SOME REFLECTIONS ON THE POLITICAL ECONOMY OF REFORM

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1. In this presentation, I would like to stand back from the concrete questions related to the future of economic reform in the European Union to ask a more basic question in the domain of political economy. Why is broad-based economic reform so difficult? And, even more fundamentally, what is economic reform anyway? While this might appear as a somewhat pessimistic approach to the issue, it seems to me that a clear understanding of the problem offers the best hope of doing better in the future than we have up to now.

2. The fact that broad-ranging, fundamental economic reform is difficult is attested to by the simple observation that it is quite rare. Much of what one observes in the economic history of OECD looks more like "coping" – often belatedly – with problems; or taking one step forward and one step back. I argue that significant reform requires a confluence of two factors that do not often come together: a broad-based popular sentiment that "things have to change", and a leadership that is able to translate this broad dissatisfaction into a concrete programme that crystallizes the issues and points to their solution. Most of the time, democratic politics turns out to be quite conservative. Mandates for real change are rarely extended to governments.

3. To see why this is so, it is necessary to figure out what economic reform actually is. How can you spot a true economic reform, as opposed to an arbitrary change in policy? I am not aware of any agreed answer to this question, and the one I offer is no doubt incomplete: the best definition I can come up with is that economic reform is policy change directed at improving the static or dynamic efficiency of resource allocation in the economy. But, at its essence, this involves taking away <u>rents</u> that have built up in the economic system or, to broaden the concept somewhat, to reduce or modify acquired rights. Of course any political programme might involve a re-distribution of rents – in favour of those who support the government, perhaps at the cost of those who don't. So reform, as opposed to redistribution, involves <u>reducing</u> rents in the economy as a whole – including rents that accrue to the "natural constituencies" of the party in power.

4. A few examples can serve to clarify the point:

- A strengthening of competition policy, broadly defined, is perhaps the most obvious example. Such a move is generally accepted to improve market functioning, but the immediate target is the rents that accrue to companies with market power, and probably also for the workers who share in these rents. It is thus not only the capitalists, but also the workers who are likely to feel threatened.

- Likewise, a tax reform to broaden bases and lower rates is clearly an efficiency-improving move. But tax distortions create rents in favour of those who are in a position to exploit them, and it is these rents that are targeted by the reform. The more outrageous the tax loophole, the greater the likelihood that someone is vitally dependent on it for survival.

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1. The views expressed in this note are strictly the personal reflections of the author, based on his own experience of "watching" economic developments in the OECD over a quarter of a century, and do not necessarily reflect the views of the OECD Secretariat or, <u>a fortiori</u>, those of OECD member governments.

- Public service reform is a more complex case, depending on the situation. In a country like Slovakia, the issue is to increase public sector efficiency by removing the ability of public servants to convert administrative power into personal income via corruption – a power that is itself a kind of rent accruing to the job. But established civil-service systems that are reasonably free of overt corruption are also liable to rent-seeking in a variety of ways – job security, the "easy life" or simply the pleasure of exercising bureaucratic power – that tend to make public administrations unusually change-resistant and conservative. What makes public-service reform so critical is the double role of the public administration in the reform process. On the one hand, a properly motivated and efficient civil service is essential to assure that the substance of economic reform, as embodied in legislation, actually translates into changes that are perceived "on the ground". On the other hand, the reforms to public administration required for this end may, for some time, result in conflict and perhaps demotivation, thus undermining the effective implementation of other reforms. This problem may suggest a reform sequencing priority – reform public administration (including the judiciary) at an early stage in the overall reform process.

- Perhaps the most provocative economic reform issue to try to fit into this "rent reduction" framework concerns social policy. On the face of it, it would be antediluvian on my part to argue that social benefits – social assistance, extended unemployment benefits, housing benefits, child allowances, etc. – that most of our societies provide to cushion the impact of adverse fortune on those least able to cope with it – constitute "rents". Politically, most OECD countries have opted to enshrine such redistribution as basic rights for the population, and in most countries there is at least acceptance that such redistribution is part of the fundamental social contract. Furthermore, even on narrower efficiency considerations, there is substantial evidence of dynamic positive spill-overs from adequate social support to overall economic performance – in particular as regards the safeguarding of economic opportunity for children. Nonetheless, it has to be recognized that social policy involves a double burden: on society at large via higher (and thus inevitably more distorting) taxes; and also on the supply-side, by creating rent-seeking opportunities for potential beneficiaries – a phenomenon summed-up in the economists' jargon of "poverty traps" and "unemployment traps". The solutions here are complex, but most economic reform programmes have recognized the importance of transforming unqualified "rights" to social benefits into a much more conditional "contract" between donors and recipients based on one form or other of mutual obligation and – in the end – only a contingent right. Reform of disability pension schemes is perhaps the most visible current example.

5. If reducing rents in the interest of greater efficiency is a task that can be counted on to evoke the opposition of those whose rents are at risk, it would be hard enough. But the problem goes deeper, because of the general tendency for rents to be capitalized out of the economic system. This is the famous "taxicab medallion problem" of the textbooks – but it has wide applicability in public policy issues.

- Housing subsidies, for instance. When introduced (perhaps for apparently compelling social reasons) such subsidies constitute a rent to those who can now afford more housing than otherwise. But over time, the subsidy gets built into the price of houses. This is a capital gain to those who happen to own a house, but for new entrants into the market there is really no benefit. The value of the subsidy is just offset by the higher price they have to pay for the house. The point is, while it might make sense to scrap the subsidy, it is very difficult to do because the current crop of house owners (assuming the subsidy has been around for a while) didn't benefit from the subsidy, but do bear the cost if the subsidy is stopped. This could be seen – with considerable justice – as a very unfair policy.

- Agricultural subsidies are very similar. Their value is capitalized in the value of land; but it is extremely difficult to know who has actually benefited. Current farmers are not the most likely beneficiaries; but they are the ones likely to be wiped out if the subsidy is halted.

- A final somewhat more complex illustration is provided by the difficulty of reforming pay-go pension systems. Following the Samuelson consumption-loan model, the initial generation essentially gets a free ride. The one-time gain in going from a system where you provide for your own pension to one where your kids provide it for you is capitalized out of the system. But then, even under stable demographics, future generations earn a much lower return on their contributions than their parents did; and in an ageing society this return becomes small or even negative. In these conditions a funded system would look far more attractive, but to achieve it requires putting back the capital that was taken out by the first generation of this example – a burden on the "transition generation" that most societies are not prepared to face.

6. So, to summarize the argument, economic reform is about reducing rents. It will be opposed by those whose rents are at risk – and they know who they are. The beneficiaries from the efficiency gains brought about by reform are much less aware of the benefits, which in any case tend to be dynamic rather than static. Thus, if competition policy or regulatory reform creates new market opportunities, one can predict that these opportunities will be exploited; but one cannot identify ex ante <u>who</u> it is that will exploit them (they may not know themselves at the time of the reform!). On top of that, in many cases the rent reductions that are the consequence of the reform may be seen, and indeed felt, as unfair in that it is not the beneficiaries of the rent who bear the cost of its reduction. It is, in my view, this nexus that makes reform so difficult.

7. In view of this difficulty, it is perhaps amazing that reform nonetheless happens. The upshot is, that with very few exceptions, broad-based reform seems to require, as a necessary condition, a perception of crisis – acute crisis as in the case of Scandinavia at the start of the 1990's; or at least a sense of chronic deterioration, as in New Zealand prior to the 1980's reform and in the Netherlands in the mid-1980's, or the United Kingdom under Thatcher. The hallmark of such crisis situation, - not surprisingly if you think about it – is an out-of-control budget. I guess the point is that real reform only becomes possible once the possibilities of throwing money at a problem are foreclosed. One conclusion from an OECD study of some 20 years ago, now out of print, that was entitled "Why Economic Policies Change Course – Ten Case Studies" could be paraphrased, somewhat provocatively, as: "Democratic government can be counted on to do the right thing … but only after they have tried everything else!"[2]

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2. Perhaps the clearest instance of this proposition in the case studies covered by the study – or at least the one I was personally most closely involved with – is the United States' approach to dealing with inflation in the period 1977-1980 during the Carter Administration. For much of this period, in an intellectual context that held that "Inflation is caused by higher prices", the Administration (with at least the tacit support of the Federal Reserved headed by William Miller) sought to deal with a chronic deteriorating inflation problem by judicious use of price controls, seeking to generate favourable "supply-side" shocks and issuing the famous WIN buttons for loyalists to wear on their lapels (WIN – Whip Inflation Now). The arithmetic of the "sacrifice ratio" (the econometric estimate of the output costs required to bring inflation down through orthodox means) was simply not acceptable politically until it became very clear that it just could not be avoided. To the great credit of President Carter, he "faced the facts" in 1980, by naming Paul Volker to succeed Bill Miller at the Fed with a clear mandate to "do the necessary" with respect to monetary policy. The extent to which monetarist ideology (as opposed to monetarist rhetoric) actually

8. One supposes that crisis conditions may also, in the end, prove a sufficient condition for reform, at least in mature democracies where one imagines that good sense will prevail in the end. But it is clear that the timing of reform depends on political leadership – in the first instance leadership to make clear that there is a crisis. The last decade in Japan following the collapse of the bubble economy, indicates how – even when international observers have no difficulty in identifying crisis conditions, popular perception may not coalesce into something solid enough to permit a fundamental departure from "politics as usual", forcing the government to move cautiously and step-by-step for a very long time.

9. I recognize that this presentation seems to have led me into a somewhat nihilistic corner, to the point of saying that the most realistic reform scenario is to wait for things to get so bad that there is no other option. I have to confess that, as regards "core Europe", my sense is that in this sense the pre-conditions for fundamental reform have not yet been met. But let me end with four more hopeful caveats to this line of argument:

1. As I noted above, the timing of reform can surely be influenced – perhaps decisively – by political leadership. Effective communication can crystallize the vague sense that "something is wrong" into a broad perception for the need for change. Objectively, the economic situation in the United Kingdom prior to the Thatcher reforms was bad, but not obviously critical. Nonetheless the message that "there is no alternative" somehow got through. In saying this, I recognize that in electoral politics one rarely sweeps into office by offering pain – quite the contrary. So one message for reform politicians might be to play at least some of your cards close to your vest; and work on strategies to walk away from electoral promises as elegantly and quickly as possible. And then use the incumbency to explain what the real problems are.

2. Even so, the evidence is that reform governments don't stand a very good chance of being re-elected – though such electoral success is not unprecedented. The reason for electoral failure is probably that the benefits of reform just don't come through quickly enough to fit into the electoral cycle, even if (as logic suggests) reform governments do the hard things right at the beginning (which, surprisingly, they often don't). But the good news is that deep reforms are typically not reversed by the successor government – certainly not in a wholesale manner. As I argued, what makes reform so hard is the opposition generated by the rent reductions required to increase efficiency. But once this is done, a successor government would have to be ideologically blinkered to forego the economic benefits made possible by the reform when the costs have already been absorbed by the opposition. Again I would cite the UK as an example – but there are

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influenced Fed policy thereafter can be debated, but the upshot was a very sharp rise in short-term interest rates (perhaps made easier politically by the argument that this was not a deliberate policy action but a consequence of exercising control over money supply growth). The economics of the "sacrifice ratio" certainly made themselves felt thereafter with a sharp slowdown in the economy. It could be argued that President Carter's decision to appoint Mr. Volker was a "suicide" decision to do what needed to be done for the economy rather than what needed to be done for re-election. Certainly the timing was, electorally speaking, awful; but other factors (i.e. the Iran hostages) may have been more decisive. As a footnote to this footnote, it is worth emphasizing that the critical decision to pay the costs of disinflation was taken by the Carter Administration – though it was the Reagan administration that followed that reaped the political benefits. By the same token, I cannot forget the insightful comment of Lyle Gramley, at that time (1980) a member of the President's Council of Economic Advisers and subsequently an inflation hawk on the Board of Governors of the Federal Reserve. He said, on hearing of Volker's appointment and of his intended monetary programme: "My God, we've just wiped out the Savings and Loan industry!" He was correct, of course, though it took the government almost a decade to admit this and accept the costs which had, in the meantime, been substantially bloated by the moral hazard of allowing insolvent financial institutions to play roulette, or worse, with other people's money when there was no capital of their own left at risk.

many others. Perhaps the most striking case is Chile. Here the democratically elected Social-Democrat government that followed the Pinochet autocracy opted, in a profound historic compromise, to preserve much of the essence of the “Chicago reforms” that had been imposed by the previous non-democratic regime.

3. Third there is, I think, a definite role for suicide in politics. When a government reaches the point in a reform process where the prospects for re-election become dim, one has much less to lose by continuing with the reform. Politics is a repeated game, and the political parties (if not, usually, their leaders) will be back to fight another election. While I am sure that Gerhard Schroeder would not accept the characterization of his statement, following the Hamburg debacle, that “reform would continue”, as an example of this proposition, I think it has some relevance. The contrast with France, where the regional electoral setback seems to have driven the reform agenda more deeply underground, is an interesting one.

4. Finally, and perhaps of greatest relevance in times when fundamental reform is just not “on the cards” politically, there is always scope for useful preparatory action by governments: to move ahead in areas where the ground for reform has been best prepared; and to lay the groundwork for further reform by setting out to shape, or re-shape, popular understanding of the issues. Various techniques – advisory “expert” commissions, budget sustainability exercises, even tripartite consultations (if not allowed to become a kind of second government outside electoral validation) can play a very useful role. And indeed, in this domain, effective international support for reform via institutions such as the EU or the OECD can play a significant supporting – or indeed at times initiating – role.