

Innovation and Bureaucracy Under Soft and Hard Budget Constraints

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Yingyi Qian, Chenggang Xu

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Abstract

Because of the inherent uncertainty, promotion of innovation critically depends on screening mechanisms to select projects. This paper studies the relationship between bureaucracy and financial constraints as two such mechanisms. The lack of commitment to hard financial constraints interferes with its *ex post* screening capability; *ex ante* bureaucratic screening is optimally chosen as a substitute. However, bureaucracy makes mistakes by rejecting promising projects and delays innovation, and the efficiency loss due to soft financial constraints increases as prior knowledge becomes worse and as research stage investment requirements become lower. In a centralized economy, bureaucracy may reduce the number of parallel projects, particularly for projects with higher uncertainties and less research stage requirements. This theory fits much of the evidence and in particular it explains why the computer industry, but not the nuclear or aerospace industries, has fared so poorly in centralized economies.

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