“Labour and Product Market Deregulation: Partial, Sequential or Simultaneous Reform?” by Helge Berger and Stephan Danninger

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1. Summary:
Structural reform is often slow, inadequate or curtailed. It is impeded by regulation in other sectors (eg labour market reforms by product market regulation, tax restrictions). This leads to a need for joint reform programmes. Berger and Danninger argue for sequential or coordinated reform packages. They base their argument on:
a) Empirical evidence of the employment creation effects of labour and product market reforms in the OECD, highlighting the (positive) influence of the interactions between reforms in different sectors. Some reforms are not beneficial without reforms elsewhere.
b) The impact of reform costs, causing the delay or postponing of reforms.
c) Strategic interactions may halt reforms when many decision agencies are involved. They show that in practice
• Product and labour market deregulation has increased employment growth
• This outcome is dependent on mutual interactions between reform programmes.
• Fiscal constraints/reforms are not mentioned
• Coordination failures are a principle reason for the failure of reforms to take hold.

2. Their hypothesis: The slow pace of economic reform is due to high implementation costs and coordination failures. An alternative hypothesis: the more important reasons are high short run costs relative to expected benefits (a low reform potential); high indirect costs or constraints; weak or easily neutralised instruments; and a fear of free riding by others. I argue this alternative is more likely.

3. Comments on the Empirical Model as a motivation
• Distinguish between causality and coincidence; in this case between the necessary and sufficient conditions for reform to have an effect. Example from Hughes Hallett, Jensen and Richter (2005) where reforms have to make unit labour costs fall or nothing will happen. Need to model the motivations of the employers to respond, in order to capture the incentives for reform or not to reform.
• The importance of fiscal policy. Interaction with fiscal “reforms” also necessary in this model to show the influence of fiscal restraints like the SGP or balanced budget legislation. Another example where interactions are crucial, but one which may have the opposite effect (sign) from that modelled here.
• Why are there interaction effects, but no spillovers in costs therefore?
• Are the empirical results robust to changes in the weighting or construction of the reform indices? The formulation of the reform games section depends on this.
The modelling of the interaction terms: figure1 is right, but the appendix doesn’t support it. Can we in fact distinguish between nonlinear effects in the results, and the interaction effects when reforms are coordinated (jointly or sequentially)?

4. Comments on the Reform Games Section: the guts of the paper

- The unspoken question is, why have so few reforms been carried out in practice? This paper argues it is because the implementation costs are too high, or because of a coordination failure between reform agencies. But an alternative hypothesis is that the short run (political or economic) costs are high relative to the expected future benefits; or that the reform instruments are weak; or that a fear of free riding by others eliminates the desire for reform.

- What is missing here is any discussion of the mechanism by which the reforms generate those benefits that would enable us to resolve that question. In this context, it must be the degree of competition (competitiveness).

- The reform and interaction terms are all specified as if they were all independent actions with only first order and joint effects, but no secondary or interdependent effects (i.e. $dR_i$ appears, and $dR_{ij}$, but no terms in $dR_i/dR_{ij}$ etc. in these games).

- As a result, the possibility that reforms not done as a package might make things worse rather than better is not considered. As it stands, the only reason for not doing a reform is because it costs too much, not that in its current form it is perceived to make things worse. Counter-example: the tax reforms in Bokan and Hughes Hallett (2006) make things worse, and not just in the short term, because the removal of a tax distortion without any accompanying market liberalisation measures merely raises price distortions (the degree of imperfect competition).

- Which reform measures? Reconstruct these diagrams/payoff matrices for different levels of effectiveness: A) cases where $\gamma \approx 0$; B) cases where $(\alpha - \gamma \Delta R) < 0$ because $\alpha$ is small (ineffective reform instruments), $\gamma$ is large (dependence on another party), or $\gamma \Delta R$ becomes large (the effects are neutralised by actions elsewhere); C) where free riding eliminates any incentive for reform.

- Extend Figure 2 therefore to recognise that this analysis tells you when there will be no partial reforms ever (by i or $\neq i$), or no reforms of any kind ever. Might these not be the more likely cases, given the observation that reforms are often not undertaken in practice despite the apparent long term benefits?

- Distinguish the Groucho Marx problem (who carries the burden of adjustment after) which may hold up reform efforts, from the commitment/coordination problem (who is tempted not to deliver reforms) which may or may not hold up the reform programme but is likely to alter the outcomes.

- Reformulate Figure 4 to remove the central section horizontally since it will always be known what i has decided to do before $\neq i$ plays.

- Extend Table 6 (and Figure 6) to show that high costs, low reform potential, and weak/ineffective instruments are the real cause of reform failures, not coordination failures as such.
NOTES:

1). $\Delta R_i (\alpha_i - \gamma \overline{R}_{xi}) < 0$ when reform policy is weaker than the spillovers from distortions or lack of reform in other markets/sectors (domestic reform policies are neutralised).

2). $\Delta R_i (\alpha_i - \gamma \overline{R}_{xi}) < 0$ when reform policy is still less effective than the spillovers from distortions or a lack of reform in other markets (after reforms elsewhere).

3). At point A: $\alpha_i \Delta R_i + \alpha_{zi} \Delta R_{zi} - \gamma (\Delta R_{zi} \overline{R}_i + \Delta R_i \overline{R}_{zi}) \leq 0$ if $\frac{(\alpha_i - \gamma \overline{R}_{xi})}{-(\alpha_{zi} - \gamma \overline{R}_i)} \leq \frac{\Delta R_{zi}}{\Delta R_i}$

when (say) $\alpha_{zi} > \gamma \overline{R}_i$ is negative and large, which is likely since $\overline{R}_i$ is large and $\overline{R}_{zi}$ smaller. Hence there would be no reform at all if a) $\neq i$ needs to do a lot of reform ($\Delta R_{zi}$ is large), but b) $\neq i$’s instrument is weak compared to, or easily neutralised by the spillovers it used to receive from distortions in $i$. In that case, $\neq i$ will have a strong temptation to free ride on the reforms made by those who have already made reforms. This is the Groucho Marx theorem of economic reforms.
Figure 4. Equilibria of the Sequential Game

C ≠ i

\( \Delta R_i > 0, \Delta R_{x_i} = 0 \)

Partial reform:

\( \Delta R_i > 0, \Delta R_{x_i} > 0 \)

Full reform:

\( \Delta R_i = \Delta R_{x_i} = 0 \)

No reform:

\( \Delta R_i = \Delta R_{x_i} = 0 \)

Partial reform:

\( \Delta R_i = 0, \Delta R_{x_i} > 0 \)

No reform:

\( \Delta R_i = \Delta R_{x_i} = 0 \)

\( \Delta R_i = \Delta R_{x_i} = 0 \)

\( \Delta R_i = 0, \Delta R_{x_i} > 0 \)

\( \Delta R_i = 0, \Delta R_{x_i} = 0 \)

\( \Delta R_i = 0, \Delta R_{x_i} > 0 \)
### Table 6. Payoff Matrix of the Simultaneous Reform Model

<table>
<thead>
<tr>
<th>Regulator $i$</th>
<th>$\bar{R}_i$</th>
<th>$R_i$</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\bar{R}_{i\neq i}$</td>
<td>$W_i = -\alpha_i \bar{R}_i + \gamma \bar{R}<em>i \bar{R}</em>{i\neq i}$, (1)</td>
<td>$W_i = -\alpha_i \bar{R}_i + \gamma \bar{R}<em>i \bar{R}</em>{i\neq i} - C_i$, (3)</td>
</tr>
<tr>
<td>$R_{i\neq i}$</td>
<td>$W_{i\neq i} = -\alpha_i \bar{R}_{i\neq i} + \gamma \bar{R}<em>i \bar{R}</em>{i\neq i}$, (2)</td>
<td>$W_{i\neq i} = -\alpha_i \bar{R}_{i\neq i} + \gamma \bar{R}<em>i \bar{R}</em>{i\neq i}$, (4)</td>
</tr>
</tbody>
</table>

- Can easily verify that (7) < (3) and (5) < (1) for player $i$; and that (8) < (6) and (4) < (2) for player $\neq i$.

- Also that, for player $i$, (7) < (5) iff $C_i > \Delta R_i (\alpha_i - \gamma \bar{R}_{i\neq i})$ i.e. if either $(\alpha_i - \gamma \bar{R}_{i\neq i}) < 0$ (domestic reform instruments are weak), or if reform costs are large and/or the reform potential is small. Similarly, (3) < (1) under the same conditions with $\bar{R}_{i\neq i}$ on the right.

- For player $\neq i$, (6) < (2) and (8) < (4) under corresponding conditions for $\neq i$.

- Hence payoff matrices are something like the following [with $W_i, W_{i\neq i}$ in each cell]

<table>
<thead>
<tr>
<th></th>
<th>a) Costs large, reform potential small/weak</th>
<th>b) Costs small, reform potential large/strong</th>
</tr>
</thead>
<tbody>
<tr>
<td>No</td>
<td>10, 5</td>
<td>7, 3</td>
</tr>
<tr>
<td>Yes</td>
<td>8, 2</td>
<td>6, 1</td>
</tr>
</tbody>
</table>

| | No | 10, 5 | 11, 3 |
|---|---|---|
| Yes | 8, 6 | 9, 4 |

Minimax = Coordination = No, No  Minimax = Yes, Yes; Coordination = No, No  Nash = No, No  Nash = Yes, Yes

**Hence** high costs, low reform potential, and weak or ineffective instruments, not coordination failures, are the real issue behind reform failures.
Hence:

a) Agree the outcomes of cells are as marked (corresponding to cells [8], [9] and [6] in figure 5, adjusted to actual outcomes)

b) Except for the central cell (cell [5]), which is either “both or neither reform” depending on whether the costs are small and reform potential large, or whether the costs are large and reform potential small, respectively.

c) But we may get “either/or” if the costs are large in one place and small in another? That would be the story of the EU-25, with Core, Periphery, Northern “outs”, and Eastern (Baltic, Habsburg) groups.