Title:

**The political economy of public sector reforms: Redistributive promises, and transfers to special interests**

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Short Abstract:

Why is reform of the public sector so politically difficult to implement? Why is good economics not necessarily also good politics? One of the enduring questions in political economy is why "efficiency-improving" economic policies are so often politically difficult to adopt. While these reforms typically result in the creation of winners and losers, an enduring puzzle is the inability of governments promise compensation to the potential losers, in order to win their support for passage of the reform being considered. However, in previous papers, (Jain and Mukand (2003), Jain, Majumdar and Mukand (2014)), we have argued that redistributive promises have to be *credible* – and the credibility of governments may be no greater than that of private agents. The project proposed here builds on this earlier research to examine a complementary explanation for why, even in the absence of credibility problems on the part of the government, public sector workers, and voters more generally, might resist the adoption of public sector reform. If governments are better informed about the distributional effects of the reform than are voters, then voters will (correctly) be suspicious of governments' redistributive promises. Voters recognize that the government, in identifying individual winners and losers, has an incentive to use this redistributive mechanism to reward its supporters, or other special interest groups. Hence redistributive promises by the government may be insufficient to guarantee political support for public sector reform, even when the reform is economically efficient.

Extended Abstract:

Why is reform of the public sector so politically difficult to implement? Why is good economics not necessarily also good politics? If the purpose of public sector reform is to improve the lives of the majority of the population, why is that policy opposed by a significant proportion of the population? One answer is that even an efficient policy reform impacts individuals in a 'non-neutral' way – i.e., the impact on different individuals is different, and the prospective 'losers' from that reform might reasonably be expected to block the reform. But this invites the question: if the losers are strong enough to block an efficient reform, why then can the prospective 'winners' not promise to compensate the prospective losers (or, why can governments not make such redistributive promises on their behalf)?

In earlier research (Jain and Mukand (2003), Jain, Majumdar and Mukand (2014)), we have argued that redistributive promises have to be *credible* – and it is by no means clear that the credibility of governments is any greater than that of private agents. We have suggested that the government has a "time consistency" problem - its idea of what the 'best' policy is might change (even in the absence of new information) from one period to the next, driven by

concerns about its own re-election. And since voters know this, the government's apparent inconsistency in preferences over time will adversely affect its credibility in making promises of redistributive compensation.

But even if the government has no 'time consistency' problem, its actions (or promises) might still be suspect in the eyes of voters. If governments are interested not just in the welfare of their citizens, but also in retaining power, (a not unreasonable assumption), then they may be willing to trade off socially beneficial policies in favour of those that increase their chances of re-election. This research proposes a model of policy choice in which government decision-making might be biased toward policies that benefit those 'special interest groups' which are crucial to re-election. The idea that governments might choose 'pork barrel' projects to bribe key voters, or constituencies, is hardly new (see, for example, Dixit and Londregan (1995)). But the recognition, in the political economy literature, of the importance of asymmetric information (between voters and incumbents) is more recent. An influential paper by Coate and Morris (1995) shows that, in the presence of such asymmetric information, governments might use socially wasteful projects to disguise the transfers to its favoured special interests.

In this paper, we examine a complementary explanation for why, even in the absence of credibility problems, citizens/voters/public sector workers might resist the adoption of reform policies that will adversely affect a (large) proportion of public sector workers. Suppose that, after a reform is enacted, governments are better able to identify winners and losers from a reform than individual voters are. Further suppose that the passage of the reform had entailed a promise to compensate the losers by taxing the winners. In that case, the re-electoral concerns of the government will tempt it to reward or bribe key constituencies by making compensatory transfers, even when those transfers are not deserved. Not surprisingly, if voters anticipate the possibility that governments might use compensatory redistribution as a way of disguising payoffs to 'special interests', then they may be less likely to support reforms that require redistributive compensation to win public support for their passage.

From a public policy viewpoint, the implications are significant. For example, the passage of legislation to create North American Free Trade Area (NAFTA) also required the passage of accompanying provisions to assist U.S. workers who might be displaced because of the increased competition created by trade liberalization. An important policy debate subsequently erupted over whether the administration had pressured the Labor department to use the provisions for trade adjustment assistance (TAA) to compensate workers who might have been laid off even for other reasons (Richards (1997)).

This research also contributes to the political economy literature that argues that voters' (rational) ignorance about particular projects influences the set of projects (or reforms) that is adopted by the government (or by society as a whole). More generally, a political economy approach, to policy questions surrounding economic policy reform, appears to be a rich area for future research, both in terms of providing explanations for what appears to be irrational or myopic behaviour by economic agents, but also in narrowing the interdisciplinary gap between the economics and politics of policy reform, especially regarding the public sector.

References

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# The Political Economy of Public Sector Reforms: Redistributive promises, and transfers to special interests

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## The Political Economy of Reform
**Or: Why is good economics not always good politics?**

*"This government will be austere, uncompromising, and unpopular if that is what it takes to achieve economic reality"*

Mario Soares,
Portugese Prime Minister, upon taking office in 1993

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*"What is the point of loudly proclaiming reforms if these are not aimed at improving the well-being of a large majority of the population?"*

Rodrik, *JEL* (1996)

## Political economy: Winners and Losers

Does anyone like trade agreements?
*Other than economists…*

Why is dam-building so d… difficult?
*And sometimes factories too…*

## Does economics have anything to say?

- Pareto criterion
- Kaldor-Hicks compensation criterion
- Social welfare functions

Yes, but what about implementation?

*Assume a can opener…*

Add politics.

# Theoretical models

Individual-specific uncertainty
(Fernandez and Rodrik, *AER* 1991)

Redistribution to compensate losers
(Jain and Mukand, *AER* 2003)

Dynamics of policy reform: Why does public opinion turn against a reform that is performing well, while it would have been more supportive had the reform gone *less* well?
(Jain Majumdar and Mukand, *JDE* 2014)

## Individual Specific Uncertainty: An Example

(Fernandez and Rodrik, *AER* 1991)

Voters vote (directly) on a reform:

Winners gain $2 each, Losers lose $1

60 winners
40 losers

This reform is
- an efficiency-enhancing reform (the national 'pie' expands)

and

- a majority-benefiting reform

## Individual Specific Uncertainty: An Example
(continued)

Individual-specific uncertainty:

45 winners known in advance
15 winners out of the remaining 55 unknowns

Expected value to unknowns:

**Negative:** [15 * $2 + 40 * (-$1)]/55 < 0

**But note: No ex post redistribution allowed**

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## Reform with Redistribution

(Jain and Mukand, *AER* 2003)

Individual-specific uncertainty

Allow: Redistribution to compensate losers

- Government chooses a tax transfer scheme
  - subject to some limits

- But: Voters cannot take for granted that these government promises, to tax and redistribute from winners to losers, will actually be implemented.

  - Credibility of commitment cannot just be assumed

## Reform with Redistribution
(continued)

Result: The non-monotonicity of passage of reforms

- Majoritarian reforms: Fail
- Minoritarian reforms: Pass
- Super-majoritarian reforms: Pass

## Public Opinion over the Reform Process

(Jain Majumdar Mukand *JDE 2014*)

So far: static stories.

Why does economic reform that was initially supported by a majority often run into a political impasse, **especially when the reform is going well**?

- Irrationality of voters?
  *(Przeworski, Stokes, Remmer…)*
- Instead, consider: Rational, forward-looking, voters
  - face individual specific uncertainty
  - have redistributive concerns, and are (properly) skeptical of promises

Why do voters punish **good** performance?

Possible explanation: revelation of winners and losers shifts the political balance – so future redistribution becomes less likely.

## Public Opinion over the Reform Process (continued)

**"Stack the deck"**

Reform

- efficiency enhancing
- majority benefiting

**But this may not be enough**

In addition,

- Post-Reform redistribution possible

**But this *still* may not be enough**

In addition,

- First stage reform goes well

**But *even then*, this may not be enough.**

## Special Interests

So far: Reform with winners and losers; Individual-specific uncertainty; Redistribution possible; Politics (all-)important.

Incorporate these in a model of reform with special interests.

Suppose that there are 'special interest voters' in the economy, who are politically crucial for the government.

Voters know that these special interest voters exist, even if they don't know who they are.

How does this affect the likelihood of passage of reform?

## The Model

Two sectors, M ("Public") and X ("Private"), produce output using only Labor.

Each worker inelastically supplies one unit of L per period.

Differing productivities (ceteris paribus): X sector more productive than M.

However, inefficient government spending (e.g., on infrastructure for the two sectors) means that pre-reform wages are equal in both sectors, i.e.,

$w_M = w_X = w$

# Reform

Reform consists of reorienting government spending from M to X.

If reform is launched, then wages in both sectors will change.

## Winners and losers

As a consequence of the inter-sectoral wage differential, there is inter-sectoral labor reallocation.

Workers who are able to relocate to the X sector, and earn the higher wage there, are 'winners' from the reform: their wages rise by g.

Those workers who are left behind in the M sector, at a reduced wage, are the 'losers': their wages fall by d.

## Individual-specific Uncertainty

At least some workers do not know in advance whether they are going to be winners or losers.

Let $(1 - \gamma)$ denote the proportion of workers in the economy who will win for sure, and this is common knowledge.

The remaining proportion $\gamma$ face individual-specific uncertainty:

- with probability $\mu$, winner; and wage rises by g
- with probability $(1 - \mu)$, loser; wage falls by d

For simplicity, we have assumed that each of these $\gamma$ workers has an equal probability of being a winner, i.e., relocating to the X sector and earning a higher wage.

# State capacity and redistributive compensation

Redistributive compensation

After a reform, the government can choose a tax vector (r, t) where t denotes taxes and r denotes transfers

- Must be non-regressive in the gains/losses from the reform.
- Must be budget-balanced.

However, the ability of the government to implement this tax-transfer vector may be limited – we use $\tau \leq 1$ to denote the capacity of the state to actually carry out these tax/transfers.

## Special interest voters

Suppose that (at least some of) these special interest voters are scattered among the $\gamma$ workers who face individual-specific uncertainty.

Let $\rho$ denote the proportion of special interest voters.

Further, suppose that (a la Coate and Morris (*JPE* 1995)) governments are better able to identify winners and losers from a reform than individual voters are.

How does this affect the politics of reform?

On the one hand, government more likely to redistribute to compensate the losers.
On the other hand, government more likely to steer compensation to those special interest voters.

## Politics, and Timing

One period model:

At the start of the period, workers/voters elect a government, which must decide:

- whether to enact the reform
- whether (and how much) to promise to redistribute

If the reform is launched, then:

new wages are realized, winners and losers revealed.

If the reform is not launched, then:

wages stay as they were; status quo is maintained.

After (new) wages are realized, citizens again vote on whether to re-elect the government, or to replace with a randomly chosen challenger.

## Solving the model

Assume: efficiency-enhancing, majority-benefiting reform

(1) $[(1 - \gamma) + \gamma\mu].g - \gamma(1 - \mu).d \geq 0$ 'Efficiency-enhancing'

(1.N) $(1 - \gamma) + \gamma\mu \geq ½$ 'Majority-benefiting'

With no redistribution, suppose the reform would not pass, for reasons discussed above – for each of the $\gamma$ workers, expected payoff is negative; and they are in a majority:

(2) $\mu.g - (1 - \mu).d \geq 0$

(2.N) $\gamma \geq ½$

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**Ex post condition**

Looking ahead, voters anticipate that, if the reform is passed, then the first people to be compensated will be the special interests.

Suppose that limited state capacity $\tau$ will constrain the government's ability to completely compensate the other losers.

And winners plus the 'loser' special interest voters will be in a majority:

(3.N) $(1 - \gamma) + \gamma\mu + (1 - \mu)\,\rho\gamma \geq \frac{1}{2}$
(Note: this is implied by (1.N))

**Ex ante condition**

Further, suppose that, even net of the special interests, the $\gamma$ workers who face individual-specific uncertainty are in a majority:

(2.N') $\gamma - \rho\gamma \geq ½$

Hence, the decision on whether the reform gets passed or not depends crucially on the calculation made by the $\gamma$ workers:

(4) $EV(\tau) = \mu.(g - t(\tau)) + (1 - \mu).\ (r(\tau) - d)$

where budget balance in the tax-transfer regime requires that:

(5) $\gamma(1 - \mu)\rho.d + \gamma(1 - \mu)(1 - \rho).r(\tau) = [(1 - \gamma) + \mu\gamma].t(\tau)$

where $r(\tau) \leq d$ and $t(\tau) \leq g$ (by non-regressivity).

## ‘Political failure’: reform with special interests

**Result**: There exist parameters satisfying the equations above, and for which: $EV(\tau) \leq 0$

**Interpretation**

For any level of state capacity, $\tau$, there is a maximum $t(\tau)$ associated with it. Then the budget balance condition, (5), defines a maximum $r(\tau)$ corresponding to that. (Or more accurately, it defines a maximum $r(\tau; \gamma, \mu, \rho, g, d)$).

So if $EV(\tau) \leq 0$, then public sector workers (the ones who are not special interests) will not support reform. Condition (2.N’) guarantees that they are in a majority, and will carry the vote.

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## ‘Political failure’ (continued)

Why might EV(τ) be ≤ 0 for those voters?

Answer: Because they anticipate that, ex post, the government will completely compensate losing special interest voters for their loss of d. (Condition (3.N) guarantees that the winners and special interests will be in a majority).

And the remaining taxes collected will be insufficient to compensate the other losers. Hence ex ante, EV(τ) ≤ 0.

In other words, if voters (correctly) anticipate that governments might use compensatory redistribution as a way of disguising payoffs to ‘special interests’, then they may not support reforms that require redistributive compensation to win public support for their passage.

## Extension: Sustainability of reform - effect of state capacity

Recent focus on the importance of institutional differences across countries.

For efficiency-enhancing reforms to be Pareto-improving, need for state to be able to redistribute from winners to losers.

- Is it easier, or might it be *more difficult*, to politically sustain economic reforms when the state has greater fiscal capacity to tax and redistribute?