THE ECONOMIC AND SOCIAL
RESEARCH INSTITUTE

Memorandum Series No. 160.

PUBLIC AUTHORITY BUSINESS UNDERTAKINGS:
THE PROBLEM OF SOFT BUDGET CONSTRAINTS

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September 1983

Price IR£1

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In the past, Public Authority Business Undertaking (PABUs) have fulfilled, and are likely to continue to play, a major role in the development of the Irish economy. These undertakings are conducted under a variety of organizational - management structures which include statutory corporations (the 'semi-state' companies) and joint ventures between state and private equity holders, as well as activities conducted within the context of the administrative departments of Government. In all these cases the ultimate financial control lies with the government which is acting as trustees for the public in whose interest these activities are undertaken. The types of relationships these enterprises have with its customers also varies and ranges from pure market pricing, prices involving particular elements of state subsidy or taxation, to activities paid for by means of specific or general tax revenues levied on the public. As well as these the supply of government goods and services may be assigned to private suppliers rather than public suppliers or the government may exercise public control over private enterprise activities. Thus state involvement in industrial and commercial activities is quite a complex mixture and as a first step in evaluating public authority business undertakings it is necessary to consider (i) reasons for public provision of governmental services as distinct from private provision or public regulation of private enterprises and (ii) the source of major difficulties for these type of organisations. Such an examination has to be conducted prior to being able to address questions about their appropriate role and scope in the Irish economy.

CASE FOR PUBLIC AUTHORITY BUSINESS UNDERTAKINGS

The basic economic arguments for public sector enterprises are:

(i) that there is a shortage of private entrepreneurs or capital or that private entrepreneurs and investors are unwilling or unable to fulfill a leading role in industrial development.

(ii) that imperfections in the market system result in a misallocation of resources because market prices differ from 'true' social prices or, in other words, there is a divergence between private profitability and social 'profitability'.

Some implications of these aspects of the case for public enterprises can be briefly identified. In the first argument PABUs are proposed as a means for promoting development. This argument, however does not in itself suggest any criteria for selecting the lines of activity that must be, or are most appropriately, pursued by enterprises of this type. There is a need for some view of the process of economic development which is sufficiently detailed in order to identify lines of demarcation. Nor does it indicate whether competition from private domestic or foreign enterprises should be encouraged or discouraged. Finally, and most important, the question concerning what happens to such public enterprises after they have achieved their promotional role must be addressed. Should they be sold off to private investors? If not, for what reasons should they be retained in the public sector? Once again there is a need for a subsequent argument to support their continuation as public authority business undertakings to promote industrial enterprise and provide commercial services.

In the second argument PABUs are proposed because other methods are either not available or are regarded as less effective. In principle an approximate mix of taxes, subsidies, and administrative regulations could be devised to correct the distortions which give rise to the divergence between marginal social costs.[1] However in practice this first best approach may not be feasible because the range of available tax, subsidy, and regulation instruments may be severely limited or administratively highly bureaucratic and costly. Therefore this argument for public enterprises is based on the view that these are more cost effective instruments than available alternatives or that they would generate greater social welfare than would result from imperfect markets without government intervention. However, such a position must be continuously re-evaluated.

This brief consideration brings to the fore the point that the two stated, and which are perhaps the most widely cited, aspects of the economic case for public authority business undertakings are not in themselves sufficient and must be supported by further considerations. These buttressing arguments range from the ideological (e.g. a belief that public ownerhsip is a necessary pre-requisite for socialism) and political (e.g. nationalization of foreign capital to ensure economic autonomy; an element in the extension of the power of the state) to the purely pragmatic (public enterprises are more cost effective in bringing about a desired outcome). Ideological-political arguments, while not entirely absent and often implicit in discussions, have not apparently played a significant role in providing the rationale for public authority business undertakings. To the extent that debate has occurred, and is continuing, it largely centres around pragmatic issues. It is on this that we shall focus here as it is the most relevant dimension in the context of the current economic crisis.

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1. A separate but related issue concerns public goods which are not specifically addressed here. However the existence of goods or services that may have features of non-excludability and non-rivalry in consumption does not necessarily imply that they cannot be produced by private suppliers.

In approaching the operational effectiveness of public sector companies there are three broad areas that have to be considered: investment policies, pricing policies, and control-management. There is now an extensive technical documentation about the first two areas.[1] They are not considered in this section because, even if they are got right, the key issue will still come down to the operational one of control and management. It is this area which is increasingly posing difficulties and becoming one of greater concern in the face of the current economic crisis. With government becoming more determined to increase efficiency in the economy there is obviously an onus on it to start with, and to prove effective in, bringing about greater efficiency in public administration and public business undertakings. The task is complex and difficult since it involves designining "some means by which to measusure performance, a procedure to compare the measurement against some pre-determined standard of performance, and a correcting mechanism capable of bringing about the changes necessity to restore the operations of the system to the desired level".[2] In the case of public sector enterprises the essence of the problem of evaluating performance and designing incentives adequate to ensure efficiency can be highlighted by making use of the concept of

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1. The task here is to take into account the divergence between marginal social cost and marginal social benefits, i.e. to assess social 'profitability'. The basic references for public sector investment are Partha Dasgupta, Stephen Marglin, and Amartya Sen, Guidelines for Project Evaluation, UNIDO, New York, 1972 and Ian Little and James A. Mirlees, Project Appraisal and Planning for Developing Countries, Heinemann, London, 1974. Public sector pricing rules are discussed in Raymond Rees, Public Sector Economics, Weidenfeld and Nicholson, London 1976 and Deepak Lal, Prices for Planning, Heinemann, London, 1979. Such techniques have to be applied in the wider context of economy-wide or sectoral planning.

2. Miceal Ross, Systems and Management: A Review, Economc and Social Review 4 (3): 365-394, April 1973, page 379 (emphasis added).

"hard" and "soft" budget constraints, the different conditions which give rise to them, and their consequences,as characterised by Kornai.[1]

PABU AND THE BUDGET CONSTRAINT PROBLEM

The conditions for a pure hard budget constraint for an enterprise are that:

(i) the firm is a price taker;

(ii) the firm has no influence on the tax system and cannot get exemptions;

(iii) state grants or subsidies not available;

(iv) there is no credit;

(v) there is no external source of financial investment (once the firm is established).

The consequence of these five conditions is that:

(a) survival depends exclusively on the proceeds from sales and costs of inputs;

(b) expansion depends exclusively on internal accumulation;

(c) the firm must adjust to prices by real actions, i.e. a suitable change of its input-output combination and production;

(d) risks must be borne by the firm.

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1. Janos Kornai, 'Hard' and 'Soft' Budget Constraints, Acta Oeconomica 25 25 (3-4) : 231-246, 1980.

The crúcial feature of a hard budget constraint is that it acts as an effective constraint on behaviour. It is not merely an after-the-fact accounting balance but is "a whole series of partial rules which jointly restrict the behaviour of the firm".[1] Probably very few enterprises today face the pure hard budget constraint[2] but ultimately bankruptcy, involving loss of assets and employment, faces unsuccessful private sector enterprises.[3] 'Softening' of the budget constraint obviously weakens these consequences and, therefore, the firm's adjustment response to prices. The softer the constraint the less pressure there is on the firms to respond to changes in relative prices unless there are also supply shortages) in the production sphere. It means also that survival no longer depends on the relationship between sales and costs, growth is financed by external investors, and risks are spread to outsiders. Although it may not do so,it is increasingly likely - at least on casual observation-that a firm turns to the government for 'special case' treatment in terms of prices, subsidies, taxes, and market protection when it is under pressure. These all serve to weaken the incentive to efficiency and productivity improvement.

Poor financial performance is currently, and indeed has been a frequent occurrance in public authority business undertakings. This is not just a matter concerning the temporary circumstances such as the

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1. Kornai, 1980; 233.

2. A weaker - and more realistic - set of conditions will give virtually the same result (Kornai, 1980: 266-267).

3. Unless, of course, they are rescued by nationalization or state subsidy, i.e. their budget constraints substantially softened by transferring them into the public sector.

cyclical state of markets; it is fundamentally due to the fact that they operate under soft budget constraints. Indeed, although few private sector firms may face the pure hard constraint, quite a number of public sector enterprises would appear to 'face' virtually pure soft budget constraints. <u>The difficulty with soft budgets is that they do not act as effective behavioural constraints and hence have to be supplemented by other effective constraints</u>. These, however, are very difficult to devise and operate. Employees, management, and government ministers, are well aware of this but consumers/taxpayers,who are faced with the consequences of soft constraints, lack direct and effective influence. The problem can now be seen as one of how to 'harden' the budget constraint for public authority business. In order to help identify some possible approaches it will help to first consider some factors which contribute to budget softening.

Among these factors are (in the order of the conditions listed above for a hard budget):

(i) firms are able to impose their own cost increases on customers because, for example, they may have a large influence on the pricing authority's decision;

(ii) taxes may not be collected promptly or exemptions may be granted;

(iii) firms may get investment funds without repayment conditions or continuously receive subsidies for current expenditures;

(iv) firms may obtain credit although its prospective ability to repay out of sales proceeds is doubtful.

Underlying all these is the fact that PABUs are, to varying degrees, subject to the politicalpprocess which works two ways if enterprises are financially unprofitable. First, management and employees, or their respective representatives, argue that the financial loss is due to meeting social objectives so that while they may be financially unprofitable they are socially profitable. Second, it is politically very difficult for a government to declare a PABU bankrupt, inadequate, or inappropriate (even if it is actually cheaper to simply continue paying 'salaries' to employees than to continue operation.)[1] Furthermore there is, at best, only a very weak connection between managerial and employee behaviour and sanctions for inefficiency. Tax-payers must pay for the errors of management or organizational slack in the enterprise. There is no equivalent sanction to that for private enterprises which, if performing poorly, are in danger of takeover - a process which normally involves the removal of directors and higher management and a re-structuring of the enterprise which affects assets, employees, and outsiders doing business with the firm.

The necessary step in hardening the budget constraint for public sector enterprises is to devise means for distancing them from the political process which is the basis for soft budgets. Based on the preceding analysis it is possible to identify a number of elements in this process, some of which are alternatives while others are reinforcing.[2]

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1. It is also becoming more difficult for governments to allow even private companies, or at least some of them, to go out of business. The political process is generally operating to soften the budget constraint facing all firms although it would appear, at the present at least, that the approach of the current government is to resist that trend.

2. These suggestions are not stated in any order of priority, feasibility, or effectiveness.

SOME POLICY OPTIONS

Performance Criteria and Evaluation

Effective ownership and management of assets requires sufficiently clear criteria of performance and evaluation. Meaningful financial objectives provide such criteria. There is no inherent reason for the presumption that any PABU fulfilling, partly or fully, socially profitable tasks will or must be financially unprofitable. The operating premise should be one of financial viability.

The extent to which undertaking socially profitable activities undermines financial profitability could be properly identified in the financial and 'social' accounts of an enterprise. Management can best (only?) control operations if the standard financial tools of performance evaluation can be applied and, to this end, actual payment should be made for commercial sacrifices. This, prevents the owners (i.e. citizens as represented by politicians and civil servants) imposing charges on the firm to solve political problems but which then undermine the financial, including long-term investment, viability of the operation. But it also provides the government, as an owner or contractor for special programmes, with a means for evaluating performance under both these headings. Thus, for example, where PABUs are over-staffed but face political constraints on reducing employment an explicit employment subisdy should be identified and paid. Enterprise behaviour is then more effectively constrained by the budget and government and taxpayers can calculate and evaluate this approach to resolving a political or social problem i.e. they can identify the cost and benefits sides of social 'profitability'.

Control and Accountability

There is a need to bring control and accountability into line with each other. Management sanctions are weak. Perhaps more important, however is that it is not always possible for managers in the various types of PABUs to resist the pressures and demands of the owners or its agents, i.e. citizens/voters, taxpayers or their representatives. In the case of poor decisions and faulty judgements by politicians and civil servants the sanctions are even weaker than for management and, probably in fact, are non-existent. It is difficult for governemnts to effectively control PABUs without affecting entrepreneurial initiative but, paradoxically, public sector managers and administrators are apparently quite prepared to undertake high risk investment because they are protected from financial discipline. Losses can always apparently be defended as being due to the pursuance of social objectives.

One possible approach to this divergence of authority and responsibility is to group public sector enterprises into a multi-sectoral holding company (or appropriate companies) in order to achieve a strict separation of political and commercial activities. Such a parent company would bear responsibility for the professional management of its subsidiaries and for ensuring that resources were used efficiently for current operations and investment. While budget softening could occur, or be deliberately allowed in pursuance of some overall objective, the holding company, i.e. the total group, would face a hard budget constraint. They would have to operate along commercial lines without special treatment or requirements different from any other enterprise. But they would also be freed from the uncertainty which always faces management in public sector enterprises concerning how much the government will give or take away. This alternative arrangement would help avoid the situation where some enterprises are under-capitalised, others are over-capitalised, and some are, at different times, under- and over-capitalised due to their differential bargaining and lobbying strengths vis-a-vis the government. It would also facilitate spreading of risk and improved financial viability as the holding company would have a portfolio of activities over which to operate.

Ownership and Direction

There is an important distinction between public ownership of fixed assets and public direction of their use which has to be clarified. Is the purpose of public authority business undertakings to ensure that specific types of capital are available or to exercise operational control over them? In the case of the Electricity Supply Board, for example, is the provision of costly and high risk capital-intensive power stations and distribution network the essential function as distinct from the actual operation of the generating equipment? If the former, the ESB could be re-structured as a capital-leasing corporation which makes available, through competitive bidding, the contract for operating the power stations. There is no particular reason why the operation of power stations should be monopolised whether under public or private control. There is a case for having a number of independent operating companies to bring about a hardening of the budget constraint. Such an arrangement would reduce the ability of enterprises in the sheltered sector of the economy to 'pass on' unemployment in the course of passing on costs, as is the case at present. It would also force decision-makers in the capital-leasing corporation to assess very carefully the commercial viability of major investment projects i.e. how much are they likely to be offered by potential operators for the lease of equipment.

There is a further important aspect to the distinction between public ownership and public control which has to be addressed. This concerns the type of activities undertaken by public enterprises and administrative departments of governments. There is no definitive criteria about what industrial and commercial enterprises should be publicly owned. Even in the area of infrastructure such as, for example, waste collection and disposal systems, there is a wide variety of patterns of ownership and control in operation in different countries and which could be examined as alternative approaches. Because garbage collection services are funded out of tax revenues (whether general or specific charges) does not imply that such services must be supplied by public sector enterprises or government departments. A harder budget constraint may be achieved if they are actually supplied by sub-contracting to competitive bidders rather than by public sector enterprises, or government departments and local authorities.

Organisational Forms

Finally, if there were to be a re-structuring of PABU's and government services along lines such as those suggested above there is the question of what alternative organisational forms are appropriate to achieve desired goals and to ensure accountability by hardening the budget constraint. Three options were mentioned in the discussion above: (i) public sector enterprises and activities, currently conducted under the rubric of administrative departments, grouped under parent companies responsible for overall control and financially accountable; (ii) leasing capital to private sector operators; and (iii) sub-contracting the supply of government services to private sector enterprises. Although some use is made of each of these approaches at present there does not appear to be any fundamental difficulty in extending these principles of organisation to a wider range of activities. However, there are two supplementary issues to be taken into account.

The first concerns the interest of the present employees of public sector enterprises, administrative departments, and local authorities who would be affected by reforms along these lines. Some approach would have to be developed that would adequately protect their genuine interests, i.e. in the context of their future operation in the context of hard budget constraints or behaviour. One possibility is re-organisation into employee-owned or employee-directed enterprises. Although there are no examples of either type in Ireland at present they may offer, if properly structured, an approach for providing workers with a viable enterprise structure within which they themselves can protect their interests and develop their resources. They would seem to be particularly relevant in situations of severe organisational deterioration and business decline and failure.

The second issue concerns the interests of consumers/taxpayers in situations where market prices and, obviously, tax prices are established by government or administrative regulation. In order to bring about a hardening of the budget constraint in this context it is necessary for consumers/taxpayers to have more direct and concentrated influence on the setting of prices and charges for public authority business undertakings and government services. Some effective access will have to be provided to the regulation process with at least the administrative procedures subject to public regulatory hearings. More substantial reforms could include, say, the capital - leasing corporation, as suggested above, being directed as a consumer cooperative which leases equipment to worker cooperatives for actual operation. Public authority business undertakings in the area of transport, for example, would appear to be suitable for re-organization along these lines.

CONCLUSION

By way of conclusion, we can now turn to a question, sometimes posed in the fact of the present economic crisic, concerning the scope for more public authority business undertakings and suggest that the answer is that it all depends: it depends on whether the basic problem of devising and making effective harder budget constraints can be solved. This involves determining the degree of hardness which is appropriate and the means by which it can be enforced and future softening prevented. In other words it will be necessary to distance PABUs from the political forces which soften their budget constraints. A <u>business</u> should generally be supported by customers, not by taxpayers. The imposition of harder budget constraints, which are effective constraints on behaviour, operate on both sides involved in an activity i.e. on the enterprise itself (management and employees) and its owners and ultimate directors (the government, i.e. political representatives of the public, and civil servants). But this is necessary is PABUs are to fulfill the tasks for which they are established without imposing an increasing burden on the private sector other than the very minimum necessary. If this organisational objective can be achieved, then the second level questions concerning what areas of activity and whether they are intended to be promotional or not, and, if promotional, how they are to be transferred to the private sector, are relevant. It is only then that the question about the slope, need, or opportunity for further public authority business undertakings can be satisfactorily addressed.