The Impact of Politics in Policy Reforms

S.A.R, Tharanga

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Author: Tharanga Samarasinghe

1. Abstract

The economic policy reforms play an important role to increase the economic growth of the countries. The economic policy reforms can perform in both national and sectoral levels. There are two main types of economic reforms at national level including stabilisation policies and structural adjustments policies. In addition to that, economic policy reforms may happen in any sector like agriculture, industry and trade. Due to economic reforms create the distributional effects in the society, it creates both losers and winners, in addition to producing of delayed outcomes. This distributional effect might create a political volatility in the society. Therefore, political authorities are indifferent between the self-interest and uncertainty of their tenure of the office in next period. If the country suffers from political instability, the risk of losing the power of existing government is high and then, the policy reforms will be delayed. In addition to that, the literature highlights the importance of government credibility for the successful economic reforms. Some governments support for the redistribution policies, and some are not. It is entirely depended on the ideological polarisation. Therefore, for the successful policy changes, formulation of politically sound economic policies and timely implementation of those policies are essential.

Key Words: economic policy reforms, redistribution, political stability

2. Survey of Literature

2.1. Introduction

The market failure issues such as externalities, the supply of public goods, monopoly behaviour and imperfect competition make economy inefficient (Acemoglu & Robinson, 2013). As a remedy for this inefficiency, the critical economic policy reforms can be implemented at the national level (e.g., stabilisation policies and structural adjustments) and sectoral level (eg., Agriculture, Industry, Trade) (Adams, 2000; The World Bank, 2008). Economic policy reforms may create winners and losers. Some social groups lobby to delay/expedite the policy reforms due to heterogeneity of group interests and uncertainty about the benefits for the group (Adams, 2000). This lead to change the political equilibrium in the society (Acemoglu & Robinson, 2013).

2.2.The political economy models of economic policy reforms

As describes in Pederson (1997) and Adams (2000), in the policy reforms process, government/public sector parties (including policy makers and implementers) and private groups (workers, capitalist, farmers, students, etc.) expect to increase their payoff. The government parties show a rent-seeking behaviour to sell their political power, and private groups want to buy the political influence. The private groups pay briberies to the government parties to delay/expedite the policy decisions (Pederson, 1997; Adams, 2000). The ruling elite get the ultimate decision on implementation of policy reforms, and this decision depends on their self-interest and political uncertainty (Adam 2000). The decision makers are uncertain about the net benefit of the policy, redistribution of the benefits, movement of production factors in the economy after the policy reforms (Adam, 2000). These uncertainties may create a political risk, and if the power is in danger, the political elite will not decide to implement the reform policies. However, if this process ends with a Nash equilibrium, all groups obtain the benefits of policy reforms. Therefore, in the process of policy reforms, it is important to consider about the redistribution effects, political regime, economic and political stability in the country at the time of reform policy implementation.

2.2.1.Policy reforms and redistribution effect

Alsina & Rodrik (1994) explains that the demand for policy reforms depends on the distribution of productive resources in the society. The higher inequality and the poor property rights impede the economic growth (Alisina & Rodrick, 1994; Persson & Tabellini, 1994; Clark, 1995). On the other hand, the political regime decides the redistribution policies and property rights of the citizens. Following sections discuss the redistribution effects of stabilisation policies and structural adjustment policies.

Stabilisation policies target the macroeconomic conditions such as improving the balance of payments, inflation controls and currency devaluation (Adms, 2000; Easterly, 2003). Currency devaluation causes to a rapid increase in price level (Herbst, 1990). On the other hand, the Central Bank Independence (CBI) can reduce the inflation significantly if the government expenditure is medium (Acemoglu, Johnson, Querubin & Robinson, 2008). But, less government spending may affect negatively on some disadvantaged communities.

Structural adjustments mainly include the privatisation and promoting the private sector, reducing of trade barriers, export promotion, discouraging of import substitution industries, removing of price and interest rate control (Adms,2000 ; Easterly, 2003). Both privatisation and discouraging of import substitution industries may lead a short-term unemployment (Herbst, 1990). According to Easterly (2003), the structural adjustments policies are less helpful to poverty reduction because poor who are in informal sector will benefit less from the reforms in the formal sector. Therefore, the benefits transferring programmes need to be implemented to target the vulnerable groups (Easterly, 2003).

2.2.2. Economic policy reforms in different political regimes

The successfulness of policy reforms mainly depends on the political regime. The democratic political system influences negatively on the economic reforms (Gordon, 1996). Although the political liberalisation removes the constraints for economic growth (Gordon, 1996), in the democratic system, policy reforms may generate a high political risk for the government, it may cause to delay the decisions on policy reforms. Meanwhile, Marangos (2005) claims that without some minimum level of political cooperation, successful economic reforms cannot be implemented.

The voting decision affects on redistribution and thereby economic growth in democratic systems (Alisina & Rodrik, 1994). High level of democracy causes lower economic growth after the policy reforms. If the political regime is relatively longer, it lower the economic growth (Jong-A-Ping, De Haan, 2007). In addition to that, the ideological polarisation influences on the redistribution policies (Alisina & Tabellini, 1989). In contrast to the democratic regime, the authoritarian regime does not affect due to voting decisions of people in the policy reforms.

2.2.3. Best time for policy reforms

If an economy is in a crises, it means the economy is in a Pareto-inferior and existing policies are not supported. It is the best time to implement the reform policies (Drazen & Grilli, 1993; Rodrik, 1996). The political stability of the country facilitate the collective decision making for stakeholders (Cukierman, Edward & Tabellini, 1992). If policy reforms introduce under the political instability, sometimes the country might go to more inferior position.

3. Conclusion

Many countries in the world provides clear examples on the importance of political and economic relationship in the economic reforms. Both South Korea and Taiwan highlight the importance of foreign aid in economic reforms (Rodrik, Grossman & Norman, 1995). Both these countries implemented policy reforms including currency devaluation, export promotion, providing subsidies to specific industries, high public investments in infrastructure developments and human capital developments (Rodrik, Grossman & Norman, 1995; Rodrik, 1996). As describes by Rodrik (1996), in 1950s, the inequality of these countries was very low and consisted of an educated labour force. The governments of these countries did not much focus on redistribution policies due to low inequality, and implemented required economic reforms. The political leaders closely monitored the behaviour of government bureaucrats, and educated group of government officials promote the private entrepreneurs (Rodrik, 1996). The success of economic reforms in South Korea, Taiwan and other East Asian Countries highlighted the importance of stable political leadership for economic growth.

Newell (2011) shows the importance of politics in economic growth by taking the examples from Mexico. During the period from 1935 to late 1980's, the economy of Mexico showed a higher growth rate. However, the bad government policies including overvaluation of Peso, which was implemented in 1970s and early 1980s, increased government expenditure and discouraged the private sector. Eventually, the economy drove to the crises during the 1976-1982 (Nowell, 2011). Acemoglu & Robinson (2013) stress that some good economic policies does not sound politically by highlighting the devaluation experience in Ghana. In 1971, Ghana government's decision on currency devaluation to improve the balance of payments and foreign exchange condition ends up with the capturing the power by another political leader.

As Acemoglu, et al. (2008) describe that multiple policy reforms may create a seesaw effects. For instance, if government implement inflation control policies simultaneously with high government expenditure, the country will not be able to reduce the inflation. Alisina & Drazen (1991) says, although policy increases the efficiency of economy, if it has a significant negative impacts on distribution, the implementation of policy is difficult.

Implementation of economic policies are essential for economic growth and development. Any economic policy has a distributional effect and it may create losers and winners and thereby, it may change the political equilibrium in the society. Therefore, ruling elites tend to keep their tenure in office continuously by avoiding the critical economic policy reforms. As literature revealed, if the country is politically stable, the government can take policy reforms because the risk for loss the power is very low. If the country is in a situation like the external debt crises, inflation crises, banking crises, economic recession and high inequality, then it is a good time for implement economic reform policies (Agnello, Casreo, Jalles &Sousa, 2015). Therefore, in conclusion, the good economic reforms need to be politically sound, and it is essential to consider the redistribution effect, political regime, economic condition and political stability of the country.

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