Reforming the Public Sector – State Capacity and Special Interests

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UNU-WIDER conference on Public Economics for Development
Maputo, 5-6 July 2017

The Last Laugh

The Political Economy of Public Sector Reform

More generally: 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,
Portuguese Prime Minister, upon taking office in 1993

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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,
Portuguese Prime Minister, upon taking office in 1993

"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)

Figure 1: State capacity and public sector reform

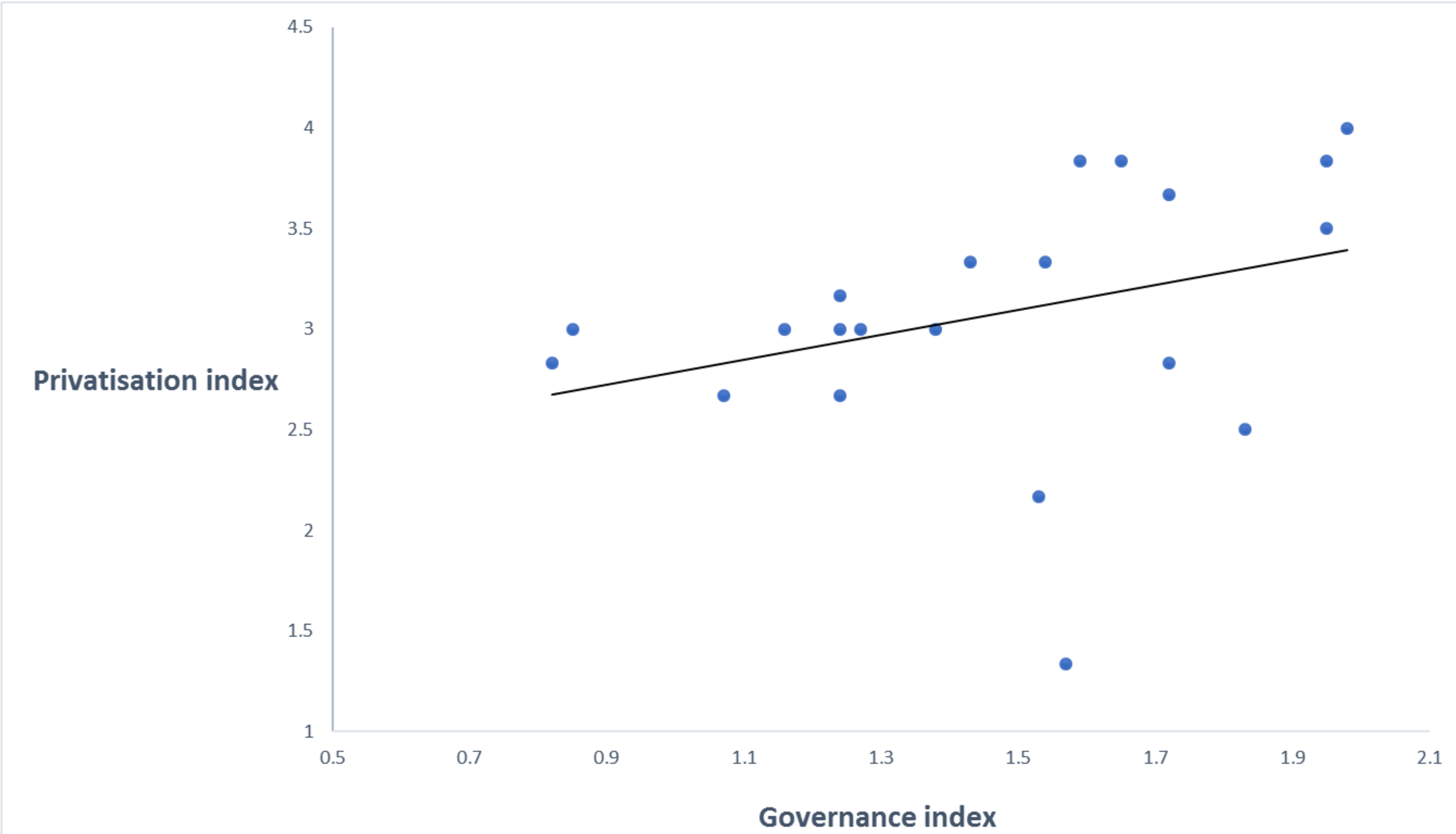

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Figure 2: Political activism and public sector reform

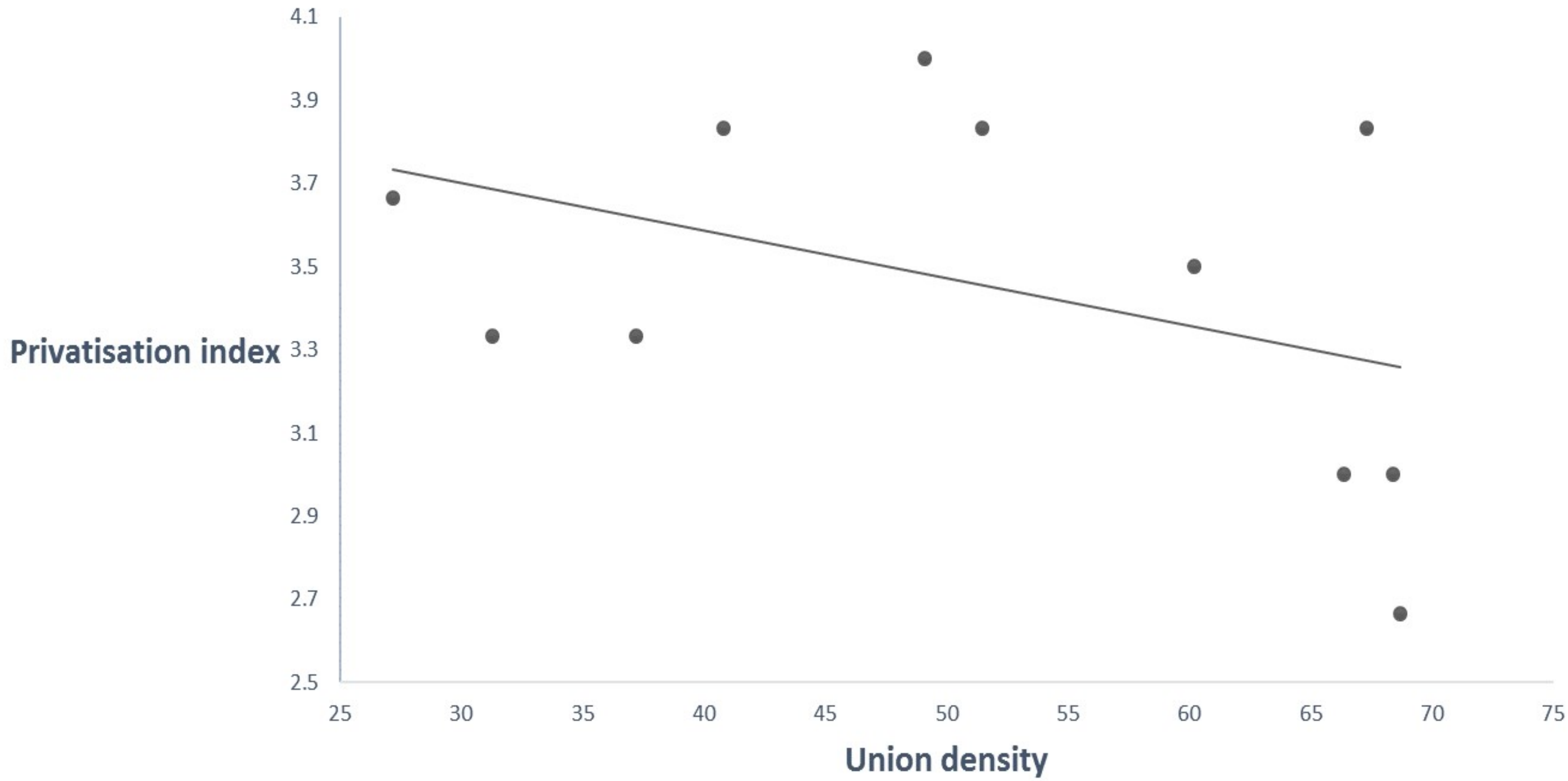

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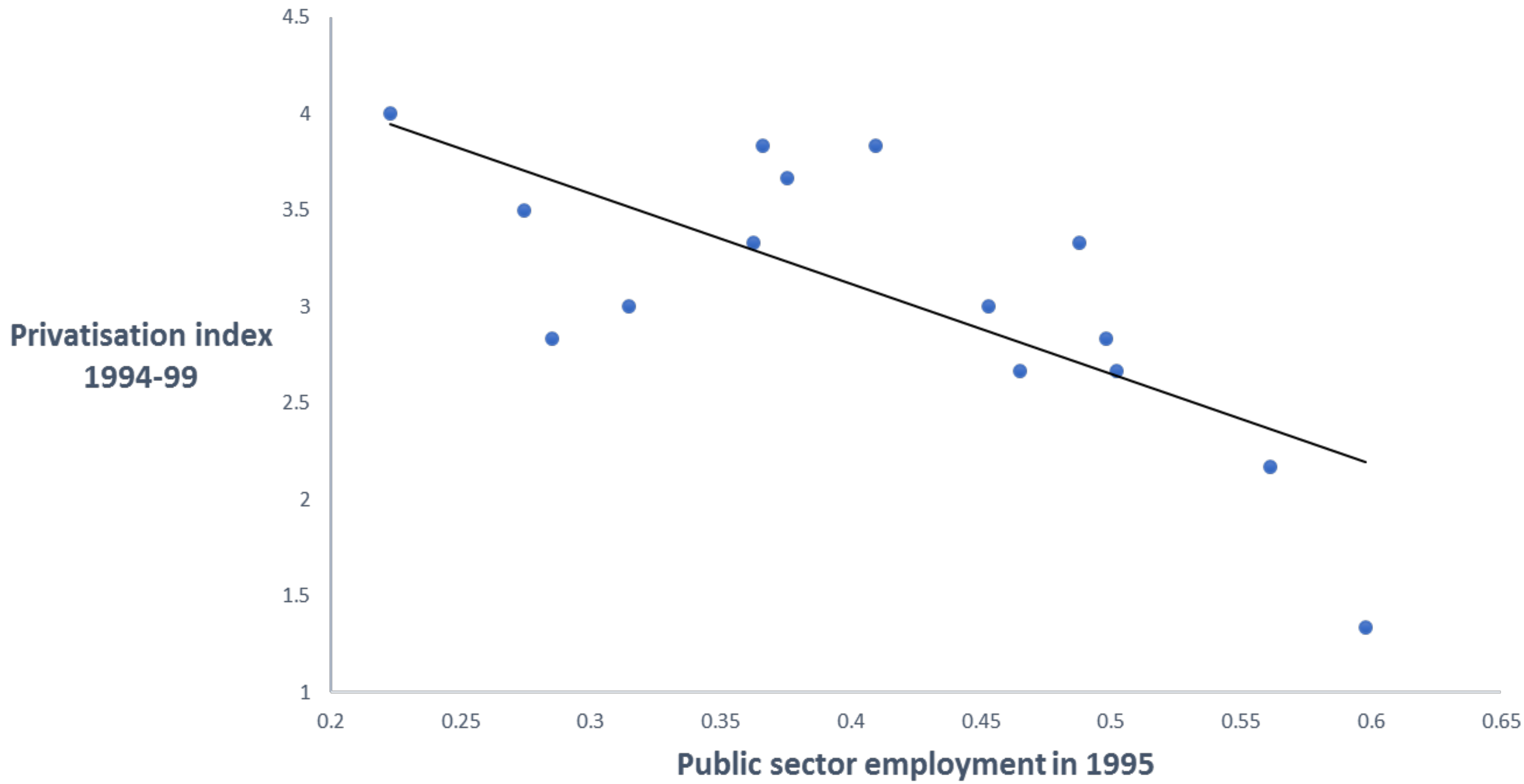
Figure 3: Public sector employment and public sector reform



Political economy of 'non-neutral' reform

Winners and losers:
"…the difficulty of institutional reform lie[s] in the fact that any major change creates **winners and losers**, and the **potential losers are often powerful enough to resist change**". (Acemoglu 2003)

- Public sector reforms
    - Privatization
    - Computerization of banking

- Trade liberalization

- Dams: Why is building dams so d… hard?

What does Economics have to say about this?

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Does economics have anything to say?

- Pareto criterion
- Kaldor-Hicks compensation criterion
- Social welfare functions
- (Social) Cost – benefit analysis

Yes, but why are these precepts so difficult to put into practice?
(Assume a can opener…)

Add politics.

Theoretical models: reforms with uncertainty over winners and losers

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

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

General idea: "economic losers" not always the same as "political losers"
(Acemoglu and Robinson *AER* 2000)

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Policy reform with individual-specific uncertainty
(continued)

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)

Setting aside credibility concerns about its (politically motivated) willingness to redistribute – does the government have the 'state capacity' to accurately identify winners and losers?

(Jain and Majumdar, *IREF* 2016)

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This paper: policy reform with special interests

Special interests: If redistribution is to happen, they will be the first recipients.
(For example: trade unions, or particular ethnic groups)

Limited state capacity: the government may be limited in its ability to tax and redistribute.

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

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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:

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

But note: No ex post redistribution allowed

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

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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.

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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.

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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.
'Special': If redistribution is to happen, they will be the first recipients.

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 (the 'public sector') and X (the 'private sector'), produce output using only Labor.

Each worker in-elastically supplies one unit of L per period.

Differing productivities, ceteris paribus: X sector more productive.

However, government spending (e.g., on infrastructure for the two sectors) means that pre-reform wages do not reflect productivity differences. Simplifying assumption: wages are equal in both sectors, i.e.,

$w_M = w_X = w$

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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 γ denote the proportion of workers in the economy who will win for sure, and this is common knowledge.

The remaining proportion $(1 - \gamma)$ face individual-specific uncertainty:

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

For simplicity, we have assumed that each of these $(1 - \gamma)$ workers has an equal probability of being a winner, i.e., relocating to the X sector and earning a higher wage.

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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.

State capacity

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 $(1 - \gamma)$ workers who face individual-specific uncertainty.

Let ρ denote the proportion of special interest voters.

Special interest voters: effect on politics

How do the special interests 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 it with a randomly chosen challenger.

Solving the model

Assume: **efficiency-enhancing**, and **majority-benefiting** reform

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

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

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Reform without redistribution

With **no redistribution**, suppose the reform would not pass, for reasons discussed above – for each of the $(1 - \gamma)$ workers who face individual-specific uncertainty: expected payoff is negative; and they are in a majority:

(2) $\lambda.g - (1 - \lambda).d \leq 0$

(2.N) $(1 - \gamma) \geq ½$

Reform with redistribution: *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 τ constrains 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) $\gamma + (1 - \gamma)\,\lambda + (1 - \lambda)\rho(1 - \gamma) \geq ½$

(Note: this is implied by (1.N))

Reform with redistribution: *ex ante* condition

Further, suppose that, even net of the special interests, the $(1 - \gamma)$ workers who face individual-specific uncertainty are in a majority:

(2.N′) $(1 - \gamma) - \rho(1 - \gamma) \geq \frac{1}{2}$

Hence, the decision on whether the reform gets passed or not depends crucially on the calculation made by these $(1 - \rho)(1 - \gamma)$ workers:

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

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

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

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

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‘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, τ, 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 $r(\tau; \gamma, \lambda, \rho, g, d)$).

So if $EV(\tau) \leq 0$, then M 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.

‘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.

However… related research (Jain and Majumdar *IREF* 2016)

When economic benefit of reform is exogenously given, higher state capacity is unambiguously positive for the adoption of efficiency-enhancing reform.

Put another way: countries with higher state capacity are better positioned to take advantage of efficiency-enhancing reforms.

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However, when (costly) individual investments are required in order to realize potential gains, then better state capacity has ambiguous effects.

On the one hand, concerns of potential losers are assuaged – the state will have more to tax and redistribute. On the other hand, disincentive effect on potential winners' willingness to undertake costly individual investments.

Hence importance of nuanced view of (effect of) state capacity.

- 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?

Redistributive promises, (limited) state capacity, and special interests

Here, special interests matter: but only when state capacity is limited.

Importance of the ability of the state to tax and transfer: popular support for reform is likely to be lowest where fiscal capacity is limited, in any case.

Further Extensions

Basic results go through even if we

- Allow for the possibility that workers' probability of emerging as winners is heterogeneous.

- Allow for the possibility that the impact of the reform, i.e., the magnitude of λ, is uncertain.

Conclusion

State capacity (or, for many developing countries, the lack of it) matters.

Special interests can distort the politics of public sector reform. And special interests matter - especially when state capacity is limited.

Constrain the special-ness of special interests: ‘civic capacity’.


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