

The Provision of Public Goods and the Soft Budget Constraints

Damien J. Neven
Lars-Hendrik Röller
Zhentang Zhang

Firms in centralized (or formerly centralized) economies often provide a public good in addition to a private good, which makes it difficult for a government to commit not to bail out the firm once it is in financial trouble. This creates a soft budget constraint syndrome which causes the firm to underinvest ex ante in order to extract state subsidy and thereby reduces dynamic efficiency. In this paper, we show that separating the provision of public goods from private goods can harden budget constraints, while introducing competition into the private market may not.

JEL Classifications: L13, L30.

Key words: Soft budget constraints, dynamic efficiency, public good provision

Correspondence:

Zhentang Zhang
WZB, Reichpietschufer 50
10785 Berlin
Germany
zhang@medea.wz-berlin.de