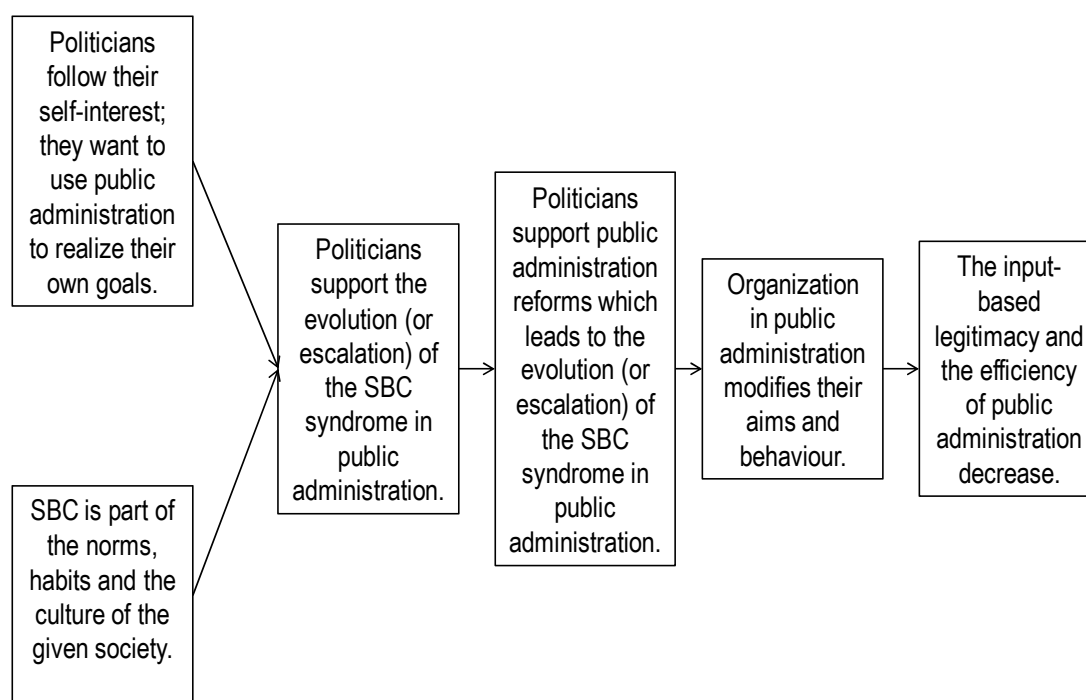
After introducing the notion we present our hypothesis why SBC evolves in the public administration and how it distorts the operation of the system. The SBC syndrome evolves in the public administration system when politicians send signals to the public organizations (in fact to the top officials of these organizations) that their survival depends solely on their loyalty to the political elite. Because the SBC syndrome transforms the motivations of the organizations, they will focus on serving the incumbent government's will and become blindly obedient. SBC modifies the goals of these organizations. Their primary goal will be to please politicians; citizens will lose their central role, meaning that the public administration's input-based legitimacy (Schmidt 2013) loses its importance. The distorted aims also change the behavior of public organizations. This can be captured in all processes such as HRM processes (professional skills are not as important as political loyalty), financial management processes (the focus is not on cost saving or increasing own revenues, but on gathering state funding), strategic management processes (strategy loses its importance since all important decisions are made at the political level). From now on, political connections rather than the improvement of performance are necessary for receiving additional resources and ensuring survival.

When the SBC syndrome is present, organizations of the public administration compete for stronger political connections and for receiving more political attention. Since the state has limited resources, this is a typical zero-sum-game competition which creates a milieu of mistrust between the organizations and hinders cooperation. Efficient vertical (hierarchical) coordination is a crucial question in a system, while horizontal coordination is mostly subsidiary.

Why do politicians trigger the SBC syndrome, if its impact on the public administration system is so negative? By using SBC as an incentive, politicians can maximize their power over the public administration system in the short run, which helps them pursue their personal or party interests (Shleifer and Vishny 1994).

Figure 1. The chain of causality in the evolution of the SBC syndrome in public administration

receive help in the future too, their decisions are also rational because the impact of the anticipated social problems without a bailout would be unforeseeable. This is why the central government provides help to local governments (a settlement's inhabitants cannot remain without public lighting) and bankrupt hospitals (a region cannot remain without health care), and completes construction projects despite the multiple budget expenditures.



Source: own compilation, but see also Table 1 in Kornai, Maskin and Roland (2004, 1107)

Following the description of the chain of causality, I shall review certain public administration reforms, which can promote the softening of the budget constraint of an organization in public administration. These reform measures are presented in Table 1.

Table 1. Reforms softening the budget constraint in public administration

Reform steps softening the budget constraint	How does the reform impact the organizations of public administration?
Centralization	Centralization may soften the local governments' budget constraint, because the central government may selectively subsidize some of the local governments, for instance those, where the mayor or the majority of the council are from the same political party as the central government.
Decentralization	Decentralization may soften the budget constraint of local governments since they have the incentive to exceed their budget constraint (Breuillé & Vigneault 2010).
Narrowing freedom of information (FoI)	By narrowing FoI, citizens lose opportunity to punish the opportunistic behavior of organizations and politicians. It increases information asymmetry, which also softens the budget constraint.
Using selective regulation on the allocation of financial resources	Ambiguous regulation itself softens the budget constraint. Regulations, which are not compulsory for all units of public administration, are the hotbed of SBC, because they broaden the room for the opportunistic behavior of organizations and politicians.
Weakening market competition	The market prefers efficient organizations and eliminates inefficient ones. Weakening the market pressure (eliminating competition) softens the budget constraint.
Less and unfair competition	The state can also demand competition for its grants.

for state grants	However, less or unfair and not transparent competition sends signals to organizations that performance is not a key factor to be successful. To the end the budget constraint of the organization softens.
Weakening internal control	Weaker internal control of performance increases opportunities for overusing financial resources and softens the budget constraint.
Weakening external control	Weaker external control of performance – by not applying any audit and reporting systems or by not employing any external controllers/auditors – also loosens the pressure on an organization to harden its budget constraint.
Reprivatization	Reprivatization prevents organizations from market competition. Since market hardens budget constraint, reprivatization softens it.
Decreasing the personal responsibility of decision-makers	Stronger personal responsibility of decision-makers not to exceed the organization's budget hardens the budget constraint. Weakening the personal responsibility softens the budget constraint.
Monopolization	Monopolies usually have softer budgets than organizations in oligopoly or competitive conditions. Monopolization eliminates competition and softens the budget constraint.
Blurring the boundary between politics and administration	By blurring the two spheres and by not giving them clear competencies softens the budget constraint. Separation is needed because politicians and public servants have distinct motivations. Both approaches are necessary for a well-functioning public sector, but the predominance of one over the other is harmful. If one becomes dominant, it may soften the budget constraint.
Restricting the freedom and autonomy in strategic planning	Autonomy in strategic planning at the organizational level makes the leaders of the organizations more responsible. With such autonomy, professional aspects are considered more seriously. Without these the budget constraint of the organizations softens.

Source: Own compilation

Please note that this list does not contain direct SBC steps such as bailouts or bad loans, but are rather reform measures that create institutional conditions for the emergence of the SBC syndrome. It must also be noted that both centralization and decentralization can be useful for hardening the budget constraint, but they can also foster the evolution of the SBC syndrome (Kornai, Maskin and Roland 2004, 1116).

After depicting the effect of the SBC syndrome in public administration, I shall demonstrate how public administration reforms can be analyzed in the context of SBC. Four different measures of the Hungarian public administration reforms introduced by the Orbán government after 2010 are taken as examples.

Some measures of the Hungarian public administration reforms

Four important measures of the Hungarian public administration reform are listed below, which serve as short case studies of how SBC can be used for analyzing the impact of public administration reforms.

1. *Establishment of County (Metropolitan) Government Offices.* The government created new, general-purpose, middle-tier administrative organs in each county and the capital city (Act CXXVI of 2010; Government Decree 288/2010 (XII. 21.)) headed by government commissioners who are explicitly political figures (oftentimes former MPs of the governing party) appointed by the Prime Minister. This reform step centralized the public administration system, hence these County (and District) Offices took over local governments' competencies, but simultaneously it deconcentrated territorially the medium level management of state administration. The County Government Offices took over not only some tasks from the local governments, but integrated seventeen different specialized administrative services (such as public health or veterinary authorities).
The aim of the politicians was to reinforce their power over the public administration by applying centralization and blurring the boundary between professionals and politicians. The reform increases the financial and personal dependence of the merged organizations from political actors. Due to the politicization the attention of these organizations changes: they focus more on actual political needs and professional considerations become secondary. These phenomena are typical signs of the presence of SBC; we can predict that the efficiency and citizen orientation of these organizations will decrease.
2. *Creation of mammoth agencies responsible for middle management in each sector.*¹⁴ The best examples of these agencies are the National Institute for Quality and Organizational Development in Health Care and Medicines (health care); Klebelsberg Institution Maintenance Center (public education); General Directorate of Social Affairs and Child Protection (social care).¹⁵ The purpose in the creation of these agencies is to strengthen the vertical coordination and the political control over these sectors, and also to standardize strategic management processes.
The means whereby the reforms were implemented are the following: (a) strong centralization of public services (health care, public education, social services) at the central level (the local level lost its importance as a public service provider); (b) organizational mergers and termination of organizations; (c) direct ministerial / political control over public service providers (politicization is so strong that even primary school or hospital directors are appointed directly by the ministers).¹⁶ The reform contributes to the escalation of SBC syndrome in the concerned sectors by politicization and centralization. Moreover by narrowing the autonomy of the public services providers and by decreasing competition between these organizations the government affirms SBC syndrome into these sectors.
3. *Radical elimination of the career-type civil service system.* After 2010, new acts on civil servants literally abolished all protection against arbitrary dismissal, and dismissal without any justification became possible (Act CLXXIV of 2010, §17, section 1). Although the Constitutional Court later annulled the most severe changes, the law continues to stipulate that a civil servant can be dismissed on grounds of unworthiness of office or loss of the superior's confidence (Act CXCIX of 2011, §63, section 2, points a and e). These steps

¹⁴ The central government took over from sub-national governments the key operational tasks of supervising primary and secondary schools and hospitals, and incorporated these institutions into sectoral mammoth agencies.

¹⁵ These are truly mammoth agencies: the Klebelsberg Institution Maintenance Center has 140,650 employees since all the teachers and the staff of primary and secondary schools are employed by the agency.

¹⁶ The unique characteristic of the system is that there is a strong personal dependence even at the lowest levels. As a result of centralized decision-making, local needs are not considered when appointing managers.

significantly contribute to blurring the boundary between politicians and bureaucrats, and lead to the over-politicization of the civil service. Moreover, superiors' ability to hire and fire contrary to the rule of law is barely limited. The aim of the reform is clear: to insure the loyalty and obedience of the civil servants to the incumbent government. This step converts the institutional environment and helps to evolve the SBC syndrome in the public sector. Since the behavior of the civil servants changes (focus on political instead of professional standpoints), it is easily forecasted that efficiency and citizen orientation will lose its importance.

4. *Modification of local governments' financial system.* The Orbán government cut back the financial autonomy of local governments and decreased their financial support. On the revenue side, the government radically decreased local government funding from 11.8% of GDP in 2010 to 10% in 2013 (Eurostat). The financial latitude of local governments was further narrowed by "earmarking" 100% of central governmental grants. Currently, local governments must obtain prior government approval when entering into commitments that give rise to debt. The most important shared tax, personal income tax, disappeared from the local government financial system, though it had been a key source of revenue since 1990. On the expenditure side, the resulting cut-backs are even more drastic. Total expenditure fell from 12.6% in 2010 to 7.5% in 2013 (Eurostat). These figures reflect the measures – discussed earlier – transferring key local public services under central government control.

Using SBC as an analytical tool sheds light on the some features of this reform step. Stronger control over the credit taking of local governments could harden the budget constraint. However, due to the selective decision making process (the government makes unique decision on each case) we cannot preclude that political interests distort the decisions so that the budget constraint of the local governments led by government party softens. We may also conclude that the centralization of the competencies of local governments hardens the budget constraint of local governments, however this is not true for the organizations which execute these tasks such as hospitals and primary and secondary schools.¹⁷

Conclusion

The aim of this paper is to shed light on the potentials of using SBC in the analysis of public administration reforms. First, I introduced the concept of SBC. In the second section, I focused on the possible effects of the SBC syndrome on the public administration system. The motivations of politicians and the means whereby the budget constraint could be hardened / softened were also examined in this section. Finally, I offered some examples of how SBC can promote a better understanding of specific public administration reform measures. I used four reform measures of the Orbán government.

When a reform measure softens the budget constraint or "merely" creates an institutional environment in which politicians have the power to makes public servants vulnerable to political influence at the operational level, the organizations of the public sector change their aims and their behavior. The SBC syndrome makes the public administration system simply a tool of the political power of the incumbent government. In that case, public administration obediently follows the commands of the political elite, without focusing on the trust of the citizens or on professional considerations.

¹⁷ It is highly questionable whether centralization hardens the budget constraint (Ben-Bassat, Dahan, and Klor 2013).

References

- Baskaran, T. (2012). Soft budget constraints and strategic interactions in subnational borrowing: Evidence from the German States, 1975–2005. *Journal of Urban Economics*, 71(1), 114–127.
- Ben-Bassat, A., Dahan, M., & Klor, E. F. (2013). Is centralization a solution to the soft budget constraint problem?. Available at SSRN 2163475.
- Benczes, I. (2011). Market reform and fiscal laxity in Communist and post-Communist Hungary: A path-dependent approach. *International Journal of Emerging Markets*, 6(2), 118–131.
- Bohle, D. (2014). Post-socialist housing meets transnational finance: Foreign banks, mortgage lending, and the privatization of welfare in Hungary and Estonia. *Review of International Political Economy*, 21(4), 913–948.
- Breuillé, M. L., & Vigneault, M. (2010). Overlapping soft budget constraints. *Journal of Urban Economics*, 67(3), 259–269.
- Broadman, H. G., & Recanatini, F. (2002). Corruption and policy: Back to the roots. *The Journal of Policy Reform*, 5(1), 37–49.
- Dewatripont, M. & Maskin, E. (1995): Credit and efficiency in centralized and decentralized economies. *Review of Economic Studies*, Vol. 62, No. 4, 541–555.
- Downs, A. (1967). Inside Bureaucracy. Rand Corporation. <http://www.rand.org/dam/rand/pubs/papers/2008/P2963.pdf>
- Fogel, K., Morck, R. & Yeung, B. (2008): Big business stability and economic growth: Is what's good for General Motors good for America? *Journal of Financial Economics*, Vol. 89, No. 1, 83–108..
- Inderst, R., Mueller, H. M. & Münnich, F. (2007): Financing a portfolio of projects. *Review of Financial Studies*, Vol. 20, No. 4, 1289–1325.
- Katsimi, M., Moutos, T., Pagoulatos, G., & Sotiropoulos, D. (2014). Greece: The (eventual) social hardship of soft budget constraints. *Changing Inequalities and Societal Impacts in Rich Countries: Thirty Countries' Experiences*.
- King, L. P., & Sznajder, A. (2006). The State-Led Transition to Liberal Capitalism: Neoliberal, Organizational, World-Systems, and Social Structural Explanations of Poland's Economic Success. *American Journal of Sociology*, 112(3), 751–801.
- Kornai, J. (1979): Resource-constrained versus demand-constrained systems. *Econometrica*, Vol. 47, No. 4, 801–819.
- Kornai, J. (1980). “Hard” and “Soft” budget constraint. *Acta Oeconomica*, 231–245.
- Kornai, J. (1986). The soft budget constraint. *Kyklos*, 39(1), 3–30.
- Kornai, J. (1998). The place of the soft budget constraint syndrome in economic theory. *Journal of Comparative Economics*, 26(1), 11–17.
- Kornai, J. (2009). The soft budget constraint syndrome in the hospital sector. *Society and Economy*, 31(1), 5–31.
- Kornai, J. (2014). The soft budget constraint: An introductory study to volume IV of the Life's Work series. *Acta Oeconomica*, 64(Supplement 1), 25–79.
- Kornai, J., Maskin, E. & Roland, G. (2003): Understanding the Soft Budget Constraint. *Journal of Economic Literature*, Vol. 41, No. 4, 1095–1136.
- Levaggi, R., & Montefiori, M. (2013). Patient selection in a mixed oligopoly market for health care: the role of the soft budget constraint. *International Review of Economics*, 60(1), 49–70.
- Piacenza, M., & Turati, G. (2014). Does fiscal discipline towards subnational governments affect citizens' well-being? Evidence on health. *Health Economics*, 23(2), 199–224.
- Schmidt, V. A. (2013). Democracy and legitimacy in the European Union revisited: input, output and ‘throughput’. *Political Studies*, 61(1), 2–22.

- Schultz, K. A., & Weingast, B. R. (2003). The democratic advantage: institutional foundations of financial power in international competition. *International Organization*, 57(01), 3–42.
- Shi, M., & Svensson, J. (2006). Political budget cycles: Do they differ across countries and why?. *Journal of public economics*, 90(8), 1367–1389.
- Shleifer, A., & Vishny, R. W. (1994). Politicians and firms. *The Quarterly Journal of Economics*, 995–1025.
- Storm, R. K., & Nielsen, K. (2012). Soft budget constraints in professional football. *European sport management quarterly*, 12(2), 183–201.
- Tjerbo, T., & Hagen, T. P. (2009). Deficits, Soft Budget Constraints and Bailouts: Budgeting after the Norwegian Hospital Reform. *Scandinavian Political Studies*, 32(3), 337–358.