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Firm Dynamics and Growth with Soft Budget Constraints

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We develop a model of endogenous growth and firm dynamics with soft budget constraints, where firms differ in their innovation speed and slower firms need additional financing in order to eventually innovate. As creditors cannot anticipate refinancing needs in advance nor credibly commit to withholding future refinancing, a Soft Budget Constraint Syndrome emerges, causing excessive entry by slow firms and crowding out potentially more efficient innovators. The resulting trade-off between the positive effects of budget constraint softening on innovation by incumbents and slow-type entrants and its negative effects on entry by fast innovators, generates a hump-shaped relationship between refinancing costs and aggregate growth. Calibrating the model to French firm-level data, we show that the budget constraint softening associated with the decline in interest rates in the aftermath of the Global Financial Crisis accounts for 54% of the observed drop in the aggregate growth rates post-crisis. Although the softening in budget constraints has had a positive effect on incumbent innovation, this was more than offset by the resulting decrease in the entry rates of good firms (by 61% relative to the pre-crisis steady state).