CORPORATE RENT – SEEKING AND THE MANAGERIAL SOFT – BUDGET CONSTRAINT

AN INCREMENTAL CASH FLOW APPROACH TO SOME CORPORATE GOVERNANCE ISSUES

*Rodolfo Apreda**

Abstract

This paper seeks to expand on two topical strands in Government Finance and Political Science literature, rent-seeking and the soft-budget constraint, so as to bring forth a strong linkage with corporate governance environments. It will attempt to accomplish this task by setting up a distinctive framework of analysis that hinges on incremental cash flows. Firstly, it claims that both rent-seeking behavior and the soft-budget constraint are worthy of being applied to corporate governance learning and practice. Secondly, the paper contributes to focus on cash-flows reliability and managers' accountability. Thirdly, it is shown how conflicts of interest underlie rent-seeking behavior, and how the latter relates to the soft-budget constraint.

Keywords: Rent-Seeking, Soft-Budget Constraint, Corporate Governance, Incremental Cash Flow model, Conflicts of Interest.

* Corporate Finance Chair, and Head of the Department of Applied Economics,Universidad del Cema
E-Mail: ra@cema.edu.ar, Phone Number: 5411 4314 2369
Address: Avda Cordoba 374, Room 612, Buenos Aires, Argentina, Zip Code: C1054AAF

Introduction

It is frequent for a concept in any scientific development that, albeit it may spring from a particular field of knowledge, sooner or later it makes inroads into other branches either in the same science or others. This has been the case in Economics with a pair of concepts that were born and have been widely used in the realm of Public Finance since the 1970s, whereas they have come in handy to other concerns as well. We are speaking about rent-seeking behavior and the soft-budget constraint.

Rent-seeking was notionally introduced by Tullock (1967), but the term as such was firstly coined by Krueger (1974). It primarily conveys the idea of rational and self-seeking behavior that redistributes resources available to society. Tullock, on the one hand, highlighted that lobbies are encouraged to effect wealth transfers by means of the government in a negative sum game as economic agents invest resources to profit from those transfers or forestall them from taking place. On the other hand, he laid stress on the fact that rent-seeking behavior has double costs: the distortionary effect of the rent itself, and the diversion of productive resources towards competition for the prize of the rent (further enlargements on this line of analysis can be found in Tullock, 1990 and also Tullock, Seldon and Brady, 2002).

The Soft-Budget constraint refers to the following environment: an unprofitable and failing company is bailed out either by the government or the company's creditors, regardless whether it is a company in the private or the public sector of the economy. In other words, instead of keeping a tight budget, managers can soften the underlying constraints because additional cash flows are likely to come out of the government or creditors' pockets, discouraging therefore a culture of financial discipline. This issue was firstly advanced by Kornai (1979) in the context of socialist economies, and then it was extended to capitalist economies (an updating can be found in Maskin, 1999). Against the background of privatizations, Tornell (1999) applied this tool of analysis to banks with low capitalization and implicit government guarantees, private mafias and non-transparent bankruptcies procedures.

Financial Economics and Corporate Finance seem to provide us with another promising research domain for both concepts although it comes as a surprise that they have not been handled together so far. There has been some research, however, limited in scope to rent-seeking only. In this sense, Edlen and Stiglitz (1995) should be marked as one of the earliest efforts to study rent-seeking in corporate finance, and Bebchuck, Fried and Walker (2002) one of the latest, with an extensive analysis on executives' compensation plans.

This paper intends to map out a linkage between rent-seeking and the soft-budget constraint in corporate life, by means of a fitting incremental cash flow approach. Such a task will be carried out, for the sake of argument, through the following stages:

In section 1, rent-seeking will be applied to for-profit organizations, taking advantage of the incremental cash flow model. Next, a brief outline on the concept of economic rent will follow so as to put the whole picture into a suitable framework.

Afterwards, we deal with internal separation portfolios and the management pay- package, two sources of rent-seeking behavior that will deserve a closer look in sections 2.1 and 2.2 before proceeding, as it will be done in section 2.3, to work out how conflicts of interest might be translated by rent-seeking behavior.

It is for section 3 to reframe the incremental cash flow model so as to make it suitable for the analysis of the corporate soft-budget constraint. And in section 3.1 we inquire into the connection between corporate rent-seeking and the corporate soft-budget constraint. Conclusions will come after.

1. Corporate rent seeking

If we look at cash flows from the point of view of modern Corporate Finance, they will tell the story about the manifold ways they may be apportioned on behalf of the company's value enhancement and the advantage of its stakeholders. The standard cash flow model (SCFM) predicates that changes in cash flows from assets are to be distributed towards creditors and stockholders along a conventional period [t ; t+1]:

$$\Delta CF_t\ (assets) = \Delta CF_t\ (creditors) + \Delta CF_t\ (stockholders) \qquad (1)$$

In other words, (1) brings forward that debt holders and stockholders have cash flow rights on the residual income of any company.

But real life and current academic research do not lend credence to this story without further qualifications, and that is why Corporate Governance is a thriving field of knowledge and practice, with the purpose of analyzing malfeasances in the cash flow management, providing with organization design and codes of behavior to take due care of stakeholders' interests (Apreda 2003a).

In this paper we are concerned with economic units (for instance, any for-profit company) within which individual actors (mainly managers or stockholders groups) play opportunistically to extract rents to their own benefit from the running cash flows of their company with loss or damage to other stakeholders. As a point of departure, we look for a broader meaning to be attached to private rent-seeking so as to distinguish it from rent-seeking in the public sector:

By *Corporate Rent-Seeking* is meant any sort of consistent and purposeful behavior with guile to the advantage of managers or stockholders groups with the following central features:

- knowing that there are economic rents to grab, they compete for them with guile;
- they appropriate more cash flows from the company than can be fairly claimed;
- or redistribute cash flows, damaging other stakeholders in their rights to those cash flows;
- in doing so, they prevent the company from achieving sustainable growth and value enhancement.

"Corporate Rent-Seeking" is an expression that can lead to confusion because it seems to focus on corporations only. We follow the mainstream convention here, by which organizations not incorporated, mostly small and medium companies, and other organizations producing goods and services, can be dealt within the narrowing term "corporate" we attach to any financial subject. A more descriptive and encompassing label would be "rent-seeking in the private sector". In this case, instead of speaking about "stockholders groups" we would refer to "owners" eventually. On this last issue, an insightful treatment is provided by Hansmann (1996).

It seems advisable to delve into the notion of "rent" before expanding on our subject, because it will provide the matter of rent-seeking not only with semantic consistency, but also stronger economic grounds.

Ownership of an economic resource (from land and capital investment to companies, licenses and patents to personal skills, monopoly grants to copyrights) allows for reward, most of the time under the shape of a stream of payments.

Sometimes, however, we can find a differential component of the payment owed to an economic resource, springing from two sources:

- there is a certain surplus economic return (or pure profit) that comes out of the ownership;
- it is a surplus over those returns actually needed to retain the economic resource in its expected use.

Such a differential component is called ***economic rent*** and repays the ability to control access to a resource or the skill to enforce its ownership, rather than any actual expenditure, effort, or past actions sunk into the resource.

In general, this economic rent is assimilated to an excedent earned or collected over the amount measured by the economic cost of providing the good or service.

Sorensen (1996), in an insightful sociological approach to rents, put the whole issue under the following viewpoint:

Rent is an advantage or surplus created by nature or social structure over a certain period of time. The creation of such advantages I shall call ***rent-creation****. The pursuit of them, once they are in existence, is* ***rent-seeking****.*

In other words, the concept of rent points to the idea of benefits that are unearned, while rent-seeking refers to any form of behavior designed to redistribute in one's favor the rents associated with particular assets or enterprises. We have to bear in mind that rent-seeking directly implies that economic agents may compete and try to grab the rent-production of another economic agent or organization. Following this line of analysis, the Public Choice approach to rent-seeking highlights how interest groups seek legislation or other political acts that redistribute income and assets in their favour (Tullock, 1993). Moreover, rent-seeking is regarded in the Public Choice and political debate as manipulation of collective action for private benefit. In consequence, the efforts and investments of rent-seekers that fail in securing those rents are wasted eventually, not being apportioned to any alternative resource production.

How these rents are to be distributed in any going concern seems to be at the root of many conflicts of interest among the main stakeholders, namely stockholders, managers and creditors. It is a fact of life that many times they compete to grab the advantages, regardless of whether they qualify or not for making such pretence.

We finish this section with the caveat that the contest for cash flows in any company, when following the book, is primarily a profit-seeking job. By far, equaling profit-seeking with rent-seeking should be regarded as utterly misplacing. From the definition above, rent-seeking hinges on opportunistic behavior with guile, which trespasses property-rights boundaries claimed by other stakeholders and, sooner or later, it brings out losers among them, even to the extent of failing the company in the course of time (Baumol, 1990). On the other hand, profit-seeking is a driver of business activity within the law. Good corporate governance attempts to set up rules and constraints so as to curb rent-seeking and foster profit-seeking.

2. Incremental cash flows and rent-seeking

So far, most of the research addressing conflicts of interest has been carried out on agency problems among stockholders, creditors and managers. However, to get a functional picture of how the real players deal with actual cash flows in the rent-seeking game, we have to reshape (1) and uncover some distinctive cash flows that are embedded into those produced by assets (details in Apreda, 2003c).

Therefore, we bring forward an expansion of the SCFM by highlighting not only those cash flows to be addressed to creditors and stockholders, but also those claimed by managers as their pay package. Heed will also be given to the source of liquidity and wealth-holding behind what we are going to call the *internal separation portfolio*.

$$\Delta CF_t \text{ (assets; net)} = \Delta CF_t \text{ (creditors)} + \Delta CF_t \text{ (stockholders)} + \Delta CF_t \text{ (internal separation portfolio)} + \Delta CF_t \text{ (management pay package)} \qquad (2)$$

Incremental cash flows from assets are labelled "net" because we shift some cash flows from the left side of (1) onto the right side of (2) by setting up two new cash flows categories: the "*internal separation portfolio*" and the "*management pay package*", whose inner structure will be developed in section 2.1 and 2.2, respectively.

There are other meaningful cash flows that could be drawn out of assets. In particular, for countries where unions wield real power over cash flows to employees and workers the analysis should take them into account eventually as seekers of economic rents. The same could be predicated on the government, when taxes do take a big slice of the cash flows and fiscal policy become predatory on companies' revenues. From this point of view, (2) would be reframed as

$$\Delta CF_t \text{ (from assets; net)} = \Delta CF_t \text{ (creditors)} + \Delta CF_t \text{ (stockholders)} + \Delta CF_t \text{ (internal separation portfolio)} + \Delta CF_t \text{ (management pay package)} + \Delta CF_t \text{ (government)} + \Delta CF_t \text{ (TUnions workers)} \qquad (3)$$

2.1. The internal separation portfolio

It's worth focusing on cash assets and long-term investment in financial assets so that the meaning of the internal separation portfolio may become operational.

a) Cash Assets

To underline the importance of cash assets, it will be shown where they come from and how we can take them apart from the left side of (1). By cash-assets we are going to mean those assets whose cash flows come out from cash not-for-operations and financial short-term investments.

The following equation exhibits the main current assets components (for ease of notation, we are going to drop "CF" before cash flows subcomponents):

$$\Delta CF_t \text{ (current assets)} = \Delta_t \text{ (cash)} + \Delta_t \text{ (financial short-term investments)} + \Delta_t \text{ (inventories)} + \Delta_t \text{ (accounts receivable)} + \Delta_t \text{ (other current items)} \qquad (4)$$

The expected cash flows from cash, Δ_t *(cash)*, can be split down into two components:

- cash that is required for the daily running of a business, Δ_t *(cash for operations)*, which should be included for the provision of working capital along the budgeted period.
- cash that would not be required for normal operations in the budgeted period, Δ_t (*cash not-for-operations)*, which performs as a stock of excess liquidity.

Furthermore, Δ_t *(financial short-term investments)* is the place where many companies ought to set up and manage financial assets portfolios with a short-term target.

Therefore, and as from now, (4) can be written as:

ΔCF_t *(current assets)* = Δ_t *(cash assets)* + Δ_t *(current assets; net)*

which sets apart the actual amount that should be allocated to current assets when we strip from them the cash assets.

b) Long-term investment in financial assets

Following the same logic as in the case of cash assets, we claim that the SCFM does not take into account the item Δ_t *(financial long-term investments)* either. It's rather surprising, because such item stands for the underlying financial assets that any company actually manages as a portfolio whose cash flows are not necessarily outflows in the period. Customarily, in the standard incremental cash flow model this item is supposed to be null and not influencing the expected changes in cash flows apportioned to non-current assets. Therefore, a sensible way of splitting the cash flows related to long-term assets would be the following:

ΔCF_t *(provisions for long-term assets)* = Δ_t *(provisions for long-term assets; net)* + Δ_t *(financial long-term investments)*

c) The Internal Separation Portfolio

Now, we have to delve into the structure of the *internal separation portfolio*, that comes defined as

S = {cash assets; financial long-term investments}

Finally, the translation of this portfolio into incremental cash flows is conveyed by

ΔCF_t *(internal separation portfolio)* = Δ_t *(cash assets)* + Δ_t *(financial long-term investments)* (5)

It should be noted that any company manages a portfolio of financial assets to trade off risk and return along a holding period. In fact, it performs as a truly separation portfolio consisting of risk-free assets and risky assets, as well. Besides, in the planning horizon [t; t + 1], this portfolio really amounts to the main source of future investment or expenditure decisions that are put it off for the time being (background on separation portfolios in Apreda, 2003b).

2.2. The management pay package

Whereas this compact of fixed, variable and contingent payments has been widely analyzed since the influential paper by Murphy (1998) laid ground on the subject, the discussion has neglected incremental cash flows so far. As the Enron's disgraceful affair brought to light, the management pay package is not a matter to be left on the side (Apreda, 2002a).

In the same fashion as we did with the separation portfolio, we have to uncover distinctive components of the management pay package. It must be kept in mind, however, that the following factoring of components into the pay package is not the only one available, but rather a functional categorization for this paper's purposes.

ΔCF_t *(management pay package)* = Δ_t *(salary in cash)* + Δ_t *(fringe benefits)* + Δ_t *(corporate expenses account)* + Δ_t *(performance bonuses)* + Δ_t *(deferred income)* + Δ_t *(deferral payments)* + Δ_t *(long term incentives)* + Δ_t *(loan advances)* + Δ_t *(exercised stock options)* + Δ_t *(directors' fees and incentives)* (6)

2.3. Conflicts of interest and rent-seeking

To gain knowledge about the rent-seeking nature of incremental cash flows, the format of cash flows depicted in (3) should be enlarged on, as it will be shown below by means of (7). In this way,

- actual sources of incremental funds will remain in the left-side hand;
- in the right-side hand care will be given, firstly, to cash flows commitments to a wider range of stakeholders, including government and unions;
- and secondly, the separation portfolio and the managers' pay package will be highlighted as an application of resources that become instrumental when tracking down on rent-seeking behavior.

ΔCF_t (from assets; net) + ΔCF_t (net new financing) = ΔCF_t *(creditors)* + ΔCF_t *(stockholders)* + ΔCF_t *(internal separation portfolio)* + ΔCF_t *(management pay package)* + ΔCF_t *(government)* + ΔCF_t *(trade unions / workers)* *(7)*

When we go from (3) to the expansion displayed in (7), not only some items are brought into light from the cash flows from assets, but also the incremental cash flows addressed to stockholders and debt holders undergo major changes. Let us give heed to this matter.

a) To begin with, we will keep under the label "cash flows to stockholders", ΔCF_t *(stockholders)*, only the actual cash flows they are entitled to receive as residual rights

ΔCF_t (stockholders) = dividends$_t$

while the remaining items usually addressed to stockholders in the SCFM will be allocated to net new stock,

ΔCF_t (net new stock) = new stock issues$_t$ – stock repurchase$_t$

The standard cash flow model bundles dividends and net new stock together, but this practice seems not functional, at least for two reasons:

- one thing is to send forth dividends to actual stockholders,
- but quite another one is to make decisions about repurchasing or to issue new stock.

b) By cash flows to bondholders we mean only the actual contractual cash flows they are entitled to:

ΔCF_t (debtholders) = interest $_t$ + debt repayment $_t$

while the remaining items that the SCFM embedded in the cash flows to debtholders will be allocated to,

ΔCF_t (net new debt) = new debt issues $_t$ – debt repurchase $_t$

c) Finally, cash flows from net new financing come defined as

ΔCF_t (net new financing) = ΔCF_t (net new debt) + ΔCF_t (net new stock)

Analyzing cash flows from this point of view seems particularly useful since uncovers distinctive sources of cleavages among competing stakeholders.

Let us assume that an economic predator in pursuit of these cash flows consistently enacts a deliberate scheme for grabbing cash flows in (7) that should be apportioned to other incumbents or be kept to fulfill the company own needs. This behavior amounts to corporate rent-seeking, by setting up a measurable economic rent with a monopolistic reach over cash flows that becomes functional as time passes by to their own interest while, on the other hand, this activity goes in detriment of other stakeholders' cash-flow rights, or against the company's goals.

3. The managerial soft budget constraint

Writing against the background of socialist countries, Kornai (1979) defined a budget constraint as *hard* when is exerted with strong discipline: the firm can spend only as much money as it has, and credit is only available on the grounds of orthodox and conservative banking procedures. The budget constraint is *soft* whenever the state and even the company's creditors (in capitalist settings) help the firm out of trouble. The state helps firms to soften their budget constraints whenever it confers subsidies, tax exemptions, hidden price increases, credit on lenient terms, even to the extent of nationalizing failing private companies or concessionaires. It does not come as a surprise, as Kornai put it, that whenever soft-budget constraint is a current practice, *the state is a universal insurance company which compensates the damaged sooner or later for every loss.*

Hence, the usual meaning attached to "soft-budget constraint" has sprung from the Economics of the public sector. However, in order to apply it sensibly to corporate governance issues, we must narrow it down to make it suitable for the Economics of the private sector.

We are going to understand by *Managerial Soft-Budget Constraint* any systematic, on-purpose behavior with guile whose core features are:

Budget constraints and their underlying incremental cash-flows statements become merely declarative.

Cash-flows are opportunistically shifted from declarative targets and allocations towards rent-seeking targets and allocations.

Growth and value enhancement are not tied to the current and future financial situation

Failures or malfeasances arising from the former procedures are met by a corporate bail-out process following a set of consecutive stages:

- the buck stops below the bottom line;
- in case of financial trouble, creditors and governments are asked to foot the bill and keep the company running;
- when things turns for the worst, creditors and governments are asked to take over the disposals.

Hence, any budget constraint adds up to an ex~ante pattern of behavior that influences not only the firm's decisions and performance, but also managers' expectations and personal agendas.

In this section, we are going to develop a framework that enlarges the SCFM so as to deal with the soft-budget constraint issue.

Recalling the modified incremental cash flow model (7), we want to shape it so as to get a perspective from within the company as a required step before dealing with the soft-budget constraint sources. Therefore, we take away from (7) any cash flows directed to government and unions which are shifted back to their original location within the cash flows from assets as in (1) or (2). The remaining incremental cash flows will fit in with the purpose of our analysis:

ΔCF_t (assets; net) + ΔCF_t (new financing) = ΔCF_t (creditors) + ΔCF_t (stockholders)+ ΔCF_t (internal separation portfolio) + ΔCF_t (managers pay package) (8)

so that the left side of (8) brings forth how resources are provided not only by *ΔCF_t (assets; net)* but also by new financing.

If we now rearrange the transient cash flows hoarded in the internal separation portfolio, a fairly informative split follows:

ΔCF_t (internal separation portfolio) = ΔCF_t (investment fund portfolio) + ΔCF_t (new growth opportunities) (9)

That is to say, the internal separation portfolio consists of two main components:

- cash assets and long-term securities issued by governments or firms, which amount to a regular investment portfolio managed within the company's Treasury;
- cash assets and long-term securities earmarked for new investment opportunities in real assets.

Such is the intuition behind (9). In other words, the internal separation portfolio performs as the company's investment fund, and also as a portfolio of financial assets to cope with real-options embedded in new growth opportunities.

Therefore, so as to give account of the actual sources related to soft budget constraints, the incremental cash flow model should be shaped eventually as

$$\Delta CF_t \text{ (assets; net)} + \Delta CF_t \text{ (new financing)} = \Delta CF_t \text{ (creditors)} + \Delta CF_t \text{ (stockholders)} + \Delta CF_t \text{ (managers pay package)} + \Delta CF_t \text{ (investment fund portfolio)} + \Delta CF_t \text{ (new growth opportunities)} \quad (10)$$

3.1. Rent-seeking and the managerial soft-budget constraint

It is useful to contrast corporate rent-seeking with the managerial soft-budget constraint. In the first place, let us give thought to a core similarity, to go on with some differences afterwards.

a) The basic likeness lies on both being examples of consistent opportunistic behavior followed by some parties in the company, to the disadvantage of other counterparts. The former profit from the fact that the latter face asymmetric information, bounded rationality and transaction costs as their restraints to handle monitoring successfully.

b) The first difference is to be found in how distinctive each behavior becomes. Whereas rent seeking can be pursued from operational, tactical or strategical perspectives, the soft-budget constraint hinges on a mood of leniency on cash flow management that could become functional to rent seeking. However, seeing the soft-budget constraint as a particular case of rent seeking would be misleading, because soft-budget constraint may also be found in many organizations that foster a culture of inefficiency, mediocrity, sheer waste, or managerial mindlessness, all of these widespread ailments in the Public Sector.

c) The second difference that matters lies in the way we can track down the ultimate players. As we saw in 2.3, rent-seeking is a game with many participants that hold a stake in the company. Instead, the soft-budget constraint is carried out by the management, most of the time.

Relationship (7) teaches how the main players' actions could be mirrored by means of incremental cash flows. Pervasive and widespread conflicts of interest, therefore, seem the distinctive feature that (8) conveys in the end.

On the other hand, (10) displays a narrower stage, because broad conflicts of interest are restricted here to agency problems among the main stakeholders in any company, namely the stockholders, debt holders and managers.

d) Although stockholders and debt holders can be influential in dealing with budget leniency, it is for managers to become instrumental in engineering cash flows transfers so as to profit from the soft-budget constraint. In this regard, however, a striking difference arises when we contrast how this behavior evolves in both the public and the private sector. In fact, three variants on the soft-budget constraint behavior are worthy of being noticed.

In state-owned companies or in government agencies, any time the public servant in charge expends and invests beyond the budget constraint, he does not feel obliged to meet neither efficiency nor efficacy targets, since he is aware that leniency goes hand in hand with lack of accountability enforcement (Whincopp, 2000).

In private companies running their business within a soft-budget constraint environment, which is fostered and nurtured by the government [like in many emergent countries, being Argentina a good case in point (Apreda, 2001)], private managers follow the same behavior that public servants, oblivious of competitive thrust, innovation, even accountability to their stakeholders. The bottom line is disregarded, because in these countries capitalism tenets and law enforcement are neglected to the extent that losers are rewarded and winners punished. Instead of economic freedom, politics intrudes in markets to lead business into a path of corruption and malfeasance.

But there is a third variant, which is the most important to our goals in this paper, and it comes under the label of "Managerial Soft-Budget Constraint", where the management perform as in the paragraphs above, but the motivation does not come from the government or the political system, but from personal and hidden agendas. The practice of the corporate soft-budget constraint can be found in developed, emergent or transient economies alike, being Enron a disgraceful example.

3.2. Following up the managerial soft-budget constraint

The managerial soft-budget constraint can be tracked down by means of (10) either from the sources of funds, or their allocation.

a) From the sources of funds

As we briefed in section 2.3, when dealing with cash flows from assets

Δ CF $_t$ (from assets; net) = Δ_t (operations) – Δ_t (provisions for working capital; net) – Δ_t (provisions for long-term assets; net)

The last two items in the right-hand side host plenty of chances to rent-seeking behavior. The negative sign before each of those cash flows means that they are outflow provisions, that is to say, uses of funds (unless, of course, that incremental cash flows carried negative signs by their own).

These provisions for working capital (for instance, credit enhancement from suppliers and to customers, short-term financing, inventories turnover) and long-term assets (storage, maintenance, renewal) provide the management with transient funds to be depleted later in unrelated purposes. Hence, the fulfillment of the goals embedded in those provisions may be impaired to the extent of leading the company towards financial distress.

On the other hand, (10) also highlights cash flows from new financing, within which there is a wide range of patterns for practicing predatory investments and the soft-budget constraint game. For a start, unaccountable repurchase of bonds that favour some bank or parental company. Also, repurchase of stock deliverable to managers through stock options arrangements.

However, the most questionable issue regarding these cash flows can be found in the increasing indebtedness of the company with state-owned banks under lenient credit requirements for interest and principal payments. It is very frequent in emergent countries that in those cases where private banks after due diligence refuse to grant any loan to the company, on the grounds of bad credit ratings, the company get access to funding in the public bank system because of political or populist qualifications. This goes hand in hand with bribes to bank officials, policymakers, influential lobbyists, and government officials. Although it is said that the Central Bank is the lender of last resort, the fact is that this sort of corruption practice conveyed by the soft-budget constraint culture imposes an undeserved levy on citizens' welfare, through inflation, transaction costs, new taxes and loss of growth opportunities.

b) From the uses of funds

With the wisdom of hindsight, and taking advantage of many disgraceful affairs in the takeover's wave along the 80s and 90s, or the example of malfeasance so suitable epitomized by Enron, it is not surprising that the main tools at the reach of managers' hands in playing the budget leniency culture are located in the following components of the left-hand side of relation (10):

ΔCF $_t$ (managers pay package) + ΔCF $_t$ (investment fund portfolio) + ΔCF $_t$ (new growth opportunities)

As we expanded on elsewhere (Apreda, 2003c) there are many transient items in the incremental cash flow model as displayed by (10). They are transient because they are ex~ante and proper allocation will take place as the planning horizon [t; t + 1] evolves. But they are also transient because managers will pursue opportunistic behavior, seeking for rents, or practicing how to make budget constraints soft.

If we recall that cash flows from assets encompassed two negative cash flows attached to working capital and long-term assets, we can get the whole picture of the discretionary use of funds on the side of the management:

Δ_t (provisions for working capital; net) + Δ_t (provisions for long-term assets; net) + Δ_t (managers pay package) + Δ_t (investment fund portfolio) + Δ_t (new growth opportunities)

This relationship is fairly comprehensive in telling most of the story about the managerial soft-budget constraint.

Conclusions

This paper claims that corporate rent-seeking and the managerial soft-budget constraint are well-defined subjects to be embedded into the realm of Corporate Governance.

Firstly, it provides the semantics for rent-seeking and soft-budget constraint when intended as topics to be developed in corporate governance learning and practice.

Secondly, a quantitative framework grounded on incremental cash flows is set forth so as to deal with the budgeting and the performance track of those cash flows from which there might be scope for attempting rent-seeking behavior and nurturing a soft-budget constraint culture.

Thirdly, it traces back to the sources of the deep relationship that arises from conflicts of interest with rent-seeking, and also the managerial soft-budget constraint with rent-seeking.

References

1. Apreda, R. (2003a). *The Semantics of Governance (The common thread running through corporate, public and global governance).* University of Cema Working Paper Series, number 242, Buenos Aires, Argentina.
2. Apreda, R. (2003b). *Simple and Enlarged Separation Portfolios (On their use when arbitraging and synthesizing securities).* University of Cema Working Paper Series, number 233, Buenos Aires, Argentina.
3. Apreda, R. (2003c). The Governance Slack Model: A Cash Flow Approach to Shape Up Corporate Accountability and Good Practices. *Corporate Ownership and Control*, volume 1, number 1, forthcoming in September.
4. Apreda, R. (2002a). *How Corporate Governance and Globalization can run Afoul of the Law and Good Practices in Business: the Enron's Disgraceful Affair.* University of Cema

Working Paper Series, number 225, Buenos Aires (downloadable from www.ssrn.org/).

5. Apreda, R. (2002b). *Incremental Cash Flows, Information Sets and Conflicts of Interest*. University of Cema Working Paper Series, number 220, Buenos Aires.
6. Apreda, R. (2001) Corporate Governance in Argentina: 1991-2000 (The Consequences of Economic Freedom). *Corporate Governance: An International Review*, volume 9, number 4, pp. 298-310.
7. Apreda, R. (1999). The Cash Float Model with Float: A New Approach to Deal with Valuation and Agency Problems. *Journal of Applied Economics*, volume 2, number 2, pp. 247-279.
8. Baumol, W. (1990). Entrepreneurship: Productive, Unproductive and Destructive. *The Journal of Political Economy*, volume 98, number 5, pp. 893-921.
9. Bebchuk, L.; Fried, J.: Walker, R. (2002). *Managerial Power and Rent Extraction in the Design of Executive Compensation*. Working Paper 9068, National Bureau of Economic Research (downloadable from www.nber.org)
10. Edlen, A. and Stiglitz, J. (1995). Discouraging Rivals: Managerial Rent-Seeking and Economic Inefficiency. *American Economic Review*, volume 8, number 5, pp. 1301-1312.
11. Grossman, H. and Kim, M. (1997). *Predation, Efficiency and Inequalities*. Working Papers 631, National Bureau of Economic Research (downloadable from www.nber.org).
12. Kornai, J. (1979). Resource-Constrained versus Demand-Constrained Systems. *Econometrica*, volume 47, number 4, pp. 801-820.
13. Krueger, A. (1974). The Political Economy of Rent-Seeking Society. *American Economic Review*, volume 64, number 3, pp. 291-303.
14. Maskin, E. (1999). Recent Theoretical Work on the Soft Budget Constraint. *American Economic Review*, volume 89, pp. 421-425.
15. Murphy, K. (1998). *Executive Compensation.* SSRN Electronic Paper Collection, number 163914 (downloadable from www.ssrn.org).
16. Sorensen, A. (1996). The Structural Basis of Social Inequality. *American Journal of Sociology*, volume 101, number 5, pp. 1333-1365.
17. Tornell, A. (1999). *Privatizing the Privatized*. Working Paper W7206, National Bureau of Economic Research (downloadable from www.nber.org).
18. Tullock, G. (1967). The Welfare Costs of Tariffs, Monopolies and Theft. *Western Economic Journal*, volume 5, 224-232.
19. Tullock, G. (1990). *The Costs of Special Privilege*.(In Perspectives on Positive Political Economy, edited by J. Alt and K. Shepsle, Cambridge University Press, New York)
20. Tullock, G. (1993). *Rent Seeking*. The Shaftesbury Papers, 2. (Series Editor: C. Rowley). The Locke Institute. Edward Elgar, United Kingdom.
21. Tullock, G.; Seldon, A. and Brady, G. (2002). *Government Failure, A Primer in Public Choice*. Cato Institute, Washington D.C.
22. Whincop, M. (2000). *Another Side of Accountability: The Fiduciary Concept and Rent-Seeking in Government Corporations.* SSRN Working Paper, number 258668 (www.ssrn.or).