

POLITICAL ECONOMY OF THE REFORM PROCESS

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ECONOMIC REFORM

- **DEFINITION:** Economic reform is a set of planned and coordinated policy decisions aim at changing the institutional structure of an economy.

Notice that

- 1) Institutional structure can change without a policy intervention (urbanization, technological advance, natural disasters etc.)
- 2) All policy decisions that affect the institutional structure should not be considered as reforms. Any policy decision may inflict an unintended, even undesired, side effect on the institutional structure.

MODELLING THE ECONOMY

Set of Structural Parameters (i.e. economic environment)

$$\Lambda = \{ \lambda_1, \lambda_2, \dots, \lambda_m \}$$

"Reaction Functions" of economic agents

$$x_{\Lambda}^j = f_{\Lambda}^j(\xi_{j|\Gamma}, \Lambda^j) \quad j = 1, 2, \dots, n$$

where

$\xi_{j|\Gamma} = \{ \xi_1, \xi_{j-1}, \xi_{j+1}, \dots, \xi_n \}$ "Messages" of other agents received by agent j

and

$\Lambda^j = \{ \lambda_1^j, \lambda_2^j, \dots, \lambda_m^j \}$ Environmental component of agent j (preferences, technology etc.)

FUNDAMENTAL POINTS TO NOTICE

- 1) Notice that the arguments of the reaction function of an agent are messages received and its environmental component. (Informational decentralization)
- 2) However, the reaction function itself may change when the economic environment changes. Therefore one will not get the same response from the agent in question when the structural change occurs. (***Uncertainty augmenting effect*** of structural adjustment)
- 3) Different agents are affected in a dissimilar way from economic reforms, since their structural components and the way they are related to others are vary.

SOME COMMON CHARACTERISTICS OF STRUCTURAL REFORM PROCESS

- Structural reforms usually produce positive results with a considerable lag.
- The benefits from reforms are not equally distributed among the members of the society. This is especially true for direct benefits.
- The costs of the reforms are generally shared among the members of the society by state intervention, i.e. through taxation.
- Therefore fairness aspect of the reform process is a political issue.

PUBLIC REACTION TO REFORMS

- Due to these characteristics of structural reforms, people usually react in a conservative manner, if not negative, to reforms.
- Authorities need to take this change in the reaction functions.
- This is not an easy task. Through interaction among different agents, those agents that seem not to be affected directly by reforms may also change their reaction functions.

A NOTE ON LIBERALIZATION PROGRAMS

- Liberalization programs envisage a more decentralized economy.
- This means, agents will bear the full responsibility of their actions. The protective umbrella of the state will disappear.
- This means, the ***perceived uncertainty*** of the agents will increase, even if the ***systemic risk*** remains invariant.
- In response, the economic agents may exhibit an over-cautious behavior.

A DIGRESSION ON *TARIQ IBN ZIYAD (689-720)*

- *Tariq ibn Ziyad* was sent by Musa ibn Nusayr in the year 711 AD as a chief commander to conquer Andalusia.
- He advanced towards a small mountain in the sea which later became known as *Jabal Tariq* (Mount Tariq) derived from which is the modern name: *Gibraltar*.
- *Tariq ibn Ziyad* and his army disembarked into the darkness of the night. He then set fire to his fleet and in his determination to conquer Andalusia.
- He told his army:
” *I have now burnt the ships, and now there is no return for us and here we will conquer or die fighting.*”

GUARANTEEING THE IRREVERSABILITY OF REFORMS

- Over-cautious behavior may lead the agents to defend the status-quo. This may hinder the reform process.
- One solution may be to launch the reform when the economy is in the crisis or the memories are fresh with the crisis experience.
- The other is to make the return to status-quo prohibitively costly (*Tarık ibn Ziyad's* solution) or by designing a reform program sounds which offers attractive benefits visible to all members of the society.

DESIGNING A REFORM PROGRAM

- A reform program can be considered as introducing a new resource allocation mechanism.
- Mechanism design is a highly complex technical problem which drew attention of the economists, especially within the last half century.
- It requires a properly defined social goal (welfare function), a well defined structure which describes technical and institutional constraints, an informational system that enables message exchange among economic agents and specification of their response functions.

POLITICAL ASPECTS OF REFORM

- The determination of social goals (who will decide?)
- How one can achieve *informational efficiency* (All agents receive all the necessary information, no more no less)
- Sequencing of reforms (Where to start? How to proceed?)
- Timing of reforms (Should the reform be launched today, or tomorrow? Why?)
- Finding a “fair” (or “just”) way of allocating the burden among various classes within the society as well as among generations.

CONSENSUS BUILDING

- It is both undemocratic and, in most instances, it is either infeasible or extremely costly to implement reforms without getting a broad support from the public.
- Expecting a full consensus on an issue where private interests may widely diverge, is unrealistic.
- However, reforms should take “consensus seeking” seriously and play utmost care for information sharing.
- Public should be informed concerning the nature of the reform, its direct beneficiaries, its social cost and the distribution of its burden among various social groups and generations.

Thank You For Your
Attention