

### 3. POLITICAL ECONOMY OF REFORMS AND CHOICES OF REFORM STRATEGIES.

Political arguments have been at the heart of transition strategies.

- Window of opportunity argument for going fast and creating irreversibility (Lipton and Sachs, 1990; Balcerowicz, 1995)
- Gradualism and sequencing for building constituencies for further reforms (Dewatripont and Roland, 1992, 1995; McMillan and Naughton, 1992)

- Privatization plans designed to overcome political constraints (Boycko, Shleifer, Vishny, 1995; Shleifer and Treisman, 2000).
- Dual-track liberalization in China (Lau, Qian and Roland, 2000)

Political economy arguments invoked to explain differences in performance across transition countries.

- Difference in extent of capture and rent-seeking (Hellman and Shankermann, 2000).
- Geopolitical differences and accession (Roland, 1997).

Importance of political constraints in transition has led to developments of the theory of the political economy of reform (Roland, 2000)

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What are the main insights from that theory?

How does it reflect the transition reality?

Political economy of reform developed in the context of transition is part of a fundamental trend in economics to integrate the political process in the analysis of economic problems

(Persson and Tabellini, 2000; Drazen, 2000):

- Trade
- macroeconomic policy
- regulation
- public finances
- ....

# THE THEORY OF THE POLITICAL ECONOMY OF TRANSITION

Two broad strands:

- normative political economy. Decisions of reformers (not necessarily welfare-maximizing) subject to political constraints. Agenda-setting hypothesis (McKelvey, 1976, Romer and Rosenthal, 1983). Derive general principles.
- positive political economy. Clash of interests groups in given institutional context. Positive analysis less developed than normative analysis in transition context.

## Normative political economy of reforms.

- Distinguish between ex ante and ex post political constraints (Roland, 1994).  
They are identical unless *uncertainty* and *reversal costs*.

Uncertainty: a majority may gain from reform ex post but be opposed to it ex ante (Fernandez and Rodrik, 1991).

$p$ : probability of winning  $g > 0$

$1-p$ : probability of incurring loss  $l < 0$

$p > 1/2 \Rightarrow$  a majority wins ex post but if

$pg + (1-p)l < 0$ , reform never passes!

Reversal costs.

Assume uncertainty resolved later in the reform process.

Ex ante: If no reversal expected, go ahead if  $pg+(1-p)l > 0$

As soon as reforms implemented, reverse only if  $pg+(1-p)l > -R$   
where  $R$  is reversal cost

Bad news in the middle of the reform process  
may not lead to reversal if high reversal costs.

After uncertainty resolution, do not reverse if  $l > -R$

But if low reversal cost ( $l < -R$ ), reversal after bad news

=> Possibility of bad news under high reversal costs lowers  
ex ante prospect

$pg-(1-p)R > pg+(1-p)l$  if  $l < -R$

## How to relax ex ante political constraints?

- “compensating” packages.
  - Efficiency gains from reform allow in principle room for sufficient compensating transfers BUT
    - distortionary taxation (raising taxes to compensate losers may end up eating more than the efficiency gains). Many countries have weak tax administration.



-asymmetric information => rents. Lewis et al. (1990),  
Dewatripont-Roland (1992)

Some lose more than others but government does not know who is who. => pay biggest loss to all (otherwise “big” losers oppose reform)  
=> “small” losers get economic rents because they are “overcompensated” => compensation is more costly.

Suppose 100 people lose 20 and 100 people lose 50.

Under perfect information, compensation cost is  $2,000+5,000$

Under asymmetric information, compensation cost is  $50 \times 100 + 50 \times 100$

- commitment problem. If government cannot commit not to renege on promises of transfers, then even more costly because losers may accept reforms only if they receive the net present value of compensating transfers.

Suppose transfers of 20 to 100 people (2,000) every year.

Suppose discount rate is 5%. Net present value of transfers is

$$2,000 \times 21 \left( \frac{1}{1 - \frac{1}{1 + r}} = \frac{1 + r}{r} \right)$$

- Bundling of reforms may be necessary to get majority approval for certain reforms (Martinelli and Tommasi,1997).

EX: trade reform and public sector reform. May be better to implement separately but public sector reform, viewed separately, may never get accepted politically unless government uses its agenda-setting power to bundle reforms.

Example:	Group 0	Group 1	Group 2
Reform 1	50	51	-50
Reform 2	150	-50	-50

Suppose that doing 1 and 2 at once is inefficient (loss of 10 to each group) compared to gradualism.

Big bang is still better because gradualism does not pass!

- partial reform (gradualist strategy).

Costs:

- less efficiency gains (delay + loss of complementarities)
- less learning (uncertainty resolution)

Benefits:

- less transfers in net present value terms (Dewatripont, Roland, 1992).

- lower reversal costs under aggregate uncertainty create option value of early reversal (Dewatripont, Roland, 1995). “Experimenting” with reforms and lowering costs of experimentation. Decollectivization of agriculture, Chinese special economic zones.

- Build constituencies for further reforms through
  - a) “divide and rule tactics” (Dewatripont, Roland, 1992; Wei 1993).

Three groups of workers: A,B and C. Laying off A and B infeasible but laying off A first and B later but threatening B to lay them off first if they do not approve.

- b) appropriate sequencing (Dewatripont, Roland, 1995). Start first with reforms likely to benefit a majority so as to build constituencies for further reform.

- Create institutions for commitment to transfers:
  - enfranchisement (Acemoglu, Robinson, 2000)
  - .....
- Wait for a deterioration of status quo.  
Alesina and Drazen (1992).

## How to relax ex post political constraints ?

- Trade off between ex post irreversibility and ex ante acceptability.
- Irreversibility can be a curse (Russian privatization).

## **POSITIVE POLITICAL ECONOMY OF REFORMS.**

- rent-seeking and capture.

Few rent-seeking models of transition.

Basic question: What are the conditions determining the extent of rent-seeking in transition, its waste and effect on political decision-making ?

May depend on specific institutions (number of veto players, political regime ...

but institutions are endogenous in transition.



Sonin (1999): with economies of scale in rent-seeking, rich and powerful agents benefit from rent-seeking to maintain low security of property rights.

Why were they rich and powerful in the first place?

Mass privatization led to concentration of power...  
but can itself be seen as result of rent-seeking activities.

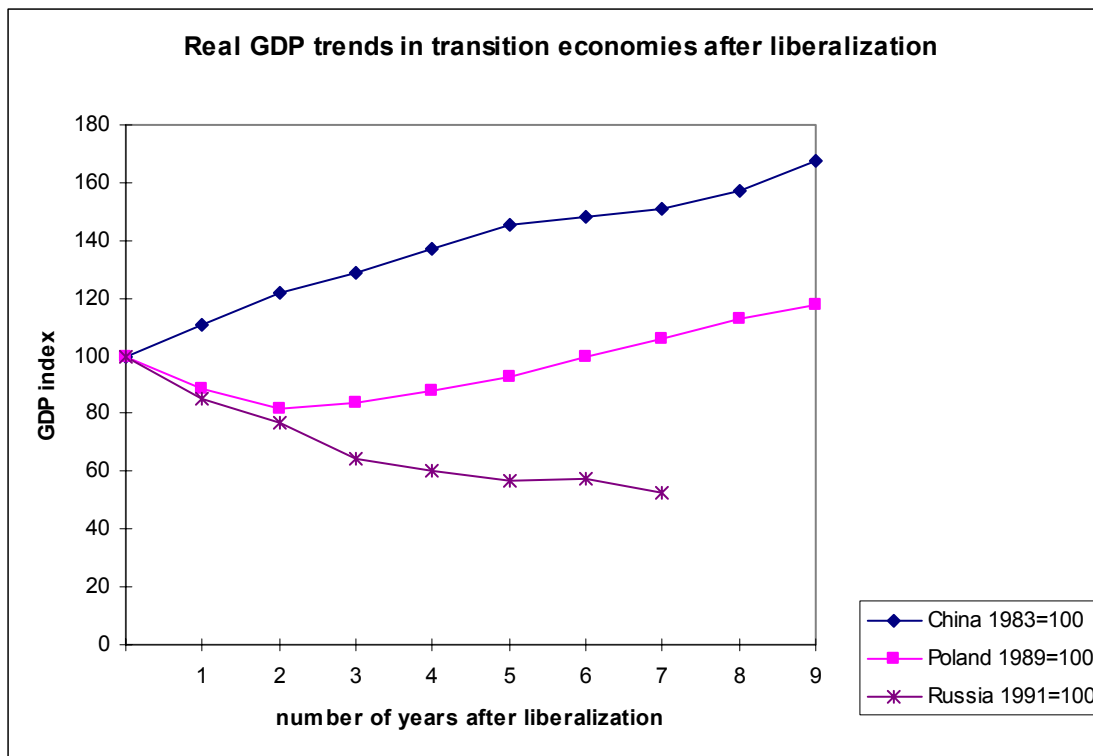
Maybe lower concentration of power in other countries like Poland was result of pre-existing civil society (Solidarity, church, less years under communism...).

## LESSONS FROM THE TRANSITION EXPERIENCE.

Country	Average months between elections	Average government duration	Average government duration between last 2 elections	Average number of parties in government
Bulgaria	31.6	21	49	2.15
Czech republic	32	18.2	12	3.2
Estonia	36	12.9	12	2.2
Hungary	48	48	48	2.7
Poland	36.5	17.9	24	3.4
Romania	42	15.3	12	2.9
Slovakia	32.7	17.5	48	2.5
Slovenia	47	23.3	24	3

Country	Percentage of left and central-left wing governments	Percentage of left and central-left wing governments as a % of time	Percentage of Reelected governments
Bulgaria	50	58	20
Czech republic	0	0	50
Estonia	0	0	0
Hungary	50	50	0
Poland	29	33	0
Romania	71	71	75
Slovakia	100	100	0
Slovenia	0	0	100

- Broad transition paths.



- Aggregate uncertainty for whole reform process and for privatization, less so for restructuring and sectoral reallocation.
- China: dual-track as specific institution for compensating for losses from liberalization. Helped also prevent the output fall and collapse of government structures.
- Effect of EU accession and geopolitical dimension of transition => differences in political constraints to transition and in focal point.

## **Sequencing:**

- Central and Eastern Europe: Democratic reform followed by economic reforms.
- China: decollectivization followed by price and enterprise reform. Family farming from 1% in 1979 to 45% in 1981 and 90% in 1984 and agricultural output went up by 56% (Lin, 1992). This created support for urban reforms (Naughton, 1995, Qian, 1999).
- Initial role of entry in China, Vietnam, Hungary, Poland...
- Privatization starts with good firms (Gupta, Ham, Svejnar, 1999; Ciaran and Walsh, 1999).

## Winners and losers

- Fidrmuc (1998b,c) looks at political support for reforms in Czech republic (1992 and 1996), Slovakia (1992 and 1994), Poland (1993, 1995 and 1997) and Hungary (1994 and 1998).

Support for reformist parties (right-wing)

- negatively affected by unemployment, weight of retirees and blue collar workers;
- positively affected by size of private sector, weight of white collar workers and university educated.

NB: In Baltic countries, losers among Russians. Less Russians in Lithuania compared to Estonia and reforms were slower in Lithuania!

## **Trade-off between speed and budgetary transfers?**

- East Germany : Employment fell by half between 1989 and 1992 (Sinn and Sinn, 1993) but associated with massive transfers (around 70% of East German GNP in early nineties).
- More gradual layoffs in Eastern Europe but much lower compensation payments. Same within transition countries (Coricelli, 1995).
- Faster restructuring associated to worsening of fiscal stance (Pirtillä, 2000).
  
- social safety net helped (Keane, Prasad, 2000; Garner, Terrell, 1998)



## **Role of political institutions**

- negative correlation between power of executives and progress of reforms.
- positive correlation between broadness of coalition and progress of reform (Hellman, 1998; EBRD, 1999):
  
- Role of new non communist elites and of counterbalances to nomenklatura rent-seeking?