

# Capital accumulation, unemployment, and self-fulfilling failure of economic reform

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## Abstract

I consider fiscal reform and the consequences of expectations about reform cancellation. The reform implies reduced taxes and the laying off of employees in an inefficient public sector. If the resulting unemployment level declines sufficiently fast, the reform is completed. On the other hand, if high unemployment levels prevail for too long, the reform is cancelled. Cancellation affects the return on capital negatively. Hence, expectations about cancellation will depress capital accumulation and increase the level of unemployment. As a result, multiple rational expectation equilibria may arise where expectations about cancellation prove self-fulfilling. The modelling framework is Leontief technology in combination with Ramsey optimization that exhibits simple and attractive algebra. © 2001 Elsevier Science B.V. All rights reserved.

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## 1. Introduction

Why do some economic reform programmes succeed while others fail? This important question is, and has been, the subject for a wealth of research. The explanation is often found to be a combined result of the economic consistency of the programme, its distributional implications, and the political environment in which the programme is carried out. Rodrik (1996) summarizes important contri-

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butions and concludes that *most economists have now come to the realization that good economic advice requires an understanding of the political economy of the situation* (p. 38).

The literature on the political economy of reform has a multitude of contributions; both empirical and theoretical. Notable contributions to the many case studies are Williamson (1994), Haggard and Webb (1994), and Hellman (1998). Among the theoretical contributions are, for example Alesina and Drazen (1991), Dewatripont and Roland (1992a,b), and Rodrik (1995). These works are all concerned with how the political system may or may not be conducive for the implementation of reform. At the focus of discussion is how a reform programme should be designed in order to get sufficient political support and avoid cancellation. An extension to these issues is how *expectations* about the completion/failure of reform may affect the programme's performance. Hence, is it possible that the mere expectation about failure leads to a dismal programme performance that in turn leads to programme cancellation? I.e. a self-fulfilling failure.

The possibility of multiple equilibria, in models of economic reform, is explored among others by Froot (1988), Rodrik (1991), van Wijnbergen (1992), Roland and Verdier (1994), and Buffie (1995). The present work shares the spirit of these works, but it distinguishes itself in the combination of two important features: the main analytical feature is a standard Ramsey model augmented with minimum real wage and unemployment. The main conceptual feature is the focus on functional income distribution and unemployment as the cause of reform cancellation. Moreover, Leontief technology in combination with Ramsey optimization provides surprisingly simple and attractive algebra.

The argument goes as follows: consider a fiscal reform where employees in an inefficient public sector are laid off and taxes are reduced. Assuming downward sticky wages, the reform immediately lowers labour demand, leading to unemployment. At the same time, return on private capital increases, inducing capital accumulation. Hence, labour demand recovers and employment increases over time. Some time after the reform implementation there is a referendum. If the level of unemployment is sufficiently low, continuation of reform is approved and the programme is completed as planned. If the level of unemployment is too high, the resistance towards continued reform will cause cancellation. The reform policy is in that event replaced by a status quo policy. That is, unemployment is instantly removed by tax-financed re-employment by the government. Cancellation will, because of the tax increase, instantly lower the return on capital. Hence, expectations about cancellation will depress capital accumulation, giving high unemployment at the time of the referendum. Expectations about cancellation can therefore prove self-fulfilling, generating multiple rational expectations equilibria. For a given programme, both expectations about cancellation and completion can turn out to be *ex post* rational.

The present analysis uses a stylized model of economic reform to explore these possibilities. Failure of reform is shown to depend both on economic factors and

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