

Political Economy of Structural Reform: reforms among resurgent populism

European Central Bank

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Outline

- I. Traditional view on obstacles to reform
- II. Other hypothesis, based on bounded rationality
- III. Implications for reform avenues

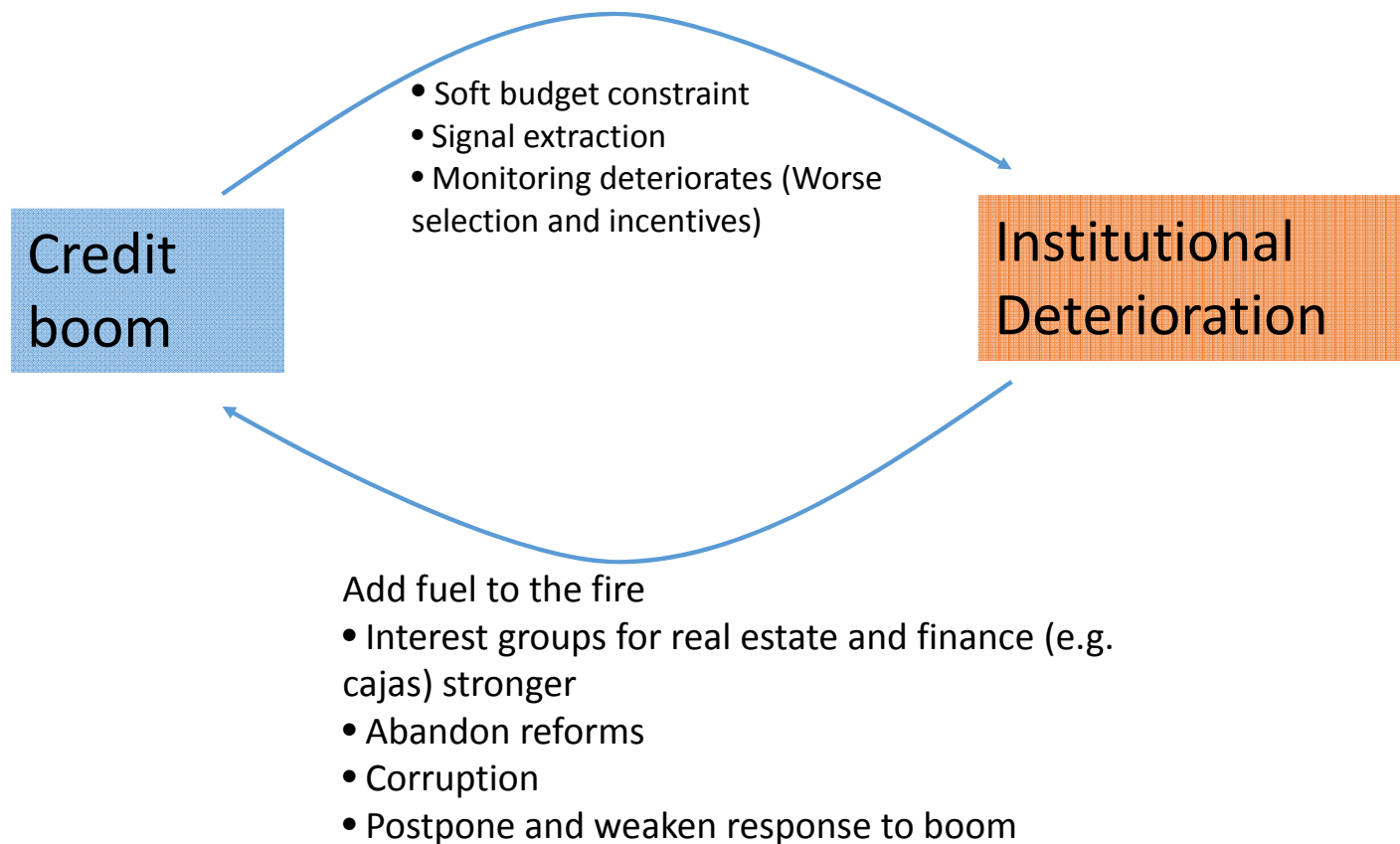
Why is reform hard? Traditional reasons

Politicians are rational maximizers

- Olson (1965) Logic of collective action: organizing a large group to obtain public goods for members.
 - Favors small group, big gains, against large, diffuse gains
 - Solution: selective incentives (services, trips...)
- Rent Seeking (Tullock, 1967, Krueger 1974), waste of resources involved in obtaining programs
- Stigler (1971) regulatory capture: politicians maximize votes and cash
 - Interest groups that can deliver those win (NRA)
 - Chicago school of regulation: Peltzman , Becker...

Political Credit Cycles

(Fernández-Villaverde, Garicano, Santos, 2013)



Soft budget constraint

- “Soft budget constraint” syndrome: cheap external funding undermines incentives to maintain good institutions (Challe, López, Mengus, 2017)

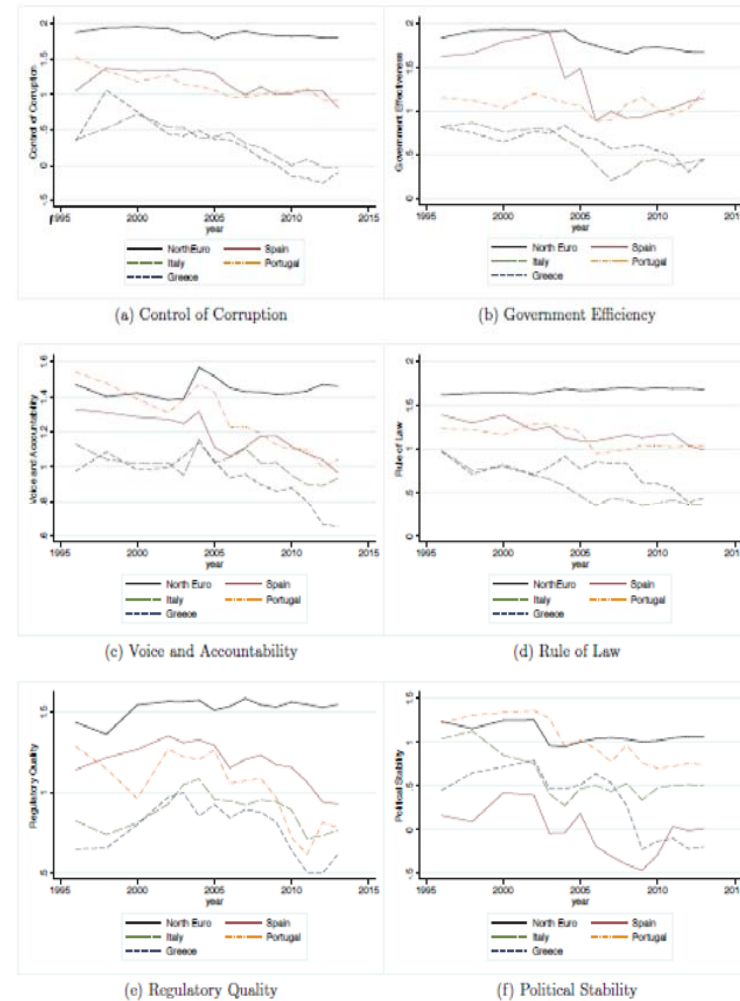


Figure 1 – World Bank Indexes of institutional quality

Implications

1. No automatic stabilizing role of Euro or EZ

- Probably the opposite: reduction in the incentives to take difficult decisions

2. Market discipline will never be enough

3. Explicit conditionality useful

- Linking ECB decisions to reforms has worked to reverse soft budget constraint
- But has had large political cost
 - Legitimacy of European project and European institutions (Commission/ECB)
 - Government by technocracy is one of key factors leading to populist backlash (more later)

Sure, capture matters/self interested politicians matter, but a lot more going on

- But there is a lot more going on
 - Brexit, Trump, Cat... which interest groups behind moves?
- Important to understand populist explosion to make reform recommendations

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Some hypothesis

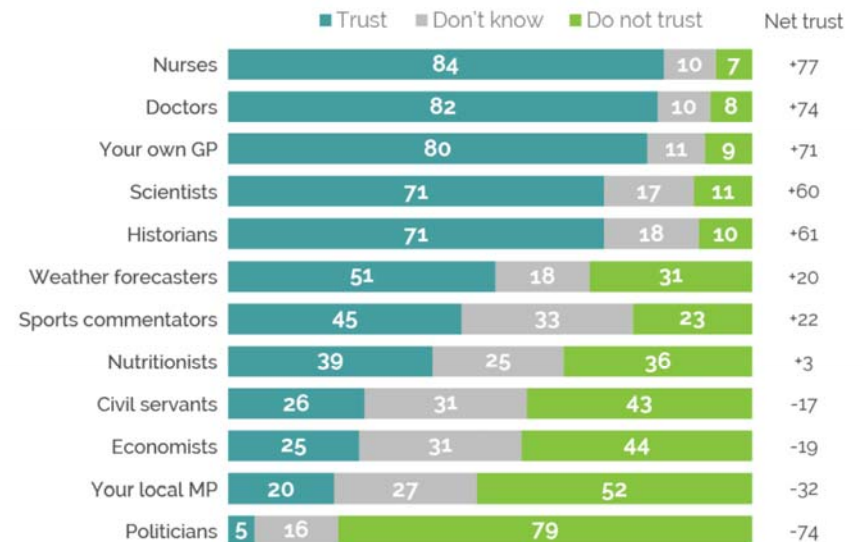
- (1) Bounded rationality, mistrust of experts
- (2) Bounded rationality, huge framing effects
- (3) Polarization: different beliefs/different priors
- (4) “Rational” Leninism

1. Bounded rationality + Mistrust of experts

- Reform policies are hard to explain
 - When voters trust experts that is fine
 - But that seems to no longer be the case

Public trust in experts

Of the following, whose opinions do you tend to trust when they talk about their fields of expertise? %



Consequences of mistrust of experts

- Mistrust of experts:
 - Most people cannot understand how a toilet works!
 - If all opinions are of same quality, “correct” opinions cannot succeed
 - Examples:
 - Labour market reforms, with mistrust impossible
 - VAT, incidence
- How do experts build trust back?
 - Second best policies that are easy to explain, easy to quantify
 - Killer example

2. Bounded rationality + massive framing effects

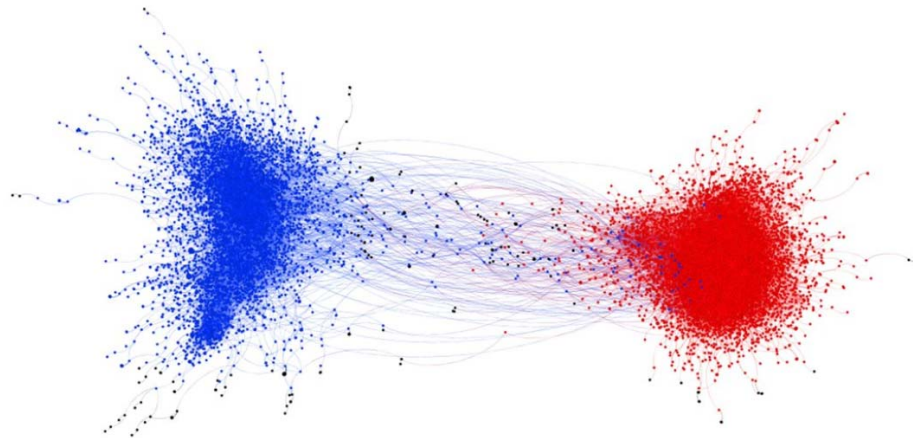
- Little space on the “little book of advice for policy makers” for communication
- And yet that is 95% of success
 - Discount the Coke in winter? Yes!
 - Raise price in summer? Are you kidding?!
- Populists are better at simple, easy answers
- Solutions
 - Again, second best policies that are easy to quantify and communicate
 - (i.e. include “understandable” restriction)
 - Learn from the populists, communicate extremely simply (Values)

3. Polarization, differing priors

- Shocking aspect of recent (Trump, Brexit, Cat) debates: completely different beliefs about reality observed. No common knowledge
 - Solid empirical evidence for US supports casual observation
- Social media must be making a difference here
 - “The capacity to disseminate misinformation, wild conspiracy theories, to paint the opposition in wildly negative light without any rebuttal — that has accelerated in ways that much more sharply polarize the electorate” (Obama)
 - But research shows (Boxell, Gentzkow, Shapiro, 2017) that polarization growing more in groups less likely to use Internet

Polarization and emotions

Moral-emotional language increased diffusion more strongly within liberal and conservative networks, and less between them (Brady et al. PNAS 2017).



Polarization, differing priors

- Bottom line: impossible to convince those with different priors/beliefs/world view
 - Much less clear about what to do here
- Example: opinions of experts disregarded in e.g. Brexit
 - A wall of cynicism makes view from “other side” invisible
 - It is not about reason, evidence, but about values, morals

4. The death of incrementalism: (somewhat) rational Leninism

Many voters have decided (after 30 years of observation) that status quo does not work for them

Also do not believe promises of experts, compensation

They would rather deal the cards again. So prefer to “heighten contradiction of existing system”/sow chaos

A substantive constituency has disengaged with “normal policymaking”

Solutions?

III. Implications for Policy: bounded rationality

- Economists and policy makers must think much harder about how are policies communicated and framed
 - Simpler policy recommendations
 - Single objectives
 - Easier to communicate, if cannot be explained, can it be pursued?
 - The single graph text
 - Stop with the huge reports, many graphs, many lines.
 - Start producing simple, one graph reports (remember the elephant graph by Milanovic?)
- We must all think much harder of how to cross belief “gulf”
 - Policies, recommendations, reports must appeal to emotions, values
 - (We don’t know much of any of it!)

III. Implications for policy: Trust in Euro context

- Rebuilding trust?
 - We need to assume public expects the worst
 - They do act as in the economics model! (they are Stiglerian about experts)
- Clear limit to technocratic institutions: Stability & Growth Pact is dangerous
 - Commission cannot continue being the EDP enforcer, telling countries what they can and cannot do with their budget.
 - It involves the Commission excessively and fruitlessly in the core function of a democratic parliament
 - Feeds southern populism (“stop Europe meddling”!)
 - Feeds northern populism (“the Commission is failing to rein in spendthrift Southerners”!)
- Cannot ever again design policies without thinking through politics (bank rescues were a disaster!)

III. Implications for policy: Leninism

- Gulf and Leninism
 - Strange and dark turn may lead the world further and further away from the optimum.
 - Existential priority to fight these impulses.
 - Threatens everything that Europe has built over the last few years
 - May require “Brexit vaccine”