STUDIES IN REGULATION

Regulating the Finances of State-Owned Enterprises in Central and Eastern Europe

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1. Regulating the Finances of State-Owned Enterprises in Central and Eastern Europe.

The soft budget constraint under central planning, market socialism and in the process of systemic transformation.[1]

SUMMARY

The paper starts with a reinterpretation of the debate between Janos Kornai and Stanislaw Gomulka on causes of shortages in the Soviet-type economies (STEs). Since bankruptcy makes no sense in an economy in which most of the means of production belong to the state and bargaining has replaced market mechanisms, the soft budget constraint must be considered to be a systemic feature of the STEs. Whether and to what extent the soft budget constraint has some negative consequences depends, however, on the degree of decentralisation.

The paper discusses both economic and political aspects of control of firms' finances and shows that the solution of the agency problem by regulation alone must lead to very disappointing results. What is more, despite far reaching changes in the last three years, there is still considerable continuity in respect of firms' behaviour in Central and Eastern Europe is concerned. Most importantly, this continuity may undermine the prospects of successful reestablishing of market economies in Central and Eastern Europe.

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1. Introduction

Even though examples of the soft budget constraint can be observed in market economies too, this concept was introduced by Kornai to explain why socialist economies were characterised by persistent shortages which in turn, in his opinion, constituted the most important difference between the two ways of organising economic activities: socialism and capitalism, command and market economies. The discussion with Gomulka, which followed the publication of Kornai's *The Economics of Shortage*, helped to make clear that the problem was not exclusively a financial one: attitudes and expectations played an even more important role. Their discussion will be summarized in part 2 of this paper, but in what follows some of the conclusions they reached will be questioned, because both authors have failed to explain properly the systemic character of the soft budget constraint or to take account of all its consequences, different and not always negative as they were. A more complete interpretation will be put forward, and in parts 3, 4 and 5 this will be used to analyse the softness of the budget constraints, not only under central planning but also under market socialism (*i.e.* in the reformed STEs and in the process of systemic transformation, begun in the late Summer of 1989 and itself an attempt to recreate market economies in the Western part of the former Soviet empire). Finally, the paper will point out the disastrous consequences that tolerating the soft budget constraint may have for systemic transformation in general and for privatisation in particular.

2. Kornai vs. Gomulka revisited

The concept of the soft budget constraint, while intuitively very appealing, is troublesome to formalise or make concrete. It is, moreover, very difficult to envisage a situation in which the budget constraint is absolutely hard, necessarily making our issue a matter of degree. Nevertheless, by introducing this concept, the two types of economic organisation (command and market economies) seem to gain some kind of common denominator, and for this reason difficulties with the concept have often been disregarded. Importantly, these difficulties did, however, stop attempts to make this concept a key element of the analytical framework within which functioning of the STEs might be discussed.[2]

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[2] Kornai's most recent book, *The Socialist System*, (Kornai, 1992) marks a symptomatic departure from treating the concept of the soft budget constraint in this way.

It is not easy to say who first used the phrase "soft budget constraint", but there is no doubt that at present it is almost exclusively associated with Kornai's interpretation of socialist economies of Central and Eastern Europe and of the former Soviet Union, as presented, *inter alia*, in his article in *Econometrica* (Kornai, 1979) and, most exhaustively, in the book *Economics of Shortage* (Kornai, 1980).[3] In the latter, to quote its review by Laski, Kornai seemed to have succeeded in his attempt *"to construct a theoretical synthesis for 'self-evident' facts, and ideas 'in the air'"* (Laski, p. 5).[4] However, one has to remember that, as indicated by its title, Kornai's book, as well as his polemic with Gomulka for that matter, concentrated on the problem of existence and persistence of shortages in the STEs and was, in the last analysis, an exercise in comparative economics.[5]

What does Kornai mean by the soft budget constraint? In his 1986 article he wrote that, *"the 'softening' of the budget constraint appears when the strict relationship between expenditure and earning has been relaxed, because excess expenditure over earnings will be paid by some other institution, typically by the state"* (Kornai, 1986, p. 21).[6]

Such relaxation can take many different forms, as for example:

- soft subsidies, adjusted to past, present or future cost overruns;

- soft taxation, as distinguished from predetermined tax schedules, regardless whether favourable or not;

- soft credit, not given on "conservative" criteria and easy to restructure;

- soft input allocation; and

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[3] A full bibliography of what Kornai wrote on the soft budget constraint would have to include almost everything he published since 1979. For a revised presentation of his main ideas see Kornai (1986).

[4] The reviews by Hare (1982), as well as those by Marresse and Mitchell (1984), also stress the synthetic character of Kornai's work.

[5] At the end of this part we shall return to the issue of how useful this concept is in comparative economics.

[6] Whether he meant any (competitive) cost over-runs, as Gomulka interpreted it, or only outright losses is not at this stage of key importance.

- soft administrative prices, set according to some permissive "cost plus" principle that almost automatically adjusts the price to costs.[7]

Among multiple consequences of softening the budget constraint, Kornai particularly stresses the following:

- the general price responsiveness declines;

- allocative efficiency cannot be achieved when input-output combinations do not adjust to price signals;

- within the firm there is not sufficiently strong stimulus to maximize effort: weaker performance is tolerated;

- excess demand is formed (Kornai, 1986, p. 26 - 27).

What is more, in a statement combining economics and psychology, Kornai wrote, *"the firm can start a project even though it may have the subconscious suspicion that the cost will be more than planned and the revenue less"* (Kornai, 1986, p. 28).[8]

In short, the essence of the soft budget constraint can be seen in *"situations when a decision making unit (a firm or another organisation) gets some external assistance from some large paternalistic institution"* (Kornai, 1986, p. 2). This assistance, however, *"is not usually granted automatically, as some effort is needed to obtain it"* (Kornai, 1986, p. 24).

The very existence of the soft budget constraint was also for Gomulka almost self-evident, and his attention concentrated on its consequences and not on the phenomenon itself or its systemic origins. According to him, and at variance with Kornai, the soft budget constraint does not have to cause shortages for consumer goods. The latter are everywhere, including also under socialism, a consequence of insufficient flexibility of prices: *"since the soft budget constraint is so universal*

[7] One has to notice immediately that, firstly, according to Gomulka prices are not flexible enough to eliminate shortages and, secondly, it is difficult to square Kornai's statement with relatively high price stability in centrally planned economies.

[8] This is stated very delicately. I would argue that underestimation of costs and overestimation of future revenues were very widespread and deliberate because both were used in the process of bargaining for financial and material resources necessary to invest. The most important goal was to start a new investment or a modernisation process because afterwards, in a sense, it had to be continued. This was true both of individual enterprises *vis a vis* "their" ministries as well as of various ministries *vis a vis* central planners.

a phenomenon while shortages are not, the latter cannot be simply an effect of the former. Kornai clearly implies that the key variable is not budget softness as such but its degree, shortages appearing only when that degree is sufficiently high. The problem that arises immediately is that his descriptive definitions are not enough to provide a convenient measure of that degree" (Gomulka, [1985], 1986, p. 76). Shortages are therefore explained by the government's reluctance, for political and/or ideological reasons, to raise some important prices. In other words, shortages follow insufficient flexibility of prices. Administrative reasons -- for example, the fact that in any modern economy there are too many prices to handle their adjustments speedily and efficiently in response to changes in their determinants -- play an important role too, as does the fact that market clearing prices would have to be guessed by central planners.

Kornai, however, did not *"believe that price increase leads unconditionally to less shortage! It may or may not - you are in the hands of those who decide on supply and on 'siphoning off'"* (Kornai, 1985, p. 9). In his answer to Gomulka's criticisms[9] he continues as follows:

It is not a financial issue, in the narrow sense. SBC is the expression of a certain type of behaviour. The decision maker has a subjective perception of the probability distribution of external assistance in the event of financial trouble. The higher the perceived subjective probability of receiving external assistance, the softer the budget constraint. In other words: softness/hardness is a part of the decision-maker's expectation.

The softness/hardness (the stringency) of the BC refers - to use a Marxian term - to a social relationship between the paternalistic State and the firm which is its client. This is highly visible and extreme in the relationship between the Socialist State and the State-owned firm but it may appear usually in a much weaker form - in other relationships as well. A very important element of the SBC syndrome is that external assistance is a matter of bargaining for more subsidy, tax-exemption, for permissive administrative prices etc. Everything is negotiable not on the market, but with the patronizing bureaucratic institutions (Kornai, 1985, p. 50).

This, firstly, shows that Kornai overstressed the financial elements in Gomulka's criticism and, secondly, contains two very important pieces of information: that the soft budget constraint is a consequence of the paternalistic character of the socialist state, and that there bargaining replaces market relationships.

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[9] Paradoxically enough, the empirical evidence provided by Kornai does not reflect behaviourial patterns or expectations but only what Gomulka suggested: fiscal variables.

The former at first seems to be an answer to the question why the budget constraints of the firms in STEs are soft, but in fact it only forces us to reformulate the question. We should ask not why under central planning the budget constraints for the firms are soft, but why the state is paternalistic. What is more, the very way in which Kornai formulates his explanation suggests that the state could behave otherwise; but the issue is too important for an explanation like this to be taken for granted.[10] Moreover, because Kornai does not answer our reformulated question the whole of his explanation is suspect. Gomulka's remarks about political and/or ideological reasons for the observed behaviour of the state (the communist party) have, unfortunately, the same epistemological status.[11] Much more relevant is what he writes about informational and enforcement issues, but nevertheless he shares with Kornai the tendency to formulate his explanations as if things could have been organised differently. Namely, one can agree with him when he points out the importance of insufficient flexibility of prices, or, to be more precise, of *"the excess of budget flexibility over price flexibility"* (Gomulka, [1985], 1986, p. 74)[12], but, leaving aside the danger that increasing price flexibility would cause accelerating inflation, one may wonder about the very possibility of a command economy in which prices are flexible (and, indeed, are more flexible than budgets).

Nevertheless, regardless of whether or not it was possible to eliminate shortages without changing the system itself, the soft budget constraint remains a systemic feature of STEs because, as Gomulka writes, *"budget constraints are softer when and where tolerated economic inefficiency is greater, and it is relatively high efficiency losses, not chronic shortages, that are probably an unavoidable characteristic of the economic systems which are influenced particularly strongly by socialist principles"* (Gomulka, [1985], 1986, p. 75). If we follow Gomulka in accepting competitive costs as some kind of benchmark against which softness of

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[10] In his most recent book, *The Socialist System,* Kornai denies it and writes, *inter alia,* that his *"writings never suggested that the hardening of the firms' budget constraint would be feasible in a socialist system characterized by the dominance of state ownership*" (Kornai, 1992, p. 495, footnote 38). Be that as it may, the question: "*Is it possible to make the budget constraint on publicly owned firms hard under the prevalent market-socialist system?*" has finally received an unequivocal answer: "*No, it is not*" (Kornai, 1992, p. 495).

[11] One has to admit that he is not alone in suffering from this kind of shortcoming, because it is well known that with the exception of the public choice-type theorizing and perhaps of the new institutional economics, a complete theory of government is conspicuously absent from contemporary economics. North (1990) convincingly argues that such a theory should be part of a more general study of the role of institutions and organisations in the process of economic change.

[12] Budget flexibility is defined as "*the speed at which the firm's total income, including subsidies and the effect of increasing the prices of its outputs, changes in response to a change in the value of its inputs*" (p. 79).

the budget constraint is measured, r-softness, defined in this way, will not be a systemic feature, but its degree may well be.[13] That is so because *"in market based economies that degree is determined in part by a particular market structure in which a firm happens to operate"* (Gomulka, [1985], 1986, p. 78). In other words, *"it is the degree of economic competition that largely determines the degree of softness of firms' budgets in real terms, the r-softness"* (Gomulka, [1985], 1986, p. 86). It is precisely on these issues that this paper would like to expand, trying, *inter alia*, to answer the question of what it is about the system that leads to this state of affairs.

Yet before a more detailed analysis of the soft budget constraint under central planning, under market socialism and in the process of systemic transformation is presented, the issue of how useful the concept is for comparative economics deserves some attention.[14] It seems that, since we deal with two economic systems, *that is* with centrally planned - and then reformed - economies on the one side and with market economies on the other, search for *differentia specifica* between the two ways of coordinating economic activities provides a sensible and attractive agenda for academic research. But such a search has first to answer the question whether any system can be defined by a single characteristic. If the answer to this question is in the negative, as seems to be the case, then the search for a one-dimensional *differentia specifica* must end up with partial and impressionistic results. And this is precisely what happened to the concept of the soft budget constraint: although the concept itself may be useful, all edifices constructed on the assumption that the degree of softness of the budget constraint is the *differentia specifica* are necessarily castles in the air.[15] If, on the other hand, what defines economic systems are their synthetic principles, elements, and environment (Dembi_ski, 1991), then the search for *differentia specifica* may produce a highly complex description of multidimensional phenomena and dynamic relationships, but the final result will nevertheless be much more realistic.

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[13] In this paper, to simplify the argument, all publicly owned enterprises are treated as if they were identical. In reality, as Davies (1989) convincingly shows for the Soviet Union, firms in the branches with the highest central priority experience a softer budget constraint than those in branches of the neglected sectors (*e.g.* military complex vs. health services). Kornai (1992) adds to this that the budget constraint of large firms is softer than those of small firms.

[14] This paragraph owes much to the personal discussion between the author and Paul H. Dembi_ski and to Dembi_ski's comments on an earlier version of this paper.

[15] The question to what extent and how such a perception of STEs affected advice given by Western economists to Central and East European governments when the latter were about to design their programmes of systemic transformation has to remain open in this paper.

3. The soft budget constraint under central planning

The fact that Kornai himself interprets the soft budget constraint in terms of replacing market relationships with (bureaucratic) bargaining (Kornai, 1985, p. 50, *op. cit.*) is here of absolutely crucial importance and has very far reaching consequences. Was not central planning, defined as an *ex ante* coordination of economic activities, supposed to replace market relationships? So why be surprised that everything is done in the process of bureaucratic bargaining? Despite all claims to economic rationality advanced by Marxist socialists over decades, bureaucratic bargaining simply has to be used at all stages of writing and executing plans. Using this "coordination mechanism", *that is* using "visible fist" instead of "invisible hand", means, in turn, that (almost) everything is negotiable. So why should the budget constraints be an exception? In other words, one has to agree with Kornai that the soft budget constraint is a systemic feature of centrally planned economies, but for a different reason than that suggested by him: it is not the paternalistic attitude of the state that is responsible, but the fact that the planning mechanism is not, despite expectations to the contrary, an adequate substitute for an all-embracing market self-regulatory mechanism. Rejection of the causal relationship pointed out by Kornai is not, however, the same as denying the importance of the vertical relationships in STEs' bureaucracies, regardless of whether the word "paternalistic" is appropriate or not. But any analysis of the exact nature of this mixture of threats and patronage lies outside the range of this paper.

The conclusion regarding the systemic character of the soft budget constraint can also be reached by considering the very concept of bankruptcy which, as is usually assumed, constitutes a bottom line as far as hardness or softness of the budget constraints is concerned. Laski formulates it as follows: *"the survival of the firm does not depend on its ability to cover the production costs and to make profits"* (p. 2).[16] The closest, however, that one can get in centrally planned economies to what bankruptcy means in market economies is liquidation of a plant which is inefficient and/or which is not needed any more. Bankruptcy of a state-owned company under central planning, if it were to happen, would be deprived of the economic meaning it has in market economies based on private property (Dembinski, 1987, footnote 19, p. 296): the assets are not - and cannot be - transferred to other owners who at least potentially are able to make better use of them and (which is equally important) are prepared to bear full responsibility for their decision. The risk that they also go bust will surely mobilize them to do their best, even though bad luck or overestimation of their capabilities may frustrate their efforts and lead to another

[16] It has to be noted that many authors writing on the soft budget constraint do not specify what kind of costs they have in mind. Gomulka ([1985], 1986) is an exception and devotes quite a lot of space to define the relevant concepts.

failure. Under central planning it is even doubtful whether firms should be called firms. The concept of the Soviet Union Inc., although deceiving or simply wrong in many aspects, well illustrates the main dilemma: it is difficult, if not self-contradictory, to imagine a subsidiary going bankrupt within a given company without any relationship with the outside world. In this way it becomes impossible to use bankruptcy as one of the mechanisms that help to solve the agency problem, present in any hierarchical organisation. This last point will be developed later on.

Since bankruptcy from the point of view of central planners can at most mean that physical assets are administratively reorganised (in contrast to their reallocation by market mechanisms under capitalism), it is no surprise that the decision to liquidate a firm will be taken regardless of whether a given "firm" is profitable or not, again not least because (almost) everything is negotiable. In consequence, the reformulated version of our question - "Why are the budget constraints in STEs soft?" - should not read: "Why is the socialist state paternalistic?" but: "Why are central planners so reluctant to reorganize - or even, in an extreme case, to scrap - some of the physical assets they have under their almost complete control?" In other words, the main problem is that of political economy of bureaucracy.

One possible answer to this question is that they are interested in production; and even loss making "firms" not only still produce something, but also in many cases are the only producers of this something. Another answer could point out the obvious fact that any reorganisation disrupts the process of production, both within the reorganised firm and in the firms with which it trades, and therefore is usually avoided as much as possible. Normally the medium and long run gains outweigh the temporary losses, but the naturally conservative attitude towards restructuring is additionally strengthened by the essentially static nature of central planning, the consequences of which can also be seen in the patterns of investment (Winiecki, 1988) and innovation (Balcerowicz and Welfens, 1989) in the STEs. What is more, any attempt to include the reorganisation, necessitated by persistently reappearing losses, for example in the Five Year Plan, would mean that losses are planned. But the problem of the soft budget constraint does not consist in financial results being positive or negative, higher or lower, but in not achieving what is planned and in being able to affect the final results by *ex post* bargaining. The conceptual weirdness of "planned losses" does not matter as long as the level of subsidies is decided *ex ante* and not adjusted *ex post*. Subsidies may, because of some policy choices or for other reasons, be a legitimate source of income, especially if accompanied by price regulations. Subsidies as such do not imply that the budget constraint is soft, just as softness of the budget constraint is independent of interest rates and of taxes.[17] In short, at the bottom line the problem consists in

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[17] From the above it follows that, in terms of Gomulka's ([1985], 1986) restatement of the problem of the soft budget constraint, more importance should be ascribed to m-softness than to

tolerating underperformance and in letting technically bankrupt enterprises survive. Other explanations of the behaviour of central planners are possible and will follow.

In the meantime let us notice that under central planning prices do not reflect relative scarcities and therefore are deprived of their informational content about the values of exogenous variables. How will central planners know which "firms" are profitable and which are not if they control all variables?[18] What makes their task even more difficult is the closed character of STEs. Both *Preisausgleich* and the relatively small ratio of foreign trade to GNP make it impossible to use world prices as reference points. In such a situation production plans eventually imposed on enterprises may be unrealistic, in which case an *ex post* correction may, in theory, be justified. In practice, however, allowing for this possibility places all players in a vicious circle of proving what is justified by using the same tools that justify what is justified. Therefore any attempt to impose a hard budget constraint would be necessarily arbitrary and, in fact, unfair.

In a market economy money - and therefore profits expressed in money terms - plays, *inter alia,* the role of a yardstick (although inflation sometimes disfigures this yardstick); but under central planning no objective criterion (as measured by money in market economies) can be applied, first, to assess the economic performance of "firms", and then to reorganise their physical assets. Arbitrariness and negotiability create a vicious circle. Summarizing this line of argument, it should be pointed out that the soft budget constraint can be looked at as a relatively cheap and fair way of overcoming the problems caused not only by difficulties with writing consistent plans and monitoring their fulfilment, but also by unforeseen circumstances like, for example, a change in the terms of trade. In other words, the soft budget constraint seems to be an economical answer to the problems of incentive, information, and insufficient flexibility inherently present in centrally planned economies. What is more, having accepted this micro-conclusion and having left aside the efficiency slack aspect of the soft budget constraint (Gomulka, [1985], 1986), one can go a step further and, following Dembi_ski (1991), point out that, because money in the STEs is heterogeneous, at the macro level what looks like a soft budget constraint is in fact an exercise in equilibrating the economy and balancing various flows within it and its relationships with the rest of the world.

The above, however, presents only one aspect of the problem of the soft budget constraint. Following Gomulka one can argue that in fact the budget constraints

r-softness. Such an approach helps to get round the problem of monopolies which may be simultaneously very inefficient and very profitable, the more so as Gomulka rightly points out the relationship between the soft budget constraint and market environment.

18 Gomulka ([1985], 1986) makes the same point.

are not so soft as they appear at first sight. His point may be made even stronger by expressing it in terms of distinction between firms and their managers: although the budget constraint faced by firms in STEs has to be soft for systemic reasons, it is debatable whether the same can be said about their managers. Gomulka writes as follows:

Managers in CPEs, in view of incentives which penalise for under-fulfilment of output plans but tolerate high unit costs, might like to have output targets near zero and inputs virtually infinite. In practice, however, each manager would be competing with other managers for the same limited resources and be subjected to immense administrative pressure from the centre to accept high taut output targets. (...) If these production reserves are too low, the manager risks under-fulfilment of his firm's output target. If they are too high, he risks being reported for flagrant inefficiency. In either case he may be fired or demoted. Between these two extremes there lies a point of economic efficiency which, given the particular circumstances of his own and his firm, the manager in question would judge as optimal. The optimum point would reflect the manager's subjective perception of the effectiveness of the controlling bureaucracy, that is, his best judgement about the maximum inefficiency he can still get away with. Therefore at that point the manager acts as if the marginal budget softness in real terms ends. Hence here the marginal budget effectively becomes hard (Gomulka, [1985], 1986, p. 78).

This suggests yet another interpretation of the concept of the soft budget constraint: the absence of market self-coordination mechanisms transfers all economic activities into the realm of politics and political bargaining. From this it does not follow, however, that political constraints imposed in this way are as soft as economic ones, discussed above. Indeterminacy, inseparably connected with (multilateral) political and bureaucratic bargaining, certainly is not identical with infinite softness. On the one hand, monetary or fiscal softness of the budget constraint faced by a firm, as has been argued above, is not unequivocally negative: it can be either irrelevant or even have some positive effects. On the other hand, although firms do not go bankrupt, managers are sacked from time to time because they fail to produce enough. Admittedly, they are chosen according to political criteria and their replacement may look like a merry-go-round, but the fact remains - and falling off a merry-go-round can be, because of the party monopoly on managerial jobs, very painful indeed. In other words, just to give an example, quantities to be produced according to the plan, although set in the process of bureaucratic bargaining, are not at all as flexible as their accounting counterparts, expressed in money terms. This suggests that the relevant constraint is much harder than one would expect.

From the above it follows that the soft budget constraint has, as it were, two dimensions: the economic and the political. The two differ from each other with respect to the degree of softness that exists in each sphere. What is more, the analytical framework of the agency problem can help us to unify the two. As is well known, the appearance of the problem itself is independent of the economic system and the form of ownership; this does not mean, however, that these two factors are completely irrelevant. Rather, they affect both incentives that can be used and information that is available. Since the agency problem is ultimately solved precisely by designing incentives and appropriate monitoring, the quality of solutions depends strongly on the distribution of property rights as well as on the institutional structure of the given economy. In a market economy one can safely expect that particular solutions will be better in the private sector than in the public sector because of superior motivation of principals who, as residual claimants, gain directly from such an improvement. Their efficacy will be additionally enhanced by, for example, the possibility of bankruptcy or of a takeover, as well as by competition in the goods and services markets (Jasi_ski, 1992). Thus, if the ultimate criterion of how well the agency problem is solved is economic efficiency, and if this efficiency is, in turn, said to be determined by ownership, competition and regulation (Yarrow, 1986), then one can say that all three elements of the institutional framework of market economies co-determine the way in which the agency problem is solved in practice.

From the structural point of view the same is true of STEs: only the institutions are different. In theory, central planners are just like ministers supervising the state-owned enterprises in the West in that they do not gain from improved performance of the firms under their control. Markets for managers and performance related payments are by and large of equally limited applicability. In practice, however, since there is no alternative to the public ownership of the means of production -- bankruptcy does not make sense and takeovers are impossible -- and since competition is also excluded, the agency problem under central planning was tackled by regulation alone, and that with a very limited access to reliable information and with no clearly defined property rights. The more or less totalitarian character of individual regimes does not imply in this context any essential difference because of the rigidity of the very nature of the economic system. As even in market economies the first best solutions of the agency problem are rarely available, it is no surprise that the main task faced by central planners is that of limiting the damage. The soft budget constraint is both a sign and a solution of existing problems.

From this it once more follows that talking about the soft budget constraint as if it were possible to get rid of it, as Kornai did, does not make any more sense than tracing back the low economic efficiency of centrally planned economies to the phenomenon. Both the soft budget constraint and the low level of economic efficiency have their roots and causes in the attempts to solve the agency problem by regulation alone, discussed above. The same can be said about Kornai's other "consequences" of the soft budget constraint: the low price responsiveness and the formation of excess demand. In particular, as far as any causality is concerned, shortages, which appear in the absence of flexible prices, have very little to do with the soft budget constraint defined as *"relaxing the strict relationship between expenditure and earnings*".

Plans are written in terms of physical quantities and it is these quantities of produced goods that matter. In the sphere of production money plays only, as is often said, a passive role. As long as circulation of money in this sphere is successfully separated from the realm of households' allocative decisions, the soft budget constraint, expressed in monetary terms, is irrelevant: for an enterprise it is not enough to have a surplus on one of its bank accounts. It has to be allocated goods to spend it on, and for the economy as a whole it does not matter whether this enterprise is profitable or not. It means that the very nature of central planning considerably limits some of the feared - or alleged - consequences of the soft budget constraint. In particular, the explanation of shortages seems, therefore, to be much simpler and can be expressed in terms of insufficient coordination between payments and production: the two flows fail to equal each other, not least because inputs are wasted. In theory, flexible prices could remedy it, but such a solution runs against the very logic of central planning. In other words, while partial disequilibria stem from discrepancies between the preferences of the consumers and those of central planners, the overall excess demand is caused by the fact that not enough is produced or that wasteful producers of non-existent goods are still paid for their "work". But this simple, perhaps even oversimplified, explanation does not imply that finding a solution to the inherent problems of centrally planned economies is equally straightforward, if we exclude, that is, systemic transformation. Just the opposite. Even though various degrees of quality of regulation are possible, as any comparison of different STEs easily shows, regulation alone is not enough to produce more and waste less. Thus one has to agree with Kornai that shortages are a systemic *(i.e.* unavoidable) feature of STEs. But this is an agreement about phenomena and not about their causes.

4. The soft budget constraint under market socialism

The above was supposed to answer the question of why the budget constraint of the firms under central planning is - or rather was - soft. The phenomenon of the soft budget constraint appeared to be a systemic feature of the STEs, and that not only in the sense of its actual presence in all the STEs but also in the sense of its logical

necessity: under central planning, or as Kornai prefers to call it, under classical socialism, budget constraints had to be soft. That is why the main problem that the authorities had to solve was that of keeping under control micro- and macroeconomic consequences of the soft budget constraint. What is more, on the one hand, as we have seen, not all of them had to be disastrous or damaging. On the other hand, some of the negative phenomena usually present in STEs, which were often traced back to that of the soft budget constraint, can be said instead to have the same systemic causes. Their co-presence must not be confused with a causal relationship.
However, the period dominated by central planning proper was, at least in some countries of Central and Eastern Europe, relatively short and was soon to be followed by various attempts to improve the functioning of their STEs. All reforms, despite the fact that they differed from each other as far as specific solutions and a specific leadership's commitment were concerned, tried to introduce two things: to give some kind of autonomy to individual enterprises and to provide appropriate incentives for managers and workers (Dembinski, 1987). These changes, which attempted to overcome inherent problems of central planning, were first made possible and then accompanied by a gradual transformation of the political systems.

Looking *ex post* at the performance of the reformed STEs, *e.g.* Hungary after 1968 and Poland after 1981, it is clear that the economic reforms did not succeed in eliminating the soft budget constraint, which, to tell the truth, was not even perceived as something to aim at. If anything, the phenomenon became even more widespread, attracting the notice of economic analysts. The soft budget constraint gradually became a problem both in theory and in practice, and Kornai's research dates precisely from this phase of the systemic evolution of the STEs.

The question that has to be answered from the point of view of what here interests us reads as follows: what elements - if any - of our analysis of various aspects of the soft budget constraint phenomenon remain valid in the context of reformed STEs under market socialism? To avoid unnecessary repetition we shall concentrate our attention on two issues: bankruptcy and shortages. A generalized interpretation of the systemic character of the soft budget constraint under market socialism, which will end part 4, will be preceded by a brief assessment of the role and importance of the departure from Stalinism.

At the micro level one can easily agree that in the context of the soft budget constraint bankruptcy - either actual bankruptcy or a credible threat of it - constitutes some kind of a border line. If bankruptcies do not happen, and therefore the risk of going bankrupt can be ignored, the prospects for imposing a sufficiently hard budget constraint are very bleak indeed. If bankruptcy does not make sense -- that is, if within the existing economic system bankruptcy can mean only a reorganisation of physical assets and if the most that individuals involved can lose are their jobs (and that in the situation of persistent shortages of labour) -- then one has to say that the soft budget constraint simply cannot be eliminated. Unfortunately, this is precisely the situation in the reformed STEs. There was some degree of decentralisation of the decision making processes, mostly consisting in giving a certain degree of autonomy to individual enterprises and their associations, but almost all the means of production still belonged to the state. In consequence, although it is sometimes said that under market socialism bureaucrats replaced central planners, the way in which decision makers could see bankruptcy did not change a lot after the reforms were introduced.

Furthermore, to the extent that the reforms and the process of systemic transformation led to monetisation of the STEs, it has become possible to interpret the soft budget constraint in terms of liquidity and solvency (Dembi_ski, 1991, Dembi_ski and Unterlerchner, 1992). Together, in a market economy, they define what one may call a "survival constraint", in that the liquidity-providing institutions base their decisions on their assessment of solvency of any enterprise. Since under central planning and, for most of the time, also under market socialism, the soft budget constraint was merely a problem of liquidity, it is simply wrong to treat enterprises for which the problem of solvency does not exist as belonging to the same class of objects as those for whom it does. This, in turn illustrates once again, how misguided it was to perceive the degree of softness of the budget constraint as the *differentia specifica* between centrally planned and market economies.

The substantial difference between bankruptcy under market socialism and its namesake in market economies implied that in the former situation it was more appropriate to write the word "bankruptcy" in inverted commas, because it meant either restructuring or reorganisation without any change in the ownership of the assets under consideration. That is so, above all, because the ownership structure of reformed STEs did not change and, apart from allowing a very limited growth of the private sector, this structure was not supposed to change. The fact that although the private sector existed (its size and importance varied from country to country), it was merely tolerated, that there were limits imposed on the number of employees in a single private firm, and that foreign direct investment was very difficult if not simply impossible, made the prospect of transferring assets from one sector to another a purely theoretical one.

In a sense the decision makers' difficulties with "bankruptcy" followed from their monopoly with respect to the decisions about entry and exit of individual firms in the core of the economy. But what made the whole situation even more similar to that under central planning is the fact that the criteria that the decision makers could use to assess whether a given enterprise was profitable, *that is* whether it deserved to go bankrupt or not, did not improve either. Prices even of consumer goods were still heavily controlled and, what is much more important, costs could not really be estimated without properly functioning labour and capital markets. But allowing market forces to operate in these spheres was not envisaged even in the most courageous reform plans, not least because capital markets require that it is private property that dominates in the given economy (Brus and Laski, 1989, Jasi_ski, 1992). In other words, the decision makers were still playing the game in which almost all rules were endogenous (*i.e.* set by themselves) and therefore subject to bargaining. It is no surprise that they did not trust what they saw on the score boards.

Endogeneity of almost all assessment criteria did not mean, however, that all processes were under control or were possible to control, which brings us to the issues in which Kornai was most interested, namely to the problem of shortages. At the macro level, as Dembinski (1987) shows it, the reforms unified the circulation of money. At the same time inflationary pressures increased dramatically, although the extent to which it was possible to deal with open inflation was limited by the degree of authoritarianism of the given regime. To avoid this, giving autonomy to the enterprises had to be accompanied by imposing financial discipline. The soft budget constraint is nothing else but a situation in which such a discipline is absent to a greater or lesser extent, and empirical evidence suggests that nobody really achieved any success in this sphere. As the examples of Czechoslovakia and the GDR, which entered the post-communist era with relatively well equilibrated economies, show, it was apparently better to stick to the old type arrangements.[19] Be that as it may, even if a near hyperinflation in Poland in the Autumn of 1989 can be considered as an exception, the market-oriented reforms ended the period of relative price stability in the economies in which they were introduced, and various forms of inflation as well as monetary overhang became permanent features of these economies.[20] That is precisely why one can say that reforms enhanced the disastrous consequences of the soft budget constraint or

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19 On the other hand, it seems that the Polish economy and, to an even larger extent, the Hungarian one were much better prepared to start the process of systemic transformation. As neither choice was made in view of facilitating a return to capitalism, it is no surprise that the jury is still out on the issue of the relative superiority of respective starting points.

20 Obviously, inflation, whatever its form, was in the last analysis a consequence of the softness of the central budget, remedied by printing money. However, regardless of the way in which the soft budget constraint at the enterprise level was dealt with in practice, ultimately micro-softness had to result in macro-softness.

simply made its consequences damaging. It is also in this sense that reforms prepared the present systemic transformation.[21]

The absence, to say the least, in the reform programmes of any elements which could control, let alone eliminate, the soft budget constraint directs our attention to politics. To be sure, after Stalin's death, which in a sense made possible the design and implementation of market oriented reforms, the countries of the Soviet bloc did not become liberal democracies. Nonetheless the extent of political terror diminished substantially. This could not fail to affect the "politics of the soft budget constraint": the changes in the micro- and macroeconomic spheres were accompanied by considerable easing of the pressure under which individual managers operated. Needless to say, this easing did not harden the budget constraints. Just the opposite.

Of course, the institution of nomenklatura survived, and the state's quasi-monopoly on providing managerial jobs had to be kept in mind, but Gulags were no longer playing the same role that bankruptcy plays in market economies. On the other hand, the fact that bureaucrats replaced central planners (i.e. that the mechanisms used by the state to determine the level and composition of the national output also changed) was not without implications either. Among other things, various lobbies, regional or otherwise, appeared, and their role gradually increased. This kind of development turned the all-embracing bargaining into a much more complicated process than the previous vertical relationship. When outsiders like Solidarity joined the game, the economy became almost impossible to manage.

Since, in the last analysis, the degree of softness or hardness of the budget constraints had to be determined, for systemic reasons, above all by political means (*i.e.* by the degree of softness or hardness of the political constraints) changes in this sphere proved to be decisive. They not only strengthened the damaging effects of decentralisation in managing the economy but also, as any comparison between, say, Poland and Hungary will prove, affected the situation in which the process of recreating market economies in Eastern and Central Europe occurred.

If we look at the attempts to introduce certain market mechanisms into centrally planned economies from the point of view of the soft budget constraint we can see how superficial in fact were all the reforms. The most important systemic features remained unchanged, and it was precisely those features from which the necessity of the soft budget constraint followed. The soft budget constraint was not only an

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[21] In this situation to postulate greater price flexibility, or rather to expect that such a flexibility will eliminate shortages, as in Gomulka's criticism of Kornai's analysis, meant to play with the fire of hyperinflation, as indeed happened in Poland in the Summer and Autumn of 1989.

unpleasant consequence of the paternalistic attitude of the state but also remained a necessary systemic feature of reformed STEs. That is why the conclusions formulated in part 3 in terms of the principal/agent problem can be repeated here almost without changing anything: under market socialism the degree of incentive compatibility allegedly improved, and the participation constraint was not binding because of the state's monopoly on managerial jobs, but monitoring deteriorated significantly. The existing structure of ownership rights together with diminished political pressure reduced strongly the commitment of principals to improve information flows as well as incentives structure for agents. What is more, although even in Western liberal democracies no general election is fought exclusively on the issue of the performance of the public sector enterprises, complete absence of this kind of mechanism was yet another negative factor. At the same time, if we agree that it is ownership, regulation, and competition that jointly determine the level of economic efficiency, the situation in the reformed STEs may also be interpreted as a continuation of the attempt to solve the agency problem by regulation alone and that by regulation deprived of any independent yardstick. In other words, the efforts of principals, insufficient as they were, could not be supported by the pressure coming from various markets, for example from the markets for managers, for property rights, and for goods and services. There was neither threat of bankruptcy nor of hostile takeover, and banks, even if there were more than one, were only an element of the all-embracing bureaucratic structure. Knowing their disciplining effect on managers, one should not be surprised at what happened under market socialism.

5. The soft budget constraint in the post-communist economies

That the soft budget constraint was a necessary feature not only under central planning but also in reformed STEs, that decentralisation made this phenomenon much more damaging, and the exact nature of the phenomenon itself all have to be kept in mind when we attempt to discuss fiscal discipline and managerial behaviour and expectations in the post-STEs.

Again the situation differs from country to country and any generalisations are very risky, as comparison of starting points, for example, in Poland and in Czechoslovakia makes evident. Nevertheless all over Central and Eastern Europe marketisation, *in the form of* more or less limited attempts to introduce some market mechanisms, has been replaced by attempts to return to (or to recreate) market economies. The private sector has begun to grow very rapidly, which is sometimes called privatisation from below (Kawalec, 1989); and privatisation from above (transferring assets from the public sector to the private) has become a necessary element of the economic policy agendas, despite differences between individual countries (Frydman, Rapaczynski and Earle, 1993, Estrin, 1993). The only problem with foreign direct investment is that Western firms seem not to be keen enough on coming to Central and Eastern Europe. Last but not least, there is apparently no reason to expect that the new regimes, which took over the power to (re)establish capitalism, will follow the example of the old ones in their paternalistic attitude towards state-owned enterprises.[22]

Thus the environment in which firms operate has apparently undergone a revolutionary change. For example, in Poland the shock therapy commenced on 1 January 1990 ultimately got rid of compulsory plans, put an end to central allocation of resources, strongly reduced subsidies[23], liberalized prices and foreign trade, introduced internal convertibility, and strongly reduced the scope for individual treatment of enterprises by fiscal authorities.

If we compare this new situation with the constraints under which both state-owned and private firms previously operated, it seems reasonable to expect that the soft budget constraint should have immediately disappeared. Furthermore, there seems to be no reason to expect that the soft budget constraint will be a systemic feature of the economies in transition. In practice, however, things are much more complicated, and that for at least two reasons: recession and dominance of state-owned enterprises in the economy. It was also naive to expect that the institutional inheritance with which each of these economies began its transformation would be no hindrance.

Domestic recession, however long is the list of its causes, accompanied by a loss of the CMEA markets, uncertainty about privatisation and/or commercialisation, internal power structures (the so-called Bermuda triangle: management, workers' council and trade unions), and the sheer inability or unwillingness of the majority of SOEs to adjust to the new situation, evidenced by numerous surveys, resulted, after an initial jump in profitability[24], in a rapidly increasing number of enterprises making losses and delaying payments to the State. These non-payments included turnover and profit taxes, NICs, "dividends" (a sort of capital tax paid on assets

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22 Again, Poland may be considered as some kind of exception, as it was the Solidarity trade union that played such an important role in bringing the communist rule to an end.

23 In 1989 various subsidies to goods and services and to enterprises constituted 31 per cent of the state budget (6.69 trl Zloty). In 1990 their share fell to 14.7 per cent and in 1991 to 12.1 per cent. In the 1992 budget the share of direct subsidies was to be equal to 6 per cent (Witold Gadomski, Parasol nad gospodark_, *Gazeta Bankowa*, 26/1992, p. 16).

24 Schaffer (1992) shows that most of these profits were only a consequence of historic cost accounting and had nothing to do with improved performance. It is therefore no surprise that once the rate of inflation went down, so did profitability.

"owned" by the founding organ of the given enterprise) and "popiwek" (the highly progressive tax imposed on above norm increases of the first wage bill and subsequently of average wages). Interfirm credit (i.e. delaying any payments to suppliers) is becoming more and more of a problem. If one adds to this the fact that many enterprises survive despite having been declared uncreditworthy and, in consequence, the share of bad debts, above all, in state-owned banks continues to be very high, it is difficult not to be tempted to interpret this situation precisely in terms of the soft budget constraint.[25] From this point of view there appears to be much more continuity in the process of systemic transformation of the economies of Central and Eastern Europe than is usually acknowledged. But it has to be noticed immediately that the phenomenon radically changed its nature and dynamics and is likely to be much more difficult to eradicate and, unfortunately, much more damaging in its consequences than under market socialism.

As a first approximation, the problem faced by post-communist governments is similar to that faced by governments in established market economies, and therefore it could be solved if an appropriate social safety net was established (Hardy, 1991). But the very size of the public sector in the post-STEs as well as the depth of its problems introduce a qualitative difference.

On the one hand, in parts 3 and 4 we argued that almost exclusively public ownership of the means of production in practice deprived bankruptcy - and therefore the threat of bankruptcy - of any sense.[26] It could mean at best reorganisation of physical assets, but in practice it simply almost never happened. That was so because these assets could not be transferred to another owner, in this case to the private sector, which played even in reformed STEs only a marginal role. This is no longer the case.[27] Obviously, it would be difficult, if not simply impossible, to find a domestic or foreign buyer for what was one of the white elephants of central planning, but the problem is becoming more and more that of

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[25] Since we dwelt in this paper rather long on the controversy between Kornai and Gomulka on the causes of shortages, it is worth noting that what has been happening in Poland since 1989 seems to show that it was Gomulka who was right, because the soft budget constraint not only persisted but also in some spheres became more of a nuisance, while at the same time shortages disappeared.

[26] Of course, the threat of bankruptcy is not the only factor that forces enterprises to engage in more or less productive activities. It plays, however, a key role as far as eliminating efficiency slack from production processes is concerned and its absence - or the absence of its threat - substantially softens the budget constraint.

[27] According to GUS, in December 1992 the private sector outside agriculture employed 47 per cent of all employed (the so-called "old" private sector, i.e. without cooperatives - 36.3 per cent). In the economy as a whole 58.5 per cent of the employed worked in the private sector.

the total obsolescence of the assets, instead of that of the absorption capacity of the private sector. In other words, weakness of the private sector, although still considerable, seems to be temporary and will be less and less relevant.

On the other hand, although bankruptcy now makes sense, it still has to be triggered by a decision either of state organs (either the Ministry of Finance or the so-called founding organ, usually the Ministry of Industry and Trade or local government) or of another state-owned enterprise, be it either a bank or a supplier. Many small and medium enterprises have been closed, but because of the ultimately political nature of any such a decision, especially those taken by state organs, taking and enforcing such a decision in practice often proves to be very difficult, as many examples from Western mixed economies have shown over decades. But even if we put aside the problem of the politics of bankruptcy of state-owned enterprises, the whole process will be enormously complicated in a country such as Poland. Its multidimensionality stems from the fact that each firm faces many kinds of liabilities. Let us look in turn at each possibility that a given enterprise, *or more precisely* its managers, may use to soften the budget constraint.

From the point of view of the authorities which do not receive their due, it is relatively - but only relatively - easy to be tough on an individual enterprise[28], especially if it does not employ too many people, the more so as shortages disappeared (the fact that an insolvent firm still produces something can no longer be used as an excuse for tolerating non payment of taxes; a high degree of monopolisation means, nevertheless, that the eventual disruption may be considerable) and a social safety net was established. But the results achieved by state-owned enterprises are highly correlated both across industries and in the economy as a whole. At the beginning, after the prices were liberalized, almost every firm became highly profitable, partly because of the newly opened possibilities to exploit monopoly positions, but more importantly because goods could be sold at new prices but produced out of the materials hoarded in the previous period (inflation profits, Schaffer, 1992). The falling rate of inflation eliminated this kind of gain, and by the end of 1991 the recession completed the job of

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[28] At the end of June 1992 there were 1400 enterprises which had overdue payments with respect to the Treasury, but 31 per cent of the overall sum should have been paid by only 11 enterprises: PKP, Polmos, FSO, PLL "LOT", "Polfa" Tarchomin, Huta "Warszawa", PGNiG, PP "Porty Lotnicze", Poczta Polska, Warszawskie Zaklady Telewizyjne "Elemis", ZG RSW Prasa (*Polityka*, 35/1992, p. 2). That kind of debt of state-owned enterprises was almost as high as the planned budget deficit - 54 trl. Zloty compared with 65 trl. Zloty. (In 1991, 27 trl. Zloty, equal to 87 per cent of the actual budget deficit, *i.e.* of the budget deficit without overdue payments: Jacek Rostowski, Dzwignia, *Gazeta Bankowa*, 26/1992, p. 20, and Pozytywy, negatywy, *Gazeta Bankowa*, 32/1992, p. 3).

trimming down high rates of return.[29] That is why there were never single firms which could and should be declared insolvent because they were not making their payments. When such firms appeared, their group was immediately too large for any prompt and exemplary action.[30] Since action was not taken in the first moment, its likelihood gradually diminished. In other words, any expectations by the officials from the Ministry of Finance that things would happen by themselves proved unfounded. (The stories about some kind of collusion between managers of large state-owned enterprises are not implausible but very difficult to prove.) The post-communist governments lost their ability to commit themselves just as quickly as they had acquired it.

Social problems and fairness considerations complicated additionally the whole issue. In some cases huge firms in financial trouble are localized in small towns which are completely dependent on these firms and there bankruptcy seems to be unviable because it would result in uncontrollable unemployment. One must not forget either that at least some of the financial problems experienced by firms resulted from decisions for which they could not be held responsible. For example, the burden of credits which were taken - or rather allocated - before January 1990 became almost unbearable once it was decided that real interest rates should be positive. The fact that enterprises accumulated various non-productive assets because of their welfare functions did not help either. The new post-communist governments were also to blame because they did not always play according to the rules they themselves set, of which what happened to the shipyards is just one example.[31] In such a complicated situation, with some prices still being controlled, how were good enterprises to be distinguished from bad ones, temporary problems from hopeless cases?

Last but not least, the whole administrative framework within which bankruptcy procedures are exercised in general, and the judicial system in particular, were not

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[29] The rate of return for state-owned enterprises fell from 46.5 per cent in 1989 to 29.9 per cent in 1990 and further to 8 per cent (according to the changed methodology, 4.9 per cent) in 1991 and 3 per cent in 1992 (on the changed methodology; the old method having been discontinued). From January to November 1992, gross profits were equal to 68.4 per cent of those in the same period one year earlier (the inflation rate was in this period equal to about 43 per cent!) and various payments listed in the text of this paper were equal to 118.8 per cent of gross profits.

[30] According to GUS (*Rzeczpospolita*, 6.02.1993), in November 1992, 41.1 per cent of state-owned enterprises were making pre-tax (gross) losses, and for every 1000 Zloty of revenue they were losing on average 4 Zloty.

[31] Stocznia Pó_nocna in Gda_sk was to sell to the former Soviet Union three war ships, but the money never arrived and in the meantime the government withdrew its guarantees, which led the shipyard to the brink of bankruptcy.

really prepared and lacked sufficient expertise and experience to deal with these kinds of problems, let alone cope with the number of cases which would have had to be solved. It is only very recently that things have began to improve.

Obviously, all these factors were not unknown to the enterprises, and the more the impotence of the authorities was becoming evident, the less it was likely that the budget constraint would become any harder. At one stage it even looked as if the authorities became a hostage of state-owned enterprises. Clearly, promises of debt reduction made by politicians with populist orientations did not help to solve these problems, but continuation of sound macro-economic policies does seem to be forcing enterprises to do something about their future. The new Act on financial restructuring of state-owned enterprises and banks of December 1992 is definitely a step in the right direction, as it provides new legal tools for dealing with all kinds of debts.

At the beginning of the Balcerowicz plan, the attitude of state-owned banks was similar to that of the state, and in most cases they simply added penal interest to the overdue credits.[32] Again the situation has many dimensions and variants, and both sides of the conflict could claim limited responsibility for the balance sheets with which they began the new capitalist era. In the case of serious social problems in which tens of thousands were threatened with unemployment, political pressure and arm twisting were more than likely, the more so as the state-owned banks accounted for about 95 per cent of the "turnover" of the banking sector of the Polish economy, and bad debts are highly concentrated. Inefficiency of the judicial system did not encourage the banks to take any decisive action either, and some elements of old-boy (nomenklatura) networks are more than likely.

One more aspect of the softness of budget constraint in the economies in transition is its horizontal dimension, namely the relationships between different state-owned enterprises.[33] Interfirm credit was already a widespread phenomenon in the last

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32 Credit for investment increased from 6.2 trl. Zloty (at 1.01.1990) to 37 trl. Zloty in December 1991 and 62 trl. Zloty in May 1992 (credits longer than one year). It is estimated that 30 - 40 per cent of the total debts are the so-called bad debts, which for the banking system as a whole is a sum of 65 - 85 trl. Zloty (Witold Gadomski, Dlugow darowanie, *Gazeta Bankowa*, 32/1992, p. 18 - 19). In November 1992, 4546 enterprises were declared credit unworthy. To give one detailed example, according to Ernst & Young, in Powszechny Bank Kredytowy in June 1991 bad debts constituted 27 per cent of all credits (2.2 trl. Zloty); most of them are older than the bank itself and were "inherited" when NBP was divided into 9 commercial banks (Rozbrajanie bomby, *Gazeta bankowa*, 32/1992, p. 18 - 19).

33 Inter-firm credit (zatory platnicze) is estimated at about 250 trl. Zloty. Taken together with other payments, after the first four months of this year payments to be received were equal to 90.1 per cent of the payments to be made (respectively 286.4 and 317.9 trl. Zloty). Obviously, this phenomenon does not appear exclusively in post-STEs, as a recent article in the *Financial Times*

years of communist rule, and now seems to be by and large out of control. In the situation of the high degree of monopolisation of the Polish economy, there is an evident trade off between on the one hand preserving the long established cooperative links or assuring that the only producer of a given good does not disappear from one day to another, and on the other hand forcing the kind of behaviour that corresponds to the new rules. Outstanding liabilities can be also used as an excuse for not making other payments. It is no surprise that in the first two years of the Balcerowicz plan many surveys reflected a very simple attitude: sit and wait.

All this is well known, and Polish economic weeklies, like *_ycie Gospodarcze* or *Gazeta Bankowa*, are full of more or less complicated stories describing all three dimensions of the soft budget constraint. But it is not enough to notice what is going on in individual cases. This situation has to be interpreted properly, its overall pattern discovered, and its consequences assessed.

If we compare the phenomena briefly described above with various aspects of the soft budget constraint under central planning and under market socialism, it is very easy to notice some kind of continuity: the phenomenon of the soft budget constraint is, after the first stage of systemic transformation in Poland, alive and well, and prospects for improvement are not very good because credibility has diminished and the scale of the problem has increased. The hopes of Balcerowicz and his team that all the measures introduced since the first non-communist government took power in September 1989 would, as it were, almost automatically impose the hard budget constraint proved, by and large, unfounded (Balcerowicz, 1992). Continuity should not, however, be overstressed, because the soft budget constraint has changed both its nature and dynamics.

The process of systemic transformation meant, among other things, further decentralisation of the decision making processes within the public sector, and the degree of control that the centre could, and was prepared to, exercise over these decisions diminished considerably. It was the politics of the soft budget constraint that ultimately changed the nature and dynamics of this phenomenon. In consequence, a given enterprise, enjoying far-reaching autonomy and attempting to soften the budget constraint that it was facing, had a much broader range of choice than it had, for instance, under central planning. Bargaining with central planners or bureaucrats was no longer the only option. It could simply delay - or, in practice, refuse - repayment of the credit and other debts and, as we have seen, many enterprises immediately seized this opportunity. What is more, any coordinated

shows (Micheal Cassell, The danger that lurks in delay, 23.02.1993, p. 19). The difference, however, consists in that in post-STEs it is a part of a much broader web of problems.

action by the authorities, the banks, and other enterprises was rather unlikely and these agents could be, as it were, set against each other. At the same time, if the problem of the soft budget constraint was to be solved at all, it had to be solved in all its dimensions and in its full extent. In other words, foundations for depriving the soft budget constraint of its systemic character seem to have been laid down, but its actual solution is far from being straightforward. And this is precisely what the changed nature of the soft budget constraint means in practice.

At the same time the soft budget constraint also changed its dynamics, because some firms in general strengthened their positions *vis a vis* other economic agents and the authorities. They no longer have to bargain for new credits, subsidies, or tax reliefs. Their behaviour can rather be described in terms of *fait accompli*. They do not pay, but non payment is not their problem: it is the problem of those who do not receive their due. To the extent that this statement describes actual behaviour, and there are certainly cases that can be described in precisely this way, it means an ultimate change in the politics of the soft budget constraint. Managers are no longer members of nomenklatura and it is workers' councils that play the most important role in their appointment. Consequently, they could expect that any effort aimed at keeping their firms afloat will be supported from below. The hands-off attitude of the centre, as well as the stress on legality of measures taken, seemed to be a logical consequence of the direction in which the whole economy was supposed to move, but in the short run it proved counterproductive.

One more change which has to be mentioned in this context refers to the consequences of this state of affairs. The most important change concerns the macroeconomic effects of the persistent softness of the budget constraint. This time it is the stubbornly high rate of inflation that, at least in part, can be traced back to the soft budget constraint and that in three ways. Firstly, the soft budget constraint results in extending the supply of credit to the economy and in consequence deprives restrictive monetary policy of its anti-inflationary bite. Secondly, it increases costs, above all because of high nominal interest rates, and these increases are still easily passed on to the final buyers and will be passed on even more easily if protectionist tendencies win. Thirdly and most importantly, to the extent that various forms of the soft budget constraint have a negative effect on financial results of state-owned enterprises, and it is still the state-owned enterprises that provide most revenue for the budget, the resulting high level of the budget deficit becomes a transmission mechanism from the soft budget constraint to the high rate inflation.[34]

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[34] From December 1990 to December 1991 the price level rose by 60 per cent and from December 1991 to December 1992 by 43 per cent. This is not to claim, however, that the soft budget constraint is the only, or even the most important cause of budget deficit, but this issue lies

But an inflation rate even as high as 40 per cent per annum seems to be of relatively little importance if compared with the risk of collapse of the banking system and with the far reaching interruption of trading links that can result from tolerating the present forms of some enterprises' behaviour. What is more, the economies in question are economies in transition. It means that the soft budget constraint not only endangers the stability of the economy but also the process of systemic transformation. In other words, it is the future of the economy that is at stake. A few remarks on the relationship between the soft budget constraint and the process of systemic transformation will end this paper.

6. Conclusions: the soft budget constraint and systemic transformation

The old system which constituted the departure point of the process of systemic transformation was itself a result of long evolution and in many respects was not even similar to what Kornai calls classical socialism. Nevertheless, on the eve of the departure from socialism, the economic system of Central and East European economies could still be described as based on some form of bureaucratic coordination of economic activities, as well as on the public ownership of the means of production. Systemic transformation must therefore mean full marketisation and privatisation. The former can be done by liberalisation and by the creation of a set of institutions on which then more or less efficient operation of market mechanisms depends. There exists already ample empirical evidence that the institutional part of marketisation is going far too slowly.

In a sense, to the extent that private property is the most important institution of market economies, privatisation is also an element of the institutional reform. But its importance goes much further, and therefore everything that puts at risk or slows down the process of transferring assets from the public sector to the private one is of crucial relevance. That is so because privatisation is not only - almost by definition - essential for systemic transformation but it is also essential for completion of the process of political change, for establishing a sound basis for industrial policy and, last but not least, for increasing the productive efficiency of the existing assets. Privatisation can also be legitimately seen as a supply-side policy.

The persistence of the soft budget constraint threatens privatisation in numerous ways. For example, the uncertain if not doubtful status of debts and liabilities makes a purchase of some firms a highly risky enterprise. If the scale of problems

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far beyond the scope of this paper.

created by the soft budget constraint increases or even remains at its present level, and thereby threatens the stability of the economy, fragile as it is at present, one can hardly expect that anybody will be confident enough to buy anything.

What makes things look like a vicious circle is that, apart from alleviating the most urgent consequences of the soft budget constraint, privatisation seems to be the only long run solution -- and, moreover, a solution that is able to be effective with respect to all dimensions of the soft budget constraint. It can change the motivation of managers and free the state from the obligations that follow from the public ownership of the enterprises. The very nature of the relationships between private banks and private enterprises and among private enterprises will also make the phenomena described in part 5 much less likely. In other words, the budget constraint can now be really hardened -- although it will most likely take more time than was initially foreseen -- but for this to happen the way has to be cleared, and this task is, to an ever larger extent, displaying the characteristics of a public good. It is for the government if not to solve the problem then at least to provide an appropriate legal framework for a solution. It is also a chance for the post-communist governments to regain credibility in their micro- and macro-economic policies.

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