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

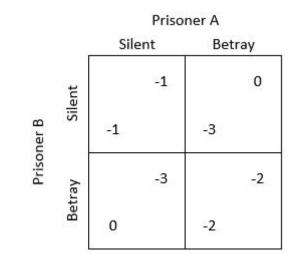
• The reform is voted down by 20 votes

- 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 reelected 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



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.