

## THE POLITICAL ECONOMY OF RADICAL ECONOMIC REFORM

### Comments by Val Koromzay at the Seminar on Economic Growth Strategy of the Czech Republic,

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#### I. When does radical economic reform occur?

Radical reform is quite rare, and usually is associated with one of three specific conditions:

a) The end of a long period of relative economic deterioration, and usually triggered by a budget that is out of control:

*e.g.* New Zealand      United Kingdom under Mrs Thatcher      Netherlands in 1980's

b) At a moment of system change, for example the transition economies after communism. In these circumstances there is no alternative to radical reform because a new system has to be put in place. But it is interesting how quickly the window for radical reform closes. That it stayed open in Slovakia perhaps reflects the fact that the first stage of post-communist reform under Meciar was such a dismal failure.

c) In the context of an acute economic crisis: *e.g.* Finland at the beginning of the 1990's

## **II. The norm for economic reform is thus gradualist and incremental rather than radical**

Indeed, much of the time politics is not about economic reform at all, but about various kinds of redistribution. Typically, economic reform is very much a lagging indicator of the need for it. It seems to be very difficult to reform in order to avoid future problems, for instance. This is unfortunate, especially now, because globalisation pressures would warrant a more ambitious approach in most countries. In this context, the Czech growth strategy – though I would describe it as an incremental rather than radical reform effort – is very much to be welcomed.

## **III. What are the objectives of reform?**

It could be argued that one reason why reform is typically slow and piecemeal is because there is a lot of disagreement about what the objectives of reform should be. I think there is less to this argument than meets the eye, at least in OECD countries. Of course there are always trade-offs among competing objectives and there is no “one size fits all” view of what constitutes a well-functioning market economy. But I would argue that senior officials in almost every OECD country whose function is to provide policy advice to governments could broadly agree to the following desiderata:

- 1) A robust macro-economic framework that assures low inflation and sustainable budgets
- 2) Dynamic, competitive and innovative product markets
- 3) Sufficiently flexible labour markets (with no doubt some nuances about what is “sufficient”, but most would recognise a too-rigid labour market when they see one)
- 4) Whatever the size and scope of government, tax bases that are as broad as possible, so that marginal rates are as low as possible
- 5) Rising human capital driven by expanding and higher quality education and training opportunities.
- 6) An efficient public administration and judiciary that delivers public services (again, on whatever scale is considered appropriate) as effectively as possible.

#### IV. The political economy of reform is about overcoming the resistance of vested interests

I thus argue that the political economy of reform is not about deciding objectives, but rather the key problem is overcoming the resistance of vested interests. If you want to identify the enemy to a particular reform proposal, look for those who derive rents from the present arrangements that would be threatened by reform, I give some examples linked to each of the objectives identified above:

A) The Macro-economic framework: in this case, the opposition to reform aiming to strengthen macro-economic discipline comes largely from within the political community itself. Politicians like power – and in particular the power to do good things for the constituents who will re-elect them. But the rules that make for a strong macro-economic framework obviously undermine this power. In almost all OECD countries, monetary policy has been taken out of politics to a large extent – and this is clearly an improvement. Fiscal rules still have a long way to go...

B) In product markets, the notion that competition is a good thing is obviously not shared by companies that, on the contrary, are attached to the economic rents that market power can deliver. An interesting point here is that such rents are typically shared among owners, managers and workers. Indeed, in a number of industries where monopolies (public or private) tend to predominate, it is the workers rather than anyone else who are best organised and most strongly committed to the preservation of these rents, and the principal opponents of reform. The notion that left-wing governments might logically be more prone to undertake product-market reform on the grounds that this would not harm their constituents (organised workers) is not empirically correct – probably for this reason. A particularly difficult problem for reform is that of regulated professions (typically self-regulated professions.) There is usually some public –good justification for such regulations, but an awful lot of rent-seeking lies behind it!

C) In labour markets, there clearly is a difficult trade-off between flexibility and job security. Economic risks have to be shared; and even without government regulation, any collective bargaining system based on a reasonably even playing field would deliver a certain amount of “rigidity”. This is no bad thing. The problem for reform arises most acutely, in my view, where various institutions segment the labour market into insiders and outsiders, with insiders reaping rents (which they will fight to protect) in the form of higher wages or “the easy life”, at the expense of outsiders who absorb more than their share of economic risk.

D) As regards tax policy, in every country one finds a whole rent-seeking industry whose job is to invent reasons why this or that activity needs a tax break. The typical history of tax reforms is interesting in this regard. Countries have managed, at times, to introduce simple, economically efficient tax systems through radical reform. (Broad bases, low rates.) If one examines these systems ten or fifteen years later, one

will typically find that the complexity of the system has massively increased, bases have narrowed and conditions for another needed reform are back in place!

A particular example that brings out another aspect of the rents problem is tax treatment of housing. Lots of countries have, at various times, introduced tax breaks to encourage the spread of owner-occupied housing. This is perhaps a laudable objective, but where supply elasticity of the housing stock is low (and it is always low at the intensive end because location is in fixed supply, and even lower because of zoning restrictions in most countries), the present value of the subsidy is largely absorbed in locational rents to existing owners. After some time, the tax subsidy will be (almost) fully reflected in higher land prices and insofar as houses have been bought and sold over the period, these rents have been “capitalised” out of the market. Current owners do not benefit from the subsidy at all. But of course, it is the current owners who would bear the cost (in terms of capital losses) if the tax subsidy is abolished. In this case, reform might well be seen as socially unfair. Reform of housing subsidies is indeed one of the hardest areas in most OECD countries.

E) As regards achieving an efficient public service, there is a real problem. In most countries, the establishment of a merit-based, professional civil service with strong job protection was a significant step forward from previous systems that allowed political patronage and cronyism to dominate the public sector. But these entrenched, rules-based employment systems can also generate an administration that is singularly resistant to change and perpetuate a lot of inertia in public policies. The political power of public-sector employees is not to be under-estimated. I find it telling, for instance, that when New Zealand enacted its radical Employment Contracts Act, which essentially did away with collective bargaining in favour of individual contracts between employers and employees (including in the public sector) the one group that was excepted from the new regime was the teachers. Teachers’ contracts continued to be set through a national wide collective agreement. Some constituencies are too strong to take on.

Finally, the right solution for the public sector is particularly important in the context of a reform programme, because one has to rely on the public administration to implement the reforms decided upon; and if implementation is poor, the gains from reform are less likely to materialise, endangering the reform process. Mr. Havel rightly identified the problem of the gap that often exists between the law and the actual practice as an important issue.

#### **IV Conclusions:**

I do not have a general recipe for overcoming resistance to reform (whether radical or step-by-step). Reform efforts sometimes do succeed, and it is perhaps the genius of political leadership to find the approach that works in a given political, economic and social context. I offer three concluding points for thought:

1) Should reform be broad-based, or look for targets of opportunities?

There is a strong case for broad-based reform, because there are clear synergies among reforms in different areas, and reform in one area may fail to yield the intended benefits if other elements are not in place.

But if one cannot reform all at once, there may be important gains in starting where progress is possible, because this may create conditions that will make it easier to overcome resistance in other areas. For example (as mentioned above), product market reform may weaken rents accruing to certain groups of workers and thus make subsequent labour-market reforms easier. This sequencing was actually followed in both New Zealand and Australia.

In sum, while it is important that conceptually a reform programme should be broad-based and comprehensive, tactics of implementation may need to be adjusted.

2) A second thought is that, inevitably, opposition to reform cannot typically just be crushed; at times it has to be co-opted. Thus while probably not first-best, the approach of grandfathering existing rents (or phasing them out quite gradually) can quiet opposition while still achieving the intended objective at the margin. The example of “grandfathering”, greenhouse emissions when introducing an emissions trading scheme by issuing the permits to present large emitters is an example. Surely, it would be first-best to auction off the permits. But if the choice is to grandfather or not to introduce at all, the former at least gets emission incentives right at the margin. A similar approach is probably needed for phasing out housing subsidies.

3) Finally, reform institutions have a critical role to play. Domestically, agencies such as the Australian Productivity Commission can provide powerful support for reform, as can economic think-tanks more generally – particularly when (like the Dutch CPB or the Belgium Federal Planning Bureau) they have intellectual independence but a formal mandated advisory function. Internationally, EU institutions are obviously of great importance; and I believe that OECD is also very important. Our country reviews are (with admittedly different impacts across OECD countries) often a useful catalyst. This is not because OECD reviews can somehow put pressure on governments to do things that they don’t want to do; but because they can encourage governments to do what they in fact want to do (even if they can’t say so out loud for political reasons) and hopefully provide ammunition to use against domestic opponents of reform.

