LECTURE VI, Part B:
Political Economy of Reforms

- In many situations what is considered by experts and generally accepted by the public to be a beneficial reform for the economy of a democratic state is not implemented.
- Examples: privatization of an inefficient public sector utility, remove protection policies in a protected industry sector, reform of an unsustainable pension system, government budget stabilization,
- Why does this happen?

- A reform of the economic system is considered to be beneficial for society as a whole, if those that benefit from the reform could, at least in principle, compensate those that lose from the reform to accept it.
- A beneficial reform is necessarily increasing the efficiency of the economic system.

Reasons for Resisting Reforms (Status Quo Inertia)

- I. Pressure groups and the free rider problem

The Logic of Collective Action: Public Goods and the Theory of Groups is a book by Mancur Olson, Jr. published in 1965. It develops a theory of political science and economics of concentrated benefits versus diffuse costs. Its central argument is that concentrated minor interests will be overrepresented and diffuse majority interests trumped, due to a free-rider problem that is stronger when a group becomes larger.

- II. Individual vs Aggregate Uncertainty
- An example: Suppose that there are 100 individuals/workers in the economy. 60 individuals work in the public sector and 40 individuals work in the private sector. There exists a reform that inverts this mix, so that every individual that works in the new private sector gains 1 unit of utility and each individual that works in the new public sector loses 1 unit of utility.
- Claim: Although the reform is beneficial, it will not be implemented in a democracy.

- Aggregate expected benefit of the reform:

  60 (+1) +40 (-1) = 60-40=20

- Expected benefit of the reform for an individual working in the old private sector:

  +1

- Expected benefit of the reform for an individual working in the old public sector:

  (40/60) (-1) + (20/60) (+1) = -1/3

- The reform is voted down by 20 votes

- III. Wars of attrition:
- If a reform is associated with a short term economic cost and a long term economic benefit, government politicians interested in been re-elected in the next election will tend to postpone the reform as the opposition politicians would exploit the short term economic cost against their political opponents.
- This explains why stabilization programs and pension reforms are delayed.

Information and Credibility Problems

- In all the reasons for status quo inertia there are information and/or credibility problems.
- In the case of pressure groups the general public may not understand the benefits of a beneficial reform and pressure groups may invest in misinformation.
- In the case of individual vs aggregate uncertainty differences there is a lack of commitment technology to ensure that losers will be compensated.
- In the case of wars of attrition, political competition does not lead to optimal outcomes as in the prisoner’s dilemma situation.

Prisoner's Dilemma

		Prisoner A	
		Silent	Betray
Prisoner B	Silent	-1 -1	0 -3
	Betray	-3 0	-2 -2

Commitment Technologies

- Constitutional balanced budget amendments
- Formal contingent contracts

Exercise/Project

- (a) Give an example from your own experience where a beneficial reform was not implemented or its implementation was needlessly delayed.
- (b) What were the reasons for not implementing the reform in (a)?
- (c) Can you think of a commitment technology that could have been used to implement the reform? Explain.