Reforms and re-elections in OECD countries

Marco Buti, Alessandro Turrini, Paul Van den Noord, and P. Biroli

Motivation

- Why are potentially beneficial reforms not undertaken or delayed ?
- Reform-related electoral costs often mentioned as an explanation, both by scholars and policy makers.
- Evidence is however mostly anecdotal (e.g, Munkhammar, 2007,…), while systematic statistical analysis is lacking
- Existing econometric analysis studying the determinants of re-election (Powel And Whitten 1993, Brender 2003, Brender and Drazen 2008) do not include structural reform as explanatory variable of re-election

What does the literature say?

- Theory
  - Political economy of reform inertia suggests a negative electoral impact of reform: lobbying, pressure groups, lack of 'social capital' and trust, uncertain payoffs versus high short-run cost (Olson, 1977; Fernandez-Rodrik, 1991; Alesina-Drazen, 1991,…)
  - Political business cycle theory suggests policy activism to signal competence and thus have a positive electoral impact (Rogoff and Siebert, 1988; Rogoff, 1990; Persson and Tabellini, 1990,…)
- Empirics
  - Voters mostly have a short memory (e.g., Fair, 1978,…)
  - Voters care more about aggregate than their own economic fortunes (e.g, Lewis-Beck, 1988)
  - Few support for the thesis that fiscal expansion would raise re-election probabilities (e.g., Brender, 2003; Brender and Drazen, 2008).

Focus of the analysis

- Are reformist governments more likely to be re-elected?
- Which reforms are more likely to help re-elections?
- Which factors help re-election?
  - Policy environment (affecting size of long-run gains vs. short-run costs and degree of resistance by pressure groups)
    - Initial structural conditions
    - Fiscal policy
    - Financial markets
  - Incumbent – specific factors (charisma, political capital, mandate for change)
    - "New" versus "old" incumbent
    - Political colour,…

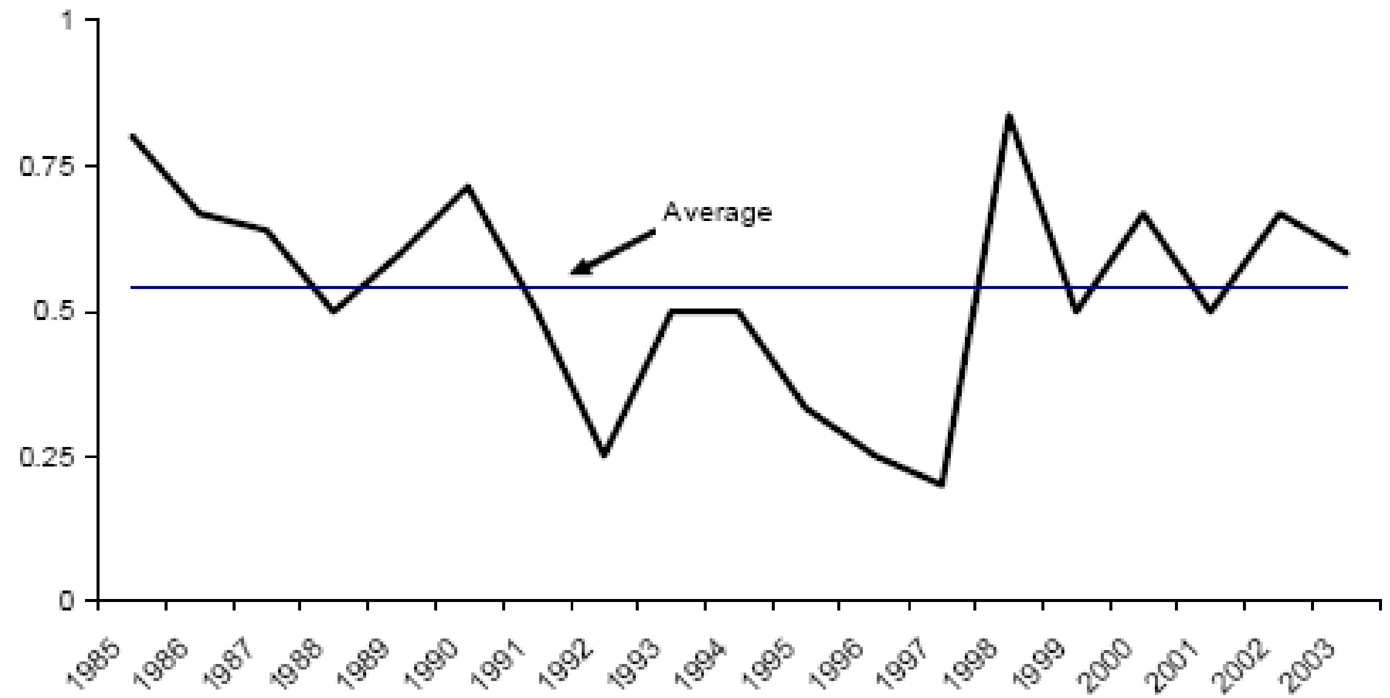
Data and variables construction

- Sample: 21 OECD countries, 1985-2003, 399 observations, 123 elections, 67 re-elections.
- Elections, from World Bank Database on Political Institutions, Dummy = 1 if chief executive is reconfirmed, 0 if not reconfirmed, missing if no elections took place. Alternative definitions are also tested.
- Reforms, constructed from OECD index of market rigidity in five policy areas
  - Reform dummy in each area= 1 if rigidity falls 'substantially' (20% percentile) in current or previous year and 0 otherwise.
  - Synthetic reform dummy : Dummy = 1 if reform in at least 1 area and none of the individual indexes increases 'substantially' (20% percentile) neither in the current or previous year and 0 otherwise. Around 25% of total observations are reform years/countries. Gauges pro-market attitude.
  - Alternative dummies tested
  - In addition to dummy approach, simple change in rigidity index

Stylised facts

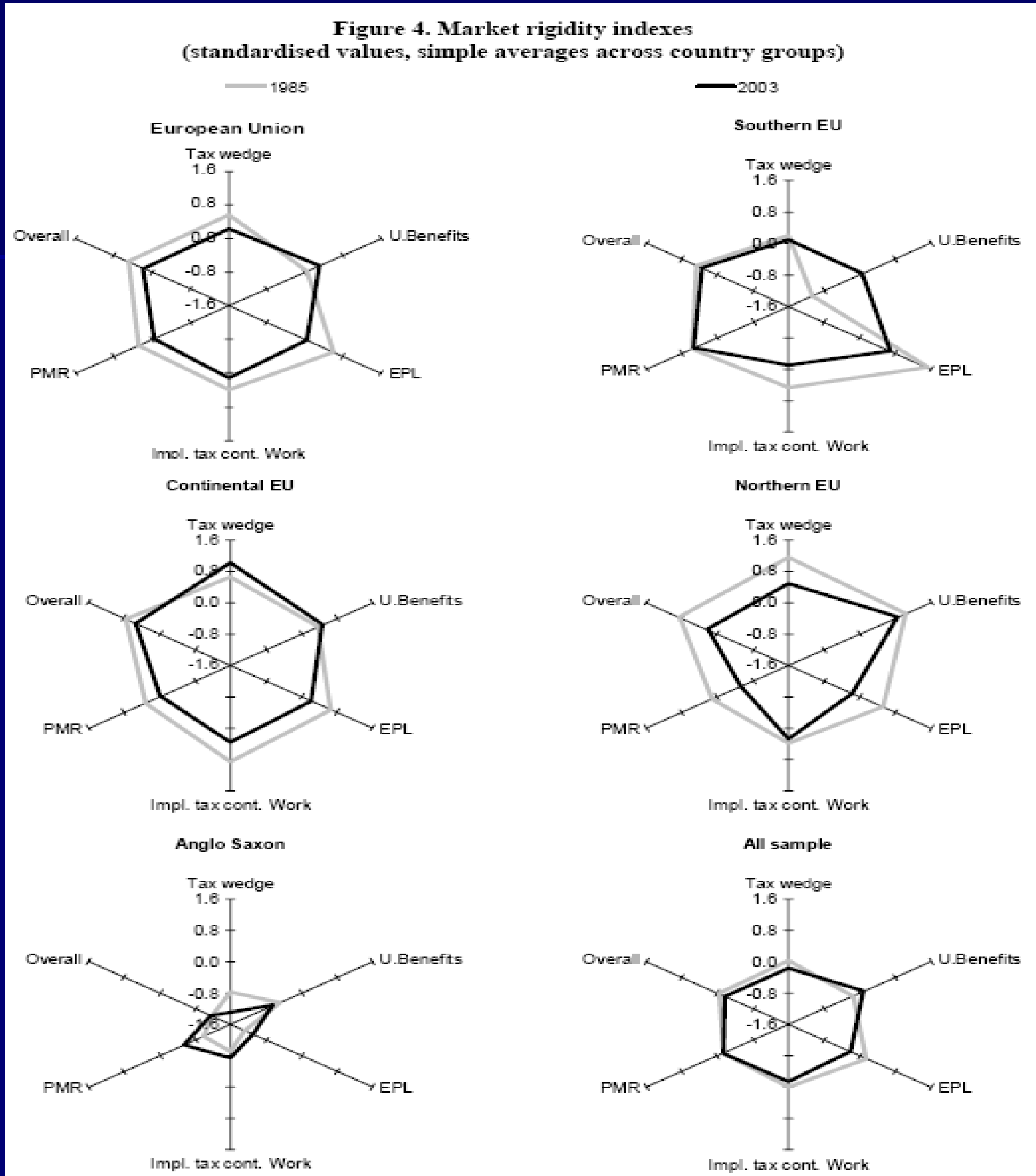
➡ **Re-election probability hovering around 50% (clearly less in 1992-97)**

Figure 1. Re-election frequency over time
(frequency of legislative or executive elections resulting into re-election of the chief executive)



Stylised facts

- Convergence of market flexibility <u>within</u> Europe but <u>not between</u> Europe and the 'Anglo-Saxons'



Reforms and re-elections: prima-facie evidence

Overall reform activism has no electoral impact, unemployment benefit reform is good for re-election, EPL and pension reform is bad for re-election

Table 1. Frequency of re-elections in the aftermath of reforms

All election sample with non missing reform data (118 obs.)	(1)	(2)	(3)
	Frequency not following reforms	Frequency following reforms	T test (1)≠(2), P value
Synthetic reform dummy	0.52	0.54	0.85
Tax wedge reform dummy	0.51	0.57	0.522
Unemployment benefits reform dummy	0.49	0.63	0.16
EPL reform dummy	0.56	0.30	0.08
Retirement schemes reform dummy	0.59	0.39	0.06
PMR reform dummy	0.55	0.5	0.62

Notes. Synthetic reform dummy defined as cases where in the current or previous year the change in the index of market rigidity is below the 20th percentile in at least one of five policy areas (unemployment benefit, labour taxes, EPL, product market regulations, retirement schemes), and neither in the current nor in the previous year a change above the 80th percentile takes place in any indicator. Source: Duval (2008). Reforms dummies in each policy area defined as 1 if year the change in the corresponding index of market rigidity is below the 20th percentile. See Appendix.

Reforms and re-elections: prima-facie evidence

Electoral fortunes of reformist governments are better if markets are already flexible, financial markets liberal, automatic stabilisers powerful, fiscal policy is prudent and the political mandate is strong

Table 2. Reforms and re-elections under different conditions, frequency comparisons

(1)	(2)	(3)
Frequency of re-elections following reforms (31 obs.)		T test (1)≠(2), P value
Countries with flexible markets **0.61**	Countries with rigid markets 0.46	0.42
Countries with high financial freedom index **0.61**	Countries with low financial freedom index 0.5	0.54
Countries with low share of current primary government expenditure 0.47	Countries with high share of current primary government expenditure **0.64**	0.35
Expansionary fiscal stance 0.5	Restrictive fiscal stance **0.63**	0.48
Established chief executive 0.41	New chief executive **0.71**	0.09

Definition synthetic reform dummy: see Table 1 and Appendix.

Empirical strategy

- Multivariate, binary-dependent-variable econometrics to control for other re-election determinants
- Baseline voters' memory assumption: 2 years
- Difficulties
  - <u>Measurement errors</u> (reform indicators,..) → check results with alternative definitions of reform and re-election
  - <u>Endogeneity</u> (reverse causation, selection bias). Instrumenting reforms poses a problem due to small sample (only election years included) → restrict the sample to reforms more likely to be exogenous (EU after 1992: Single Market, Maastricht)
  - <u>Omitted variables</u> → include both economic (cycle, inflation, fiscal stance) and political controls (political system, measures of incumbents' gov. strength: margin of majority, political polarisation,…) and additionally check fixed effects

Are reformist governments more likely to be re-elected?

Baseline specification

Dependent variable: 1 if chief executive is re-elected	Probit (Marginal effects)		OLS fixed effects		Probit fixed effects
Reform dummy	0.117	0.091	0.044	0.037	0.11
Cyclical conditions	0.043**	0.034*	0.034	0.027	0.036
Change in cyclical conditions	0.078**	0.075**	0.079	0.069*	0.108**
Change in inflation	-0.008				
Change in primary CAB	0.087				
Political controls (jointly significant)	x	x	x	x	x
Country fixed effects (jointly insignificant)			x	x	x
Year fixed effects (jointly insignificant)			x		
N. observations	105	106	106	106	106
Pseudo R- square; R square	0.19	0.17	0.27	0.16	0.26

Are reformist governments more likely to be re-elected?

Restricting to an "exogenous reforms" sample

	"Maastricht / Single Market sample"			
Dependent variable: 1 if chief executive is re-elected	Reform dummy (baseline)	Reform dummy (baseline)	Overall index of market rigidity (change)	Overall index of market rigidity (change)
Reform dummy	-0.22	-0.305	3.092**	5.031
Cyclical conditions	0.11**	0.141**	0.137***	0.204***
Change in cyclical conditions	-0.017	0.011	-0.007	0.015
Country fixed effects		Yes		Yes
N. observations	43	38	43	38
Pseudo R- square; R square	0.23	0.4	0.27	0.48

Which reforms help for re-election?

Baseline specification

Dependent variable: 1 if chief executive is re-elected	Tax wedge	Unemployment Benefits	EPL	Implicit tax on continued work	PMR	Encompassing Specification
Reform dummy	0.171**					0.138
		0.207**				0.295***
			- 0.257			-0.24
				-0.193**		-0.184***
					0.004	-0.034
Cyclical conditions	0.072	0.069	0.072	0.092	0.072	0.098**
Change in cyclical conditions	0.031	0.039	0.039	0.027	0.036	0.033
Pseudo R- square	0.18	0.19	0.19	0.2	0.17	0.27

Which factors matter for reformist governments to be re-elected?

The policy environment

Dependent variable: 1 if chief executive is re-elected			Synthetic reform dummy				Change in market rigidity index
Reform	0.137	0.168	0.139	0.124	0.176	0.171	-1.182
Market rigidity*reform	-0.245				-0.347**	-0.651**	2.99***
Change CAPB*reform		0.1					
Financial freedom*reform			0.391**		0.44**	0.295	1.32
Gov. expenditure*reform				0.018			
Country fixed effects	No	No	No	No	No	Yes	No
Pseudo R-square	0.19	0.18	0.22	0.18	0.23	0.32	0.21

Which factors matter for the electoral impact of different reforms?

The policy environment

Dependent variable: 1 if chief executive is re-elected	Tax wedge	Unemployment benefits	EPL	Implicit tax on continued work	PMR
Synthetic reform dummy					
Reform	0.217***	0.234*	-0.225	-0.135	0.013
Market rigidity*reform	-0.313***	0.009	0.114	-0.082	-0.081
Financial freedom*reform	0.373***	0.272***	0.087	0.386***	0.173*
Change in market rigidity index					
Reform	-0.812**	-0.309	0.765*	1.024	-0.398
Market rigidity*reform	0.64	-0.213	-0.086	4.524**	0.695
Financial freedom*reform	0.439	0.069	-1.662	0.399	0.531

Which factors matter for reformist governments to be re-elected?

Incumbent-specific factors

	New chief executive	Learning from previous incumbents	Colour of chief Executive	Distance from previous chief
No country fixed effects				
Interacted terms	0.308			
		0.193		
			0.08	
				0.108
With country fixed effects				
Interacted terms	0.528*			
		0.501		
			0.29	
				0.081

Conclusions

- Reformist governments have no higher re-election probabilities as such. Possible downward selection bias, but mostly for small-scale reforms

- Reform composition matters: while EPL and retirement scheme reforms reduce re-election probabilities, the opposite holds for unemployment benefits and tax wedge

- The policy environment matters: already "flexible" labour and product markets and financial market freedom increase re-election probabilities of reformist governments.

- Newly-appointed reformist chief executives more likely to be re-elected

- Policy messages:
  - Room for limiting electoral costs with appropriate reform composition
  - "Rigidity traps" (notably tax wedge and retirement schemes): role of "external" commitments (Lisbon, OECD,…)
  - Financial market freedom: indirect effects of re-regulation after crisis