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Institutions and soft budget constraints

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Abstract: This paper presents a model of soft budget constraints (SBC) in a bank lending relationship, emphasizing the role of institutions in shaping the SBC phenomena. The model allows two types of SBC to emerge according to specific constellations of parameters: the SBC as a dynamic commitment problem and the SBC as an external assistance problem. The paper sheds light on issues such as the political intervention in private contracts, the design of bankruptcy procedures, the cross-subsidization among social groups through the credit system, and the privately-owned versus State-owned bank dichotomy.

JEL classification: D21, D23, D72, G21, G33, L14.

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1. Introduction

The term soft budget constraints (SBC) refers to the persistent bail out of organizations by a third party, which can be governments, banks, upper hierarchical stages, and so on. It was originally coined by Kornai (1986) to explain a recurrent phenomenon pervasive to socialist economies but further developments extended this issue to other kind of economies.

Kornai (1986, 1992) suggest a "paternalistic view" of the SBC. It points out that the decision to soften budget constraints emerges from the concern of