

The electoral politics of public sector institutional reform

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Abstract

For politicians in office, reforming public sector institutions is an investment; they must spend resources now in order to achieve future gains. There are no property rights attached to these institutions. Therefore, politicians need to remain in control if they are to reap the full benefits of reform. When the probability of re-election is unaffected by the reform choice, political polarisation between incumbent and challenger results in a lower critical value for the cost of investment by reducing the benefits of reform compared to a benchmark of no uncertainty. The reduction in the cut-off rate is increasing in the degree of polarisation. However, if undertaking reforms increases this probability, the likelihood of investment might increase, the more so the greater the polarisation in preferences. © 2002 Elsevier Science B.V. All rights reserved.

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1. Introduction

Public sector institutions matter for economic performance. This intuitive proposition has recently received strong empirical support. For example, [Hall and Jones \(1998\)](#) find that differences in institutional quality explain much of the variation in production per worker between countries, [Knack and Keefer \(1995\)](#) show that investment and growth is higher in countries where property and contract rights are better protected, and [Knack \(1996\)](#) and [Keefer and Knack \(1997\)](#) demonstrate that the extent to which poor countries catch up with rich ones is a function of the quality of their public institutions.¹ Why some

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¹ In addition, the econometric analysis of [Mauro \(1995\)](#) shows that growth is slower in countries with more corruption (a symptom of weak bureaucratic institutions).

countries adopt more efficient institutions than others and why countries with inefficient institutions do not reform them are thus important questions.

In this paper, I develop a model of institutional reform in the context of political instability and polarisation. Other researchers have found that political instability and polarisation have a negative impact on savings, investment, and growth.² Explanations of these results usually focus on the actions of private investors. For example, political instability in combination with polarisation implies uncertainty about future economic policies. Such uncertainty could reduce private investment in irreversible capital.

I demonstrate that political instability and polarisation might also affect aggregate economic performance through a different channel, namely, the efficiency of public sector institutions. From the point of view of a politician holding office today, creating or reorganising public sector institutions is an investment; in order to realise future gains, he must spend resources at his disposal now. These resources could have been utilised for current purposes, thus creating an opportunity cost of institutional change.³ An important feature of public sector institutions is that there are no property rights attached to them. Often, therefore, a politician can only reap the fruits of his efforts in building institutions as long as he retains control over them. It follows that his expected tenure is an important determinant of the expected benefits from such activities.

In democracies, the expected tenure of a politician is usually closely linked to elections.⁴ I show that as the probability of retaining office increases, the likelihood of reforms being undertaken increases too. The intuition is that a higher probability of reelection implies that a greater share of the benefits of reform are appropriated by the person making the investment decision.⁵ For politicians who are policy-motivated, political polarisation strengthens the effect of political instability on reform incentives. When an office-holder is purely motivated by policy concerns, he is indifferent between continuing in office and being replaced by another politician with identical preferences. Thus, while political instability affects the likelihood of “good” or “bad” states occurring, political polarisation determines how much worse the “bad” state is than the “good”. The greater the differences between an incumbent and his challenger(s), the weaker are the incentives to reform public sector institutions for a given probability of remaining in office.

² See, e.g., [Alesina and Perotti \(1996\)](#) and [Alesina et al. \(1996\)](#).

³ Because informal institutions such as customs are not easily amenable to purposive design, the focus will be on formal institutions.

⁴ However, governments sometimes change between elections, prompting changes in personnel, the extent of which depends on the number of positions filled through political appointments. In autocracies, of course, political change is ordinarily not institutionalised. Still, there is generally a positive probability of a change in government or regime, and not infrequently the “politics of survival” ([Migdal, 1988](#)) dictate rotations or substitutions of personnel at the higher echelons of the state. While the form changes, potential political instability is an ever-present feature of politics regardless of regime. The electoral model of reform choice discussed below is therefore a special case of a more general problem. See [Hagen \(1997\)](#) for a discussion of this in the context of a formal model, which lacks the political detail provided here.

⁵ For simplicity, I will in this paper speak of the political alternatives as individuals. They might as well be collectives like parties.

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