

Introduction of soft budget constraint as an analyzing tool into public management

The case of the Hungarian public administration reform

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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 & Roland 2003) can be applied to this problem. In the following, I shall describe the Hungarian public administration reforms implemented by the Orbán government from 2010 onward and analyze its reforms, 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. By using the concept of SBC, I also hope to shed some light on the rationale behind the Hungarian government’s introduction of such a contradictory reform package. Previously, the concept of SBC was utilized narrowly in public management studies, mostly in the field of fiscal federalism. My goal is to apply the concept to a broader area of public management studies. My conclusion is that the concept of SBC can significantly contribute to public management studies by deepening our knowledge on the reasons behind the success and failure of public administration reforms.

**Keywords:** Soft budget constraint, public administration reforms, Hungary

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## **Introduction**

The goal of this study is to introduce the soft budget constraint (SBC) as an analytical tool in public administration studies. This concept, appearing in many fields of economics and the social sciences, is barely mentioned in the leading journals of public administration and public management. Although the concept of SBC is often employed in the study of fiscal federalism and organizations offering public services, it has not been applied to the analysis of the reforms affecting the public administration system as a whole. It is my belief 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 harden or soften budget constraints, illustrating these with examples taken from the post-2010 public administration reforms. The last section concludes.

## **What is SBC?<sup>2</sup>**

The concept of SBC was introduced by János Kornai (1979, 1980, 1986, 1998, 2014) and his colleagues (Kornai, Maskin & 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) can realistically expect to be bailed out by another organization if it faces bankruptcy. The emergence of the SBC syndrome is to be expected if the organization to be bailed out has the expectation (that it will be bailed out) on the basis of which it changes its behavior (spending more than the budget constraint would allow). However, the bailout of one particular organization does not necessarily imply that a country's economy is characterized by SBC if the expectation to be bailed out does not develop in economic actors in the wake of an occasional bailout and they do not change their behavior. It follows from the above that the main issue is not whether a particular organization has received support from another one, but 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

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<sup>2</sup> In describing the SBC syndrome, I have drawn heavily from Kornai (2014).

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),<sup>3</sup> public institutions offering public services (hospitals, universities),<sup>4</sup> local or regional governments (local governments in Hungary in 2012),<sup>5</sup> private citizens (household forex debts in Hungary), countries (Greece),<sup>6</sup> non-governmental organizations, or even large-scale investment projects (building of an Opera House, underground construction).<sup>7</sup> The central government is the prime rescuer, but banks and international and regional organizations (IMF, EU) and their foundations can also take on the role of rescuers (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 under normal market conditions. According to the rules of classical economics, business enterprises do not exceed their budget because, in that case, they would be doomed owing to market forces. However, the institutional environment – principally the central government and the modern banking system – constrains the market’s self-cleansing abilities, and the propensity for excessive expansion can arise in enterprises, in the course of which they exceed their budget constraints and find themselves in need of external support. The propensity to expand can also be noted in the central government’s organizations, namely the ability for excessive bureaucracy. 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 & Svensson 2006).

The motivations of the rescuing organizations can be quite complex. A bank can be after its money, trying to salvage what it can of its loans. 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,

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<sup>3</sup> Fogel - Morck - Yeung (2008), Storm & Nielsen (2012).

<sup>4</sup> Kornai (2009), Levaggi & Montefiori (2013).

<sup>5</sup> Cf. Baskaran (2012).

<sup>6</sup> Katsimi, Moutos, Pagoulatos & Sotiropoulos (2014) and Benczes (2011).

<sup>7</sup> Cf. Inderst, Mueller & Münnich (2007).

- 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.

In addition to the above, 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 & Recanatini 2002).

According to Kornai (2014:32–33), the SBC syndrome

- encourages wanton spending,
  - as a result of which market demand gets out of control, despite the fact that one part of this demand is not covered by genuinely available funds,
  - and irresponsible investment projects are launched, with decision-makers failing to assess with the necessary caution the risks involved and the possible consequences of the losses,
- reduces the price and cost sensitivity of decision-makers,
- alters the outlook of the managers of organizations applying for the bailout as well as their allocation of attention and activity, 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 and use a part of their resources for serving them loyally,
- undermines social morals,
- 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 & Maskin 1995). 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 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.

The SBC syndrome became a household word in economic studies<sup>8</sup> 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 sociology,<sup>9</sup> political sciences,<sup>10</sup> regional studies<sup>11</sup> and international relations<sup>12</sup> as well as in analyses of certain public services such as health care economics.<sup>13</sup>

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 offering public services as well as for the various problems in the efficiency in economic

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<sup>8</sup> I found 126 studies that used the concept of SBC in the 20 leading economic journals (with the highest 5-year impact factor).

<sup>9</sup> 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).

<sup>10</sup> 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).

<sup>11</sup> I found 58 studies that used the concept of SBC in the 20 leading regional studies journals (with the highest 5-year impact factor).

<sup>12</sup> 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).

<sup>13</sup> 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).

policies such as tax policy measures, investment decisions, corruption and organizational sociology issues and the poor allocation policy of the European Union. It is perhaps clear from this broad overview that 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, principally in health care economics, 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 the next section, I will address the impact of the SBC syndrome in public administration.

### **What are the effects of SBC in public administration?**

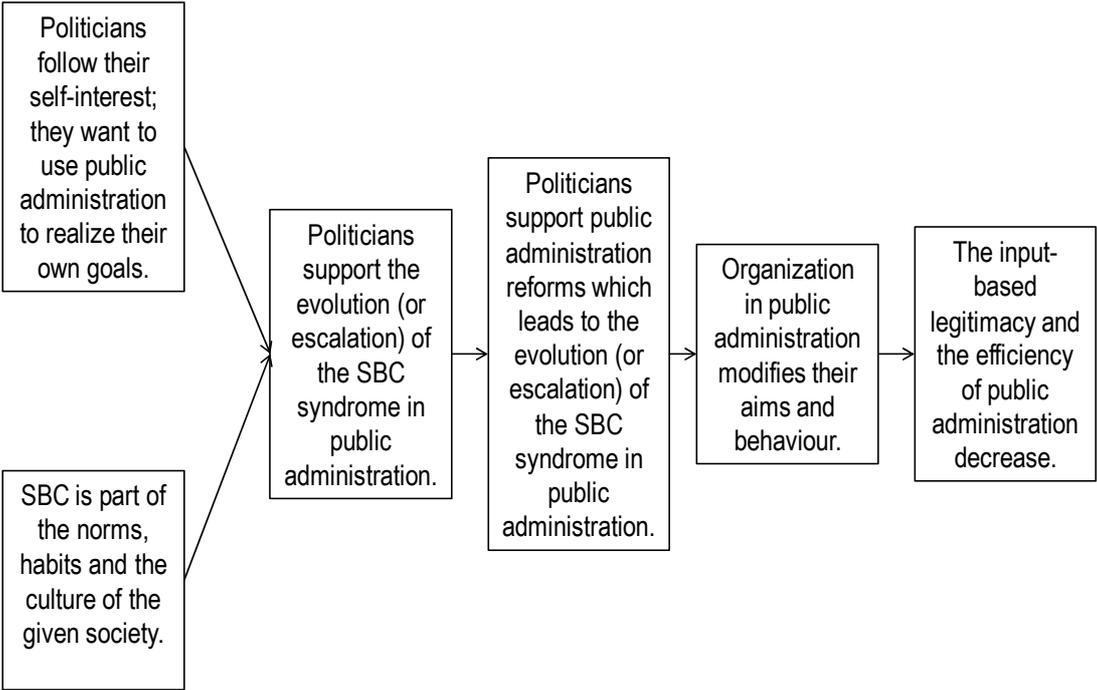
The SBC syndrome evolves when politicians send signals to the organizations of public administration that their survival depends solely on their loyalty to the political elite. Because the SBC syndrome transforms the motivations of the organizations, they will focus on serving the incumbent government's 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 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. They do not focus on citizens' trust anymore. This type of zero-sum-game competition creates a *milieu of mistrust* between these 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 & Vishny 1994).<sup>14</sup> They have the opportunity to do so because there is a clear information asymmetry between the political elite and citizens. Moreover, citizens are not a well organized group, and thus they are unable to protect their interests (Olson 2009). Additionally, citizens have a rational ignorance of public affairs (Downs 1957).

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



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

Following the description of the chain of causality, I shall review certain public administration reforms, which can promote the hardening of the budget constraint of an organization in public administration. These reform measures are presented in Table 1. Reforms with an opposite trajectory (such as reprivatization, monopolization, narrowing freedom of information or competition, etc.) are hotbeds for SBC.

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<sup>14</sup> This raised the question of how politicians could be persuaded *not* to use SBC as a tool to enforce their self-interest. I assume it depends on the informal institutional environment of a given society (norms, habits). In long run, SBC could be disastrous both for the political elite and for the public administration system.

Table 1. Reforms hardening the budget constraint in public administration

Reform steps hardening the budget constraint	How does the reform impact the organizations of public administration?
Centralization	By centralization, the central government gains control and influence over decentralized units. Stronger central control may harden the budget constraint.
Decentralization	By decentralization, competition can be reinforced which may harden the BC.
Widening freedom of information (FoI)	By widening FoI, citizens gain more opportunity to punish the opportunistic behavior of organizations and politicians. It decreases information asymmetry, which also helps hardening the budget constraint.
Using normative regulation on the allocation of financial resources	Unambiguous regulation itself hardens the budget constraint. Nevertheless, regulations, which are compulsory for all units of public administration, are an even more efficient tool for hardening the budget constraint, because they narrow the room for the opportunistic behavior of organizations and politicians.
Fostering stronger market competition	The market prefers efficient organizations and eliminates inefficient ones. Market pressure (through competition) hardens the budget constraint.
Making competition stronger for state grants	The state can also demand competition for its grants. If the competition is fair and transparent, it compels organizations to perform better and hardens their budget constraint.
Fostering stronger internal control	Stronger internal control of performance – by applying performance management systems or controllers/auditors – provides fewer opportunities for overusing financial resources and hardens the budget constraint.
Applying stronger external control	Stronger external control of performance – by applying audit and reporting systems, by using sector level performance measurement systems such as Comprehensive Performance Assessment, or by employing external controllers/auditors – also puts pressure on an organization to harden its budget

	constraint.
Privatization	Privatization and, in some cases, outsourcing too expose the organization to market competition. Market hardens budget constraint.
Increasing the personal responsibility of decision-makers	Stronger personal responsibility of decision-makers not to exceed the organization's budget hardens the budget constraint.
Demonopolization	Monopolies usually have softer budgets than organizations in oligopoly or competitive conditions. Demonopolization – even by decentralization – creates competition and hardens the budget constraint.
Use of performance-related pay	Performance-related pay as a tool compels decision-makers in an organization to focus more on efficiency. This leads to hardening the budget constraint.
Separation of politics from administration	By separating the two and by giving them clear competencies helps to harden 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.
Providing more 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. These harden the budget constraint.

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 SCB syndrome. As Kornai, Maskin & Roland (2004:1116) note,

“It is worth emphasizing that the above argument concerns the hardening of *enterprises’* budget constraints through devolution. Decentralization of government does not, however, necessarily harden the budget constraints of *regional governments*. Indeed, just the opposite may occur: giving regional governments discretion over expenditure allows them to distort the composition of this expenditure in the hope of attracting funding from the central government (see Qian and Roland 1998 for further details).”

Decentralization may soften the budget constraint of local governments since they have the incentive to exceed their budget constraint (Breuillé & Vigneault 2010); however, centralization may also 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.

After demonstrating 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 case studies of how SBC can be used for analyzing the impact of public administration reforms.

1. *Establishment of County (Metropolitan) Government Offices.*<sup>15</sup> 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 exert certain control functions over seventeen different specialized administrative services (such as public health or veterinary

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<sup>15</sup> Here, I have drawn heavily from Hajnal & Rosta (2014: 14).

authorities). The reform enhances political management and control over state administration, and aims to establish a strong and efficient state. To understand how the political aspects can be enforced after this reform, it is worth noting that in the course of employing government officers, government commissioners have veto rights also in the case of the specialized administrative services authorities. In sum, this measure radically increased centralization and to some extent blurred the boundary between the tasks and competencies of professionals and politicians.

Using SBC as an analytical tool sheds light on the following features of this reform step:

- Financial and personal dependence of the merged organizations from the political actors are increased. Politicization softens the budget constraint of the organizations, but the enhanced political control may harden it.
- The competencies of local governments (mostly administrative tasks that were delegated to local governments by the central public administration) were centralized, which may harden the budget constraint of the local governments (together with the financial reform in the local government system).
- Due to the politicization the attention of these organizations changes: they focus more on actual political needs and professional considerations become secondary. This leads to softening the budget constraint.

2. *Creation of mammoth agencies responsible for middle management in each sector.*<sup>16</sup> The best examples of these agencies are the National Institute for Quality and Organisational Development in Health Care and Medicines (health care); Klebelsberg Institution Maintenance Center (public education); General Directorate of Social Affairs and Child Protection (social care).<sup>17</sup> The purpose in the creation of these agencies is as follows: (a) stronger horizontal and vertical coordination; (b) strengthening political control and supervision over these sector; (c) strengthening professional management by increased ministerial (center) competencies; (d) realization of financial savings (providing public services more economically and efficiently); (e) standardizing strategic management

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<sup>16</sup> 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.

<sup>17</sup> 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.

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).<sup>18</sup> As Hajnal & Rosta (2014: 13–14) note, “[t]hese features of the new system represent a clear setback to democratic legitimacy and decentralization.”

Using SBC as an analytical tool sheds light on the following features of this reform step:

- Stronger horizontal coordination may harden the budget constraint.
- The competencies of the local governments (health care: hospitals, public education: primary and secondary schools) were centralized, which may harden the budget constraint of local governments (together with the financial reform in the local government system).
- Politicization softens the budget constraint of the organizations.
- Less competition between organizations (given that they are all under one mammoth agency) softens the budget constraint of the organizations.
- Less transparency of these sectors softens the budget constraint.
- Centralization of strategic planning may soften the budget constraint of the organizations, but does by no means harden it.

3. *Radical elimination of the career-type civil service system.*<sup>19</sup> 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 significantly contribute to blurring the boundary between politicians

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<sup>18</sup> 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.

<sup>19</sup> This point was taken from Hajnal & Rosta (2014:18-19)

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.

Using SBC as an analytical tool sheds light on the following features of this reform step:

- Politicization softens the budget constraint.
- Stronger defenselessness of civil servants softens the budget constraint (via less restraint power of politicians).
- Weak rule of law is also a hotbed for SBC.

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 following features of this reform step:

- Stronger control over the credit taking of local governments hardens the budget constraint. However, individual decisions by the central government on which local government has the right to take credit soften the budget constraint.
- The centralization of the competencies of local governments hardens the budget constraint of local governments (but not of the organizations which execute these tasks such as hospitals and primary and secondary schools).<sup>20</sup>
- “Earmarking” 100% of central governmental grants also hardens the budget constraint of local governments.<sup>21</sup>

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<sup>20</sup> It is also a question how we interpret the situation where local governments do not have relevant competences in public services provision, but have hard budget constraint. Is it a sign of good governance?

<sup>21</sup> It yet remains to be examined what the impact of the almost full abolishment of financial autonomy will have on the effectiveness of local governments.

## **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 make 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.

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