Reform

Political Economics: Week 10

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12th March 2010

The Agenda for Institutional Reform

- Priority for emerging economies: market reforms fostering entrepreneurship and the entry of new firms (De Soto 1999, Rajan and Zingales 2003).
  - Increase competition, allocative efficiency, and possibly innovation.
- Little consensus on which specific reforms should be undertaken with greater priority (IMF 2003, WB 2005).
  - What is the political feasibility of different reform paths?
- Caselli and Gennaioli (2008) focus on the role of political constraints in transition economies and developing countries.
- Key problem: compensating or weakening powerful insiders who stand to lose from more entry and competition and can hinder reform.

Deregulation, Financial Reform, and Entry

- Deregulation facilitates entry in product markets by reducing bureaucratic setup costs.
  - Lower setup costs and fewer opportunities for corruption foster entry (Djankov et al. 2002).
- Financial reform improves the ability of agents to borrow and lend.
  - Improvements in the protection of creditors and minority shareholders (La Porta et al. 1998).
  - Changes in the regulation of intermediaries and in the quality of enforcement (Glaeser, Johnson and Shleifer 2001).
  - $\Rightarrow$ Better regulation of financial markets fosters entry by allowing potential entrepreneurs to raise the funds required to start a new business (Banerjee and Duflo 2005).
- These reforms have been thought to yield similar economic and political consequences (Perotti and Volpin 2007).

Economics and Politics of Liberalization

- Market-opening reform cannot be assessed by looking only at the partial-equilibrium incentive for entry.
- Crucial general-equilibrium implications work through the *market for control* where *incumbent firms* are traded.
- The market for control determines the distributional effects of different reforms:
  1. *Entrepreneurship* effect on the number of entrants.
  2. *Meritocracy* effect on the quality of management.
- The similarity between deregulation and financial reform breaks down:
  1. Deregulation only increases entrepreneurship.
  2. Financial reform also increases meritocracy, which may lead to a net decrease in entrepreneurship.
- Financial reform is more politically viable because it endogenously compensates incumbents.

Economic Environment

- A static economy with measure one of wealthless agents who supply inelastically one unit of labour.
- A fraction $\lambda < 1$ have managerial talent 1 and the rest $g^{\alpha} < 1$.
- A firm with managerial talent θ_i and workforce L_i produces

$$Y_i = \theta_i L_i^{1-\alpha} \text{ with } \alpha \in (0, 1) .$$

- Managers are counted in the workforce of their firm.
- Each agent has a project to create a firm. To implement the project and create the firm, a government-issued licence is required.
- A fraction η of agents are *incumbents* and own a licence.
- Incumbency and managerial talent are uncorrelated.
  - $\lambda\eta$ incumbents are talented managers, $(1 - \lambda)\,\eta$ are untalented.
  - Inheritors of family firms or former bureaucrats.

The Selection of Managers

- Outsiders can start a new firm in the *entry market* at a cost $\varepsilon = k + r$.
  1. An exogenous real investment k must be sunk.
  2. The government demands a licensing fee r, which provides a measure of competition policy.
- Outsiders can buy a firm from an incumbent in the *market for control*
  - Existing firms are traded at an endogenous price p.
  - In equilibrium, untalented incumbents sell to talented outsiders.
  - The separation of ownership and control would be analogous.
- Potential entrants can borrow from foreign lenders.
  - Perfectly elastic supply of funds.
  - Interest rate normalized to zero.
- Firms pay competitive wages w and earn profits π
- Financial frictions imply that only a fraction ϕ of profits can be repaid to creditors.

Labour-Market Equilibrium

- Entrepreneurship is measured by the number of firms $f \in [0, 1]$.
- Meritocracy is measured by the share of firms $s \in [0, 1]$ run by talented managers.
- Each firm creates labour demand

$$L_i(w, \theta_i) = \arg\max_L \left\{\theta_i L_i^{1-\alpha} - wL_i\right\} = \left[\frac{(1-\alpha)\,\theta_i}{w}\right]^{\frac{1}{\alpha}}.$$

- Aggregate labour demand is

$$L^D = \left(\frac{1-\alpha}{w}\right)^{\frac{1}{\alpha}} f\left[s + (1-s)\,g\right].$$

- The market-clearing wage is

$$w(f, s) = (1-\alpha)\, f^{\alpha}\left[s + (1-s)\,g\right]^{\alpha}.$$

The Division of Revenue

- Aggregate output is

$$Y(f,s) = f^{\alpha}[s + (1-s)g]^{\alpha}.$$

  - The wage bill is a constant share $(1-\alpha)$ of output.

- Firms run by talented managers earn profits

$$\pi^{H}(f,s) = \alpha f^{\alpha-1}[s + (1-s)g]^{\alpha-1}.$$

- Firms run by untalented managers earn profits

$$\pi^{L}(f,s) = g\pi^{H}(f,s).$$

- Increases in f and s increase output and wages but reduce profits.

The First Best and Initial Conditions

- Efficiency is measured by net output $Y(f,s) - (f - \eta)k$.
  - r is a distributive transfer to bureaucrats and politicians.
- The first best is reached in the absence of frictions.
  - No financial frictions: $\phi = 1$.
  - No barriers to entry: $\varepsilon = k$.

A.1. Firms need to be created: $\eta < \lambda < 1$.

- Talent is abundant relative to the number of firms.

A.2. All and only the talented should manage firms: $k = \alpha\lambda^{\alpha-1}$.

- The market for control matters for $k > g\alpha\left[\lambda + (1-\lambda)\eta g\right]^{\alpha-1}$.

$\Rightarrow$ In the first best $f^* = \lambda$ and $s^* = 1$.

$\Rightarrow$ Initial inefficiencies $f_0 = \eta < \lambda$ and $s_0 = \lambda < 1$.

The Entry Market

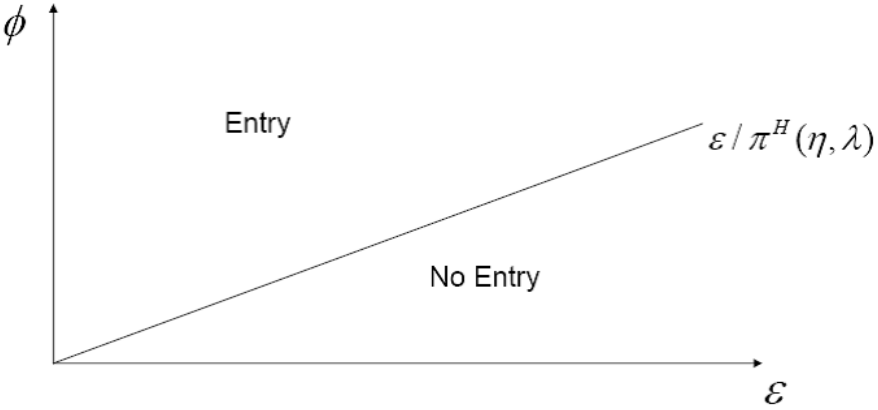
- Talented outsiders can set up new firms if they can promise repayment to foreign lenders: $\pi^H(f,s) \geq \varepsilon/\phi$.
- When talented outsiders can start new firms, they want to.
- Untalented outsiders never want to start firms thanks to $A.2$.
- On the entry market, barriers to entry ε and financial frictions $1/\phi$ affect entrepreneurship identically.

Theorem

When there is no market for control, for every (ϕ,ε) there is a unique equilibrium (f,s). The equilibrium involves no entry if and only if $\varepsilon/\phi > \pi^H(\eta,\lambda)$.

- Meritocracy and entrepreneurship are (weakly) decreasing in ε/ϕ.
- Deregulation and financial reform increase social welfare but cannot attain the first best.

Equilibrium with an Entry Market Only



The Market for Control

- A sale from an untalented incumbent to a talented outsider generates surplus $\pi^H - \pi^L > 0$.
- Trade is possible if there is a price that the untalented incumbent is willing to sell and that the talented outsider can finance by borrowing from foreigners $p \in \left[\pi^L, \phi\pi^H\right]$.
- Since $\pi^L = g\pi^H$, a feasible price exists if and only if $\phi \geq g$.
- An active market for control requires sufficient creditor rights.
- When the market for control is open, untalented incumbents are always willing to sell at $p = \varepsilon$, because $\pi^L = g\pi^H < \phi\pi^H \leq \varepsilon$.
  - The last inequality follow from $A.2$.

The Interaction between the Two Markets

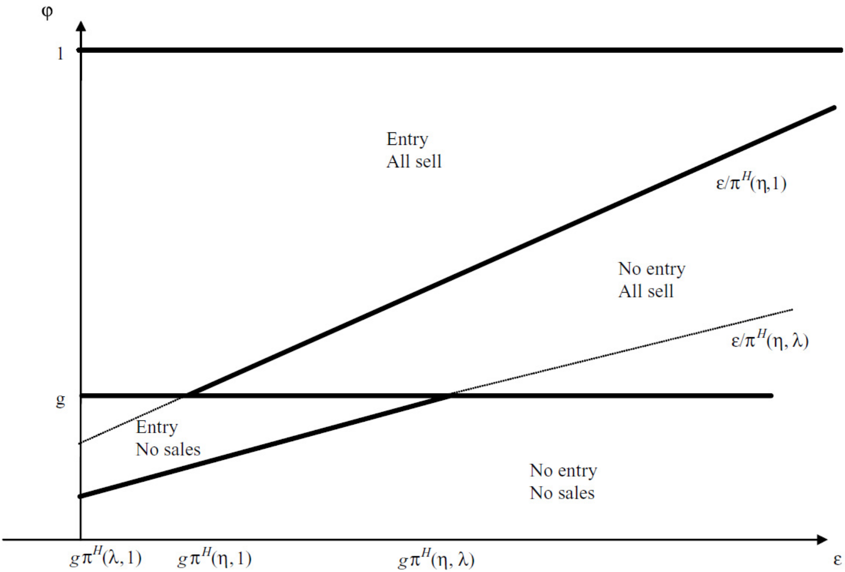
- Two-fold distinction: Entry or No Entry; All Sell or No Sales.

Theorem

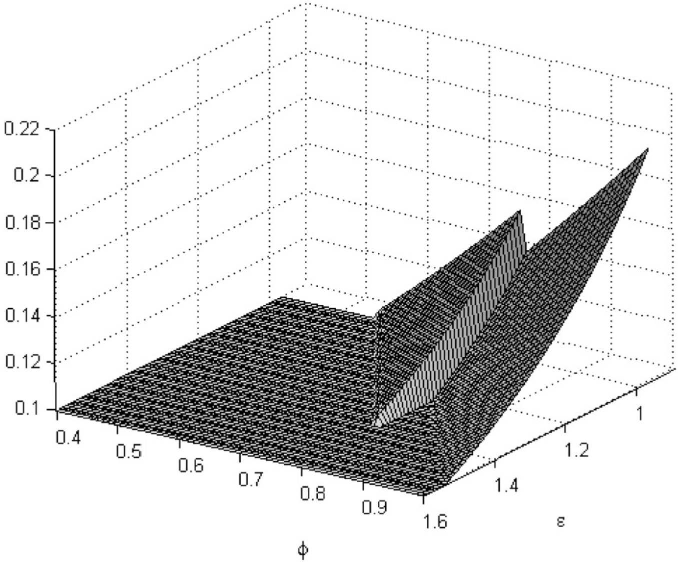
For every (ϕ, ε) there is a unique equilibrium (f, s). If $\phi < g$ the equilibrium involves no sales, and entry if and only if $\varepsilon/\phi \leq \pi^H(\eta, \lambda)$. If instead $\phi \geq g$ all untalented incumbents sell their licences, and there is additional entry if and only if $\varepsilon/\phi \leq \pi^H(\eta, 1)$.

- Deregulation of entry increases entrepreneurship and meritocracy.
- Financial reform can trigger a discrete jump in meritocracy to the first-best level $s^* = 1$.
  1. For high values of ε, $\phi > g$ allows firms to change hands without changing their number.
  2. For low values of ε, $\phi > g$ reduces the number of firms, because talented purchasers crowd out talented entrepreneurs.

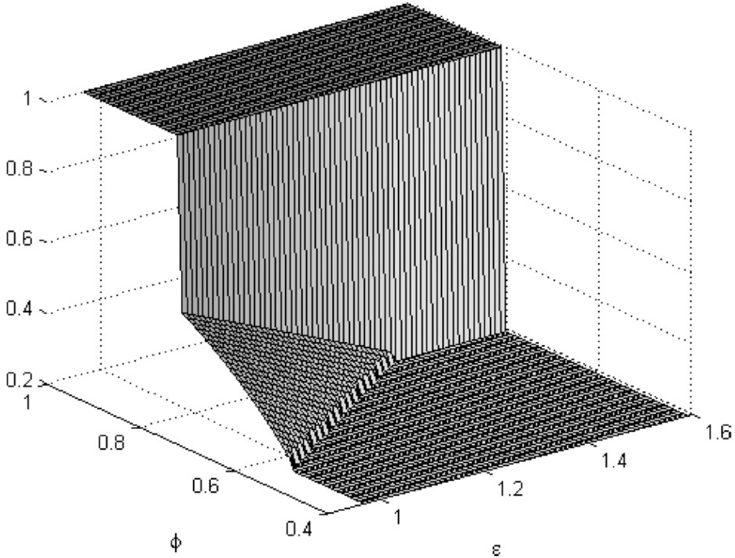
Equilibrium with a Market for Control



Institutions and Entrepreneurship



Institutions and Meritocracy



Political Economy of Reform

- The first best is attained only for $\varepsilon = k$ and $\phi = 1$.

A.3. The economy starts from a status quo with neither entry nor sales.

- Without political frictions, the optimal reform strategy follows a big-bang approach.
- Which sequence of reforms faces the least political opposition?

Theorem

When there is no market for control any pro-market reform (weakly) benefits outsiders and hurts talented incumbents. Untalented incumbents are (weakly) hurt unless $\lambda > g$ and $\eta \geq \eta^*$.

- Without a market for control, both reforms merely increase entry.
- Untalented incumbents may prefer higher wages and lower profits if the incumbency rents are very low.

Compensation of Incumbents

A.4. The price in the market for control maximizes sellers' payoffs.

Theorem

Any pro-market reform (weakly) benefits outsiders and hurts talented incumbents. Any deregulation (weakly) hurts untalented incumbents. There exists $\tilde{\varepsilon}_1 \in \left[k, \pi^H(\eta, 1)\right]$ *such that for* $\varepsilon \leq \tilde{\varepsilon}_1$ *any financial reform (weakly) hurts untalented incumbents, and for* $\varepsilon > \tilde{\varepsilon}_1$ *full financial reform* $(\phi = 1)$ *benefits them.*

- Deregulation of entry reduces the profits of all incumbent firms.
- Financial reform also does, but additionally it lets untalented incumbents internalize some of the efficiency increase.
  - The latter effect may dominate for all $\varepsilon > k$.

$\Rightarrow$ A "swing" constituency for reform: financial reform is more feasibly than deregulation.

  - Its feasibility is increasing in ε_0.

Direct Democracy

- The political feasibility of a reform is increasing in the number of agents who benefit from it.

Corollary

When there is no market for control, financial reform and deregulation have the same political feasibility. When the market for control exists:

1. *financial reform is always at least as politically feasible as deregulation, and strictly more feasible for at least some parameter values.*
2. *The political feasibility of financial reform is increasing in ε_0.*

- "Coasian" reforms that foster private contracting are more likely to be politically viable than purely rent-dissipating reforms.
- The winners may be able to compensate the losers through the market, rather than through (rarely feasible) political buy-outs.

The Sequencing of Reforms

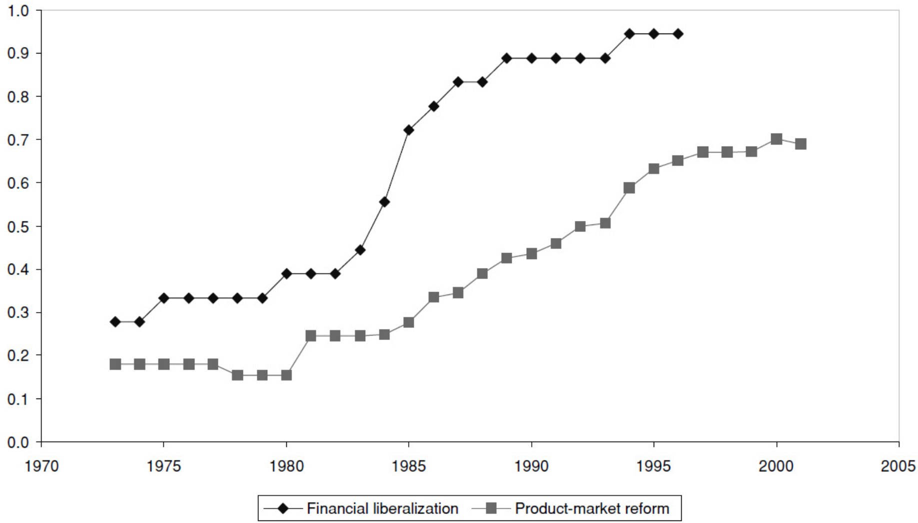
- The feasibility of financial reform can be increased by a simultaneous increase in entry barriers.
- A gradual reform path involves immediate and complete financial reform ($\phi = 1$) but full deregulation ($\varepsilon = k$) at a future date t^*.

Theorem

There exists $\tilde{t} > 0$ such that the political feasibility of the dynamic reform path is nondecreasing in t^* for $t^* \leq \tilde{t}$, and strictly increasing for at least some parameter values.

- Untalented incumbents oppose big-bang reforms which reduce their rent to k
- If deregulation is delayed, its negative impact on the value of a licence is reduced.
- Untalented incumbents support a package of gradual reforms that lets them sell their firm while it is still valuable.

Financial Reform and Deregulation in OECD Countries



Delayed Stabilization

- Countries often follow policies that are recognized to be unsustainable in the long run.
- *Stabilization* refers to a major fiscal adjustment that significantly reduces budget deficits and/or stops high and variable inflation.
- Alesina and Drazen (1991) explain the timing of macroeconomic reform with political stalemate over its distributional consequences.
  - Who bears the burden of necessary tax increases and expenditure cuts?
- Stabilization coincides with political consolidation: one side becomes politically dominant.
  - The allocation of the burden is often quite regressive.
- Successful reforms are usually preceded by several failed attempts.

War of Attrition

- Runaway growth of government debt (relative to GDP) must be stopped. No disagreement on the need for reform.
- Different social groups fight over the allocation of the costs of stabilization through a reform package.
- Uncertainty about which group is stronger.
  - Strength is the ability to withstand the costs of waiting.
  - Economic costs: inflation, macroeconomic instability
  - Political costs: lobbying, strikes, etc.
- Each group tries to wait out the others before conceding.
- The passage of time reveals which group is the strongest and can impose its preferred stabilization package.
- Delay causes aggregate inefficiency, but results from individually rational strategies.

Comparative Statics

1. The passage of time alone increases the probability of stabilization.
    - Reforms may become feasible although nothing observable happens.
2. Crises induce reform (Drazen and Grilli 1993).
    - Negative shocks can be welfare improving.
    - Asymmetric shocks that weaken one group in particular are more likely to make it concede quickly.
3. Political institutions that grant more veto powers delay stabilization.
    - An unconstrained executive reforms at the opposition's expense.
4. Political consolidation facilitates stabilization.
    - Reform is more likely at the beginning of the electoral cycle.
5. External inducement can cut both ways
    - IMF conditionality or EU requirements increase the cost of delay.
    - Foreign aid can harm by reducing the pressure to reform.

Crisis and Stabilization

- Empirically, it is difficult to disentangle causality from tautology: reform is needed when current policy fails, i.e., in a crisis.
- The best evidence concerns inflation and hyperinflation (Drazen and Easterly 2001).
- Ranking reversal: the countries in the lowest decile of performance move up in the ranking when they stabilize.
- Episodes of extremely high inflation are followed by periods of better performance than that following episodes of moderately high inflation.
  - The same result holds for the black market premium.
  - It does not hold for the current account deficit, the budget deficit, or a negative growth rate of GDP per capita.
- Deficit reduction policies in OECD countries are less contractionary when public debt is high and growing (Perotti 1999).
  - Stabilization of hyperinflation can be expansionary (Easterly 1996).

Institutions and Stabilization

- Parliamentary systems and proportional representation are associated with larger deficits.
  - Coalition governments in OECD countries had larger deficits in the '70s and '80s and were slower to respond to negative shocks.
  - Institutional constraints on the executive are associated with more delayed and less successful stabilizations (Hamann and Prati 2002).
- Political budget cycles: deficits rise close to elections.
  - More common in democracies that are less established and have less freedom of the press.
  - Pre-electoral deficits do not seem to help the incumbent.
- Little solid evidence on external inducements.
  - The criteria for entry joining the Euro seemed to work—or did they?
  - The effects of aid are a controversial and hugely political topic.
  - The same goes for IMF conditionality.
  - On the whole, there does not seem to be a robust effect.

Who Adjusts and When?

- Alesina, Ardagna, and Trebbi (2006) focus on the interaction between indicators of crisis and institutional variables.
  - Crisis means being in the worst quartile for the deficit-GDP ratio ($> 4.75\%$) or inflation ($> 14.05\%$).

1. Stronger governments stabilize more in time of crisis.
   - Presidential systems, and among parliamentary systems those in which the majority is larger and not fragmented in several coalition parties.
2. Electoral cycle: crisis generate more response after an election and far from the next one.
3. The presence of an IMF program in a crisis does not seem to generate a stronger response.
   - Substantial problem of reverse causation.