

VI European Conference



# How to Gain Political Support for Reforms?

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# *How to Gain Political Support for Reforms?*

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# Chapter 1

## Introduction

During the last thirty years, OECD countries have experienced a large number of structural reforms in several crucial sectors of the economy, such as the labour and product markets, and the welfare state. Most of these reforms went in the direction of liberalizing the product market; reducing rigidity in the labour market; and decreasing the generosity of the welfare state to contain pension spending. Alongside this movement of reduced state intervention, many governments also reduced their involvement in production, through privatisations. In particular, liberalisation and privatisations were central in transition economies, where government intervention used to be extensive under communism, and firms were state owned as a rule.

Alongside this liberalisation trend, other reform measures aimed at maintaining the generosity of the public pension system, at preserving the level of employment protection for some categories of workers, or at increasing the coverage provided by the unemployment benefit schemes (see Chapter 2). Although this ambivalent approach may appear contradictory, many of these measures may actually have been introduced as compensating measures; to obtain public support for the former reforms, through a “quid pro quo” exchange. Finally, some “protected” markets were left virtually untouched by the reform process; and some reform efforts turned out to be simply unsuccessful, as some reform proposals were turned down due to the strong opposition of some crucial economic, social and/or political forces.

The aim of this report is to explain why these different patterns emerged in the OECD countries. Why did crucial sectors of the economy undergo major liberalization, while no reform was implemented in others relevant non-manufacturing services? Why were structural reforms aimed at retrenching the welfare state carried out in some countries –such as Italy, Sweden and the UK– and not in other countries, equally in need of reforms, such as France and Germany? Why was Employment Protection Legislation, which leads to rigid labour markets, relaxed in Spain, but not in Italy? Why were state-owned enterprises privatized in some countries or sectors, but not in others? Our analysis isolates the political economy factors that have lied at the heart of both successful and failed attempts at reforming these markets.

By studying the process through which these (sometimes aborted) reforms went, we provide some answers to these crucial questions, and address the issues faced both in Western and in Eastern European Countries. Reform processes undergo several important stages –beginning with the initial motivation for a reform to its final implementation, when the process proved successful–, which eventually determine its political success or failure. As we show, the path to reforms may vary according to the economic sector featuring the changes or the country where the reform is debated. We thus identify both common and specific elements of this process.

The initial step corresponds to identifying what triggers the reform. Why do some reform measures become a debated issue in some specific sectors of the economy or countries? And, more importantly, why does a relevant political player, such as the government, or a Party or a Minister, ever decides to commit its political capital to push forward this reform? In the following chapters, we apply a “case study” analysis to different structural reforms and countries. This analysis suggests that several *different* reasons may initiate a reform process. One of the important lessons of our exercise is that there cannot be a unique answer to these questions, and no “one size fits all” policy recommendation to be drawn. On the other hand, our case study approach provides guidance as to which are the relevant “framework conditions” that a reformer must address to make his or her reform attempt successful.

A first, purely economic, driver of reforms is found to be the need of correcting large inefficiencies that emerge in specific markets or economies, for instance when the existing legislation is not any longer consistent with the current economic environment. This mismatch is typically due to technological developments or trade liberalization. This occurrence turned out to be recurrent in the product and labour markets. In other instances, structural reforms are instead triggered by emergency situations. This is the case for instance for the Italian season of pension reforms of the 1990s. A second driver of reforms is ideology. That is, as suggests our analysis, the demand for reform can be essentially politically driven in some occasions. When the political system permits, these ideological motivations may induce a shift in the balance between private and public ownership, or to a shift in the degree of state intervention in the economy. Many reforms led by the Thatcher governments in the

UK, for instance, were essentially pursued by a given political Party, at least partially for ideological rather than pure efficiency reasons. Third, external constraints –such as EU policies or the commitment to join the Euro– proved a very powerful instrument to get relevant economic reforms started. Examples of the effectiveness of these external constraints may be found in the reforms of specific sectors of the product market, in the Italian social security reforms, but also in the different experiences of privatizations enjoyed by transition economies, as the prospect of future EU membership helped governments build commitment and pursue efficiency-enhancing privatization efforts.

Even when relevant political players, such as leading Parties or the government, are convinced of the need of structural reforms, however, a further crucial step has to be taken on the path to their actual implementation. Structural reforms often have to overcome strong popular opposition –typically due to the existence of vested interests that may lose from the reforms or to the ex-ante uncertainty on the identity of these winners and losers. This opposition is channelled to the political, social, and economic arena differently, depending on some characteristics that are specific to each country (including for instance the system of political representation).

Hence, political actors committed to structural reforms have to undertake a *coalition building* effort, in order to gain sufficient popular support for their implementation. The scope for coalition building and the extent of the consensus needed to implement a reform depends on the framework conditions facing the government, as well as on the determinants that initially triggered the demand for reform. In fact, the seminal reason for reforming –economic, political or external constraints– must be used by the committed government to generate momentum and to gather sufficient endorsement to reform. Framework conditions will however define the government's authority within the institutional political system, and hence its leeway to reform. They also determine the identity of the main actors who can interfere with the reform process, which will typically depend on the status quo of the scheme or market to be reformed. These framework conditions prove crucial, since the actual implementation of successful reforms is typically shaped by the political requirements of forming sufficiently large political coalitions and of “buying out” the opposition of relevant veto players.

Thus, to repeat, our “case study” analysis in the following chapters suggests that there is no unique recipe to implement structural reforms. Although several common lessons are learnt from these reform episodes, we also observe that framework conditions in the different markets and countries tend to lead to a rather market- or country-specific packaging of politically successful reforms. For instance, our analysis of the labour market and of the welfare state illustrates that clearly defined groups with vested interests –namely, insiders for the labour market, and retirees for the welfare state– emerged in opposing the reform measures. In consensus democracies –such as Denmark, Italy and, to a lesser extent, Spain– the packaging and the pace of reforms had to be targeted to circumvent opposition; to buy out approval by the unions that represent the interests of these groups. Long transition periods, which effectively sheltered middle-aged workers and retirees from the effects of pension reforms, were engineered in the Italian pension reforms. Gradual, piecemeal, labour market reforms were implemented in Spain, to reduce their impact on tenured workers. In these occasions, the pace of the reform process was rather slow, but the large public consensus ensured wide political support for the reforms, and hence reduced the risk of reversal. The experience proved different in majoritarian countries, such as the UK. Under that type of political representation system, governments face little resistance. Therefore, reforms can be more sudden and radical in majoritarian countries, as shown by the Thatcher experience in the UK, which included the 1986 pension reform and the privatisation of several major state-owned enterprises. These reform measures clearly hurt some fringes of the population but were used by the conservative government of Mrs Thatcher to build stronger support for the Tories in the middle and upper classes of the population. Yet, the lack of a widespread popular consensus led to the subsequent reversal of some of these reforms. Some of the Thatcher pension reforms, for instance, were challenged in the following decade, as it became clear that their economic efficiency was questionable. This “learning by doing” led to these measures being largely modified (reversed) by the 1999 Blair pension reform.

By contrast, the process of reforms is less contrasted across political systems when *product market* reforms are concerned. The essential reason may be that the interest groups that emerge there, are less clearly divided along the ideological party line. Vested interests cross the left-right, worker-employer division lines, and develop instead converging incentives. Workers and employers, blue and white collars,

bureaucrats and consumers, therefore tend to join their forces in many non-manufacturing industries. In these markets, the packaging of successful reforms seem to follow a “divide and conquer” strategy, as targeted changes to existing regulations may lead to the separation of entrenched vested interests. To achieve these ends, the pace of the reform ought to be slow; it must create the conditions for a smooth and continuous reform process rather than appeal to a big-bang reform. Sometimes, this process also calls for reforms in other markets. Our analysis suggests that reforms on one market –for instance the product market– may well spill over to other markets – such as the labour market– both by helping to create the political momentum and by modifying background economic conditions.

Interestingly, the reform experience of transition economies largely differs from those in OECD countries. External constraints played a stronger role, as most reforms were inescapable. Moreover, transition countries had to establish simultaneously the role of economic and political governance. We review the various mass privatisation programs that occurred in transition economies, and show that many were precisely designed to target political motives, rather than purely economic efficiency ones. To exemplify the role of political governance and external constraints, we also detail the privatization of the main Czech and Ukrainian car makers. That case study clearly illustrates that, while the prospect of a future EU membership allowed the Czech government to commit to an efficient privatization plan, the excessive freedom of action of the Ukrainian government led to the protection of particular lobby groups and politicians, at the expense of the population at large. Similarly, the power vacuum after the collapse of the Soviet Union largely explains the failure of many reforms in Russia. In Russia as well, weak legitimacy made the Yeltsin government vulnerable to the support of special interests, and led to the capture of state decisions. A distorted corporate and regulatory governance system, in which strong interests sought to maximize and secure short term gains, produced a massive build-up of non-payment, tax evasion, and barely conceived asset theft. Moreover, the failure to restrain these non-cooperative strong interests had a reinforcing impact on the perception of poor legitimacy and credibility, leading to diffused non-compliance, cash-stripping and rational collective non-payment, and eventually to a fiscal and banking crisis.

The remaining part of the introduction provides a brief overview of the case studies carried out in the following chapters.

### **1.1. How to rationalize the welfare state: Pension reforms in Italy and the UK**

Italy, in the 90s, and the UK, in 1986, were able to implement major reforms aimed at rationalizing their pension systems. In both countries, these reforms represented a major break with a history of growing pension spending, and set two –rather different– examples of how political support for unpopular reforms can be obtained.

The Italian reform season of the 90s was triggered by external constraints –the requirements on inflation and public finance aggregates imposed by the Maastricht Treaty and a large speculative attack on the Italian Lira in September 1992– which imposed the downsizing of a large and generous public pension system despite the absence of alternative private schemes for retirement income.

Despite the institutional changes experienced during the 90s –the Italian electoral system became mainly majoritarian in 1994– Italy can be described as a consensus democracy, characterized by unstable coalition governments and with strong pressure groups. In this institutional context, successful reforms had to be agreed upon by a large majority *and* to be negotiated with the institutional and de-facto veto players. The experience of the Amato and Dini reforms showed that a consensus for reforming the system was possible if the negative impact of the reform on current relevant political actors –the elderly workers and the retirees– was minimized. The packaging of politically sustainable reforms required a long transition to the new *notional defined contribution scheme*, and hence entailed efficiency and equity losses.

By contrast, the motivation for the 1986 British reforms belongs to the political arena. The British public pension system was relatively small by European standards, and coupled to a widespread second pillar, composed of occupational plans. Yet, the information released by the government forecasted raising costs for the public pension system under population aging. According to several scholars, the ideological and electoral push of the Conservative government –and its desire to descend on unions– was the main trigger for retrenching the public pension system, while increasing the

scope for private intervention in the pension industry. The strong, majoritarian, government led by Mrs Thatcher chose a rather uncompromising style with other political actors, but had to back up from the original plan of scrapping SERPS –which would have eliminated the role of the state from the earning-related part of the pension–, essentially because of opposition from *within* the government (by the Treasury), concerned with the potential financial costs of the reform.

Interestingly, the Conservative government did not face the typical trade-off between strong political power in the Parliament and large political accountability towards the electors. In fact, despite the decision of imposing, with the brute force of its large majority in the Parliament, a typically unpopular reform, the Conservative Party won the 1987 general election, thanks to its effort in the reform to target the more mobile voters –the middle-class– by providing them access to a new savings instrument –the private pension plans; but also to a weak Labour Party.

## **1.2. Labour market reforms in Denmark and Spain**

Denmark and Spain represent two extreme cases of labour market institutions. Denmark has a tradition of high job flexibility –with no general legal provision protecting the workers against “unfair” dismissal– and of generous unemployment benefits, amounting to 90% of the previous wage. In Spain, permanent jobs were highly protected, prior to the 1994-1997 batch of reforms, but unemployment insurance is quite low (60% of the previous wage, after six months of unemployment). Despite these differences, both countries suffered from high levels of unemployment in the early 1990s, which triggered substantial reforms to correct this “emergency situation”. As both countries benefit from a highly proportional representation system, they faced the potential opposition of many veto players. As one of our “common lessons” suggests, the status quo creates a “constituency effect,” since entrenched interest groups coordinated their actions to defend the benefits they had acquired under the status quo. In Spain, more than two thirds of workers were holding a permanent job and were protected by EPL. They clearly favoured employment protection. In Denmark, workers accepted flexible employment because of generous and long-lasting unemployment benefits covering them against the risk of losing of their job.

Under the threat of veto by these groups, since political representation required large consensus to be reached, the governments in both countries had to seek support of representative social partners for their reforms. Indeed, governments were able to *take advantage* of the social dialogue to build commitment towards reforms and create a window of opportunity for reforming. In Denmark, unemployment insurance reforms were centrally discussed among the government and the social partners, from 1994 onwards. In Spain, a revival of the social dialogue took place since 1994, after the institutionalization of a national bargaining system, which led most phases of employment protection reforms to be negotiated and approved by labour market organizations (especially the major 1997 reform).

In 2001, social dialogue collapsed in both countries. However, in Spain, the government relied on its strong majority in the Parliament to approve some aspects of the 2001 reform, favouring the employers' proposal of a further reduction in the cost of "unfair" dismissals; and against the unions' proposal to increase the cost of temporary contracts, in order to limit abuses by employers. In Denmark, instead, the newly elected Conservative government, which tried to impose some reforms in 2001 without building consensus among social players, failed. The Danish Minister of Employment proposed to reduce the eligibility threshold; to decrease the unemployment benefits for temporary workers; to postpone the date for receiving the initial benefit to employees with high wages; and to base the benefit on the average salary over the past six months instead of the original three months. As the employers' organization opposed the first two measures arguing that they would significantly reduce flexibility, the government revised the measures several times; however, due to the sustained opposition by both employers and unions, the whole reform proposal was eventually withdrawn.

Framework conditions hence guarantee a paramount role to the unions in the organizing the social dialogue and eventually in affecting the design, the appropriate timing and pace of successfully reforms. An important lesson may hence be learnt by other countries that repeatedly failed to reform their labour markets: it may sometimes prove very productive politically to reorganize how the social dialogue takes place or to invest political capital in improving the social dialogue. Reform processes started in

1994, while triggered by severe recessions, were implemented only gradually, with compensatory measures designed to balance some harming effects and to widen the support for reform among the potential losers.

### **1.3. Reforms in the product market**

While trade and financial flows liberalisation have been common to many OECD countries, liberalisation and competition policies in utilities and non-financial service industries has been most uneven, even though the scope for change is large in these sectors, since regulations have traditionally been most pervasive in non-manufacturing. To analyze this issue, we use a dataset covering reforms in seven non-manufacturing industries for 21 OECD countries over the 1975-1998 period. On average, reform policies have succeeded in relaxing regulations that restrict competition and private governance in the OECD area. Yet, the scope and depth of reforms varied widely, with several countries and industries experiencing a sluggish and protracted reform process. This evidence suggests that powerful economic determinants may trigger the demand for reforms; yet strong opposition emerges, due to the convergence of different vested interests –ranging from bureaucrats to entrepreneurs and workers.

Our analysis identifies three main factors triggering reforms in the product market. First, technical progress disrupted decades-old regulatory arrangements, as, in many industries, information and communication technologies (ICT) created opportunities to provide services and organise logistics in ways that altered the value and the costs of regulation for different interest groups. Second, developments in trade policies led domestic producers to search for lower prices for intermediate inputs, because of the extensive international competition in tradable goods and services. At the same time, participation in trade agreements typically required ending government subsidies to these inputs. Hence, there was little alternative, other than promoting efficiency and lower costs. Third, in several countries, supranational legal constraints (related to trade agreements) and newly-created domestic institutions put mounting pressure on anticompetitive non-manufacturing regulations, also offering opportunities for politicians to shift the responsibility for reform outcomes onto third parties.

Interestingly, while these gains from liberalizing are sufficient to account for road freight liberalization, their impact on other industries and countries has to be combined with country-specific and political factors. In fact, the persistence of regulatory arrangements in utilities and non-financial service industries may be due to a distinctive feature of this market: the *convergence* rather than rivalry of vested interests supporting the regulatory status quo, which also generates a different link between these diffused interests and the political and institutional setting. In particular, our analysis suggests that the following framework conditions play a significant role in lowering the overall level of (restrictive) regulations in the long-run: (i) participation in regional economic integration, such as the Single Market Programme; (ii) small degree of public ownership; (iii) reforms implemented by trading partners; and (iv) reforms in other non-manufacturing industries.

The recipe for reforming non-manufacturing industries hence contains four main ingredients. First, private vested interests in non-manufacturing industries need to be unbundled, through a “divide and conquer” strategy. Targeted –even marginal– changes to may break up entrenched coalitions of interests and provide new strength to potential supporters of reform (such as new entrants). Second, gradual, piece-wise reforms may stir less resistance than all-encompassing ones, because of spillover effects from industries to industries. Third, other framework conditions should be considered in the “packaging” of the reform by making sure that (i) major price distortions are eliminated progressively, so that the redistributive effects of reform are diluted over time (and possibly offset by compensation mechanisms); (ii) institutions that provide voice to special interests opposing reform are phased out; and (iii) bureaucratic impediments to an effective ground implementation of reform are removed. The last piece of advice concerns the communication strategy of the government, since demonstrating the benefits to be expected, together with peer pressure effects (e.g. from reforms enacted in other industries or countries), can be effective in soothing concerns about the uncertainty of the reform’s outcomes; and hence be crucial to gather the necessary support for policy.

#### **1.4. Privatizations in Western and Transition Economies**

Since the 1980s, many OECD governments initiated a substantial process of privatisation, which reduced the market share of State-Owned Enterprises (SOEs) by a third. Our analysis identifies two economic factors that typically trigger the privatisation process in Western economies. First, many SOEs are often less productive than their private counterparts. Second, privatisations may help reduce public deficits, since they stop the flow of subsidies to these SOEs, and their sale generates additional income. Yet, privatisations may face three problems. First, the productivity differential may result from a selection bias, in which case privatisations need not increase their productivity. Second, although the sale may generate a one-off income for the state, it may also reduce the government subsequent earnings. Third, even when productivity is low *only* because state ownership reduces incentives to manage the firm efficiently, entrenched interests may oppose its privatisation; and external constraints may be needed to initiate reforms. These constraints may originate from i) increased international competition, ii) increased costs of budget deficits (and of taxes), and iii) deregulations on the product market, which call for more transparent rules of competition.

Our analysis suggests that coalition building for privatization partly depends on political institutions. Strong governments, facing little resistance by opposition parties or by other economic and social players, may choose to undertake rapid privatization process, by selling all the assets of the firm at once, as often done by the Thatcher conservative government. If oppositions are able to block radical policies, wider consensus needs to be obtained. The government may then maintain a golden share in the firm, to guarantee its control and generates a “gradual” transition from state to private ownership. Analogously, the method of sale may be negotiated with the opposition, to meet their requests at the expense of generating lower revenues.

In transition countries, external pressures were much stronger, and most governments decided to undertake *mass* privatisations. Moreover, transition in these countries involved a process of “large scale institutional change” towards democracy, during which the political balance of powers among various actors was extremely unstable. Depending on the relative power of these actors, sharply different outcomes eventually

materialized. To illustrate this instability and address the salient features of these economic and political tensions, we analyse the privatisation of two important car producers. In the Czech Republic, the car maker Škoda and the German Volkswagen Group created a joint-venture. In Ukraine, the car producer AvtoZAZ was partly sold to the Korean Daewoo.

Our analysis suggests that the policy choices of each country were directly influenced by the framework conditions faced by these countries. In the case of Škoda, the government initially retained some control on the strategic decisions of the firm through a majority stake; but managed to *commit* to a gradual withdrawal from the joint-venture, by selling a majority of shares to Volkswagen, to refrain from interfering with the management of Škoda, and to gradually remove protectionist measures; while Volkswagen, instead, committed to an ambitious development plan for the joint-venture. Our analysis indicates that this commitment capacity was in good part provided by the EU accession prospects, and proved crucial to implement a market-oriented and efficient privatization of Škoda. The situation was somewhat different in Ukraine, where AvtoZAZ was partly sold to Daewoo in 1997, amidst weak political institutions, sluggish economic conditions and strong opposition to the entire privatization process. Weak democratic institutions led the government to tailor the privatization process to reinforce the monopoly position of the company and to maintain the employment level in the firm; thereby limiting the scope for efficiency-enhancing investment of AvtoZAZ, or for promoting competition in the Ukrainian market. Furthermore, the lack of government commitment allowed Daewoo to renege on several of its initial promises.

### **1.5. Corporate governance in Russia**

The history of transition reforms in Russia and its 1998 financial crisis represent a compelling and instructive case study from which many lessons can be learnt. Although the financial collapse was clearly driven by a combination of an unsustainable fiscal deficit coupled with massive capital flight, the micro foundations of the crisis were the poor design of reforms due to the capture by strong interests.

Our analysis suggests that framework conditions, consisting of seventy five years of Soviet rule, with no institutions left to ensure proper arrangements in the vacuum created by the collapse of a regime based on fear, played the crucial role. In such power vacuum, only popular support could have promoted the necessary, but painful reforms. Yet, the independent Russian Republic created by Yeltsin had no diffused perception of a Western national identity or any promise of joining the European Community to flag in order to gather popular support for unpopular reforms; and faced even larger adjustment costs in the transition to a market economy than other former socialist countries. The painful reforms that the Yeltsin government initiated could thus not count on a sufficient popular legitimacy, as they missed a powerful disciplinary mechanism for policy implementation. Much of the initial support for painful adjustment measures dissipated rapidly as it became clear that politically connected interests could go about unchallenged, while costs were socialized.

Thus, we explain the lack of credibility of the new reforms under Yeltsin by a combination of concentrated power in the hands of a few veto players, who put them above enforcement, matched by –or rather leading to– the lack of legitimacy for the reforming institutions. The effect of this poor credibility led to a massive non-compliant response to new laws and reforms by individuals and firms, which fatally undermined the process. The realization of the vulnerability of the reform process by itself hastened the process of opportunistic stripping, and gave powerful incentives for rapid capital flight. In a systemic adjustment, enforcement depends critically on a sufficient adjustment response; as a result, expectations are critical in determining the aggregate outcome. Cynical expectations regarding the response by other agents and the credibility of enforcement may thus produce a critical mass of non-compliance regarding legal and financial obligations, which creates an insuperable barrier for enforcement. In conclusion, state capture is fatal for the credibility of reforms.

## **Chapter 2.**

### **What triggers reforms? How is popular support gained?**

#### **Empirical evidence and theories of reforms**

##### **2.1. Empirical and anecdotal evidence about the reform momentum**

In principle, successful reforms should be the ones that have the potential to improve aggregate welfare and, as illustrated in Table 2.1, there is ample room for such welfare improving reforms. There is room for reforms in the employment protection legislation (EPL), in the tax system, in product market regulation, or in the way in which wages are bargained, in order to increase the aggregate rate of employment, and thereby stimulate economic growth.

As Table 2.1 also makes clear, tax wedges frequently introduce distortions that reduce aggregate employment. To reduce this wedge, the state may have to withdraw from some activities, or use other instruments than taxes to provide public services. One such service that is generally financed by means of a tax on labour is pension. Most European countries instated widespread pay-as-you-go pension systems after World War II, at the time of the baby boom. Since then, fertility rates dropped and life expectancy increased, which reduced the ratio between the number of active workers and that of retirees. As a result, the financing needs of the state have increased noticeably, increasing the tax wedge and the disincentives to work. Reforming pension systems might therefore also bring substantial direct (through better incentives to work) and indirect (through reduced tax wedges) benefits to employment, growth, and aggregate welfare.

In order to stimulate growth and employment, the Lisbon European Summit also stressed the need to enhance the knowledge acquisition in Europe. While many countries focus on improving their education system, reforms of product market regulations could also be used to that end.

<b>Table 2.1</b>					
<b>Accounting for differences in employment rates across European countries</b>					
	<b>Contribution from:</b>				<b>Total</b>
	<b>EPL and benefit policies</b>	<b>Tax wedge</b>	<b>Product market regulation</b>	<b>Others, including bargaining system and unionization</b>	
<b>Austria</b>	-0.1	-1.6	-0.2	23.0	<b>21.1</b>
<b>Belgium</b>	-2.5	-3.3	-0.7	-1.8	<b>-8.3</b>
<b>Denmark</b>	-3.0	-3.0	-0.6	9.7	<b>3.0</b>
<b>Finland</b>	-0.6	-1.8	-0.2	-0.4	<b>-3.0</b>
<b>France</b>	-2.3	-2.2	-1.4	-4.6	<b>-10.5</b>
<b>Germany</b>	-2.7	-1.3	0.0	17.7	<b>13.7</b>
<b>Greece</b>	-1.3	0.3	-2.0	-22.8	<b>-25.8</b>
<b>Ireland</b>	3.8	1.9	-1.4	-22.7	<b>-18.4</b>
<b>Italy</b>	-2.2	-1.5	-1.9	0.7	<b>-5.0</b>
<b>Netherlands</b>	-3.8	-3.6	-0.8	1.0	<b>-7.2</b>
<b>Norway</b>	-2.9	-0.5	0.4	-2.1	<b>-5.0</b>
<b>Portugal</b>	-4.6	2.0	-1.5	-1.6	<b>-5.7</b>
<b>Spain</b>	-3.8	0.5	-0.1	-12.7	<b>-16.1</b>
<b>Sweden</b>	-2.2	-3.6	0.8	10.1	<b>5.0</b>
<b>UK</b>	6.4	2.4	2.2	-3.9	<b>7.1</b>
<b>AVERAGES</b>					
€countries	-1.8	-1.0	-0.9	-2.2	<b>-5.9</b>
Non-€countries	-0.4	-1.2	0.7	3.5	<b>2.5</b>

**Source:** Nicoletti (2003) – **Note:** these results are based on parameter estimates from pooled regressions covering 20 OECD countries over the period 1982-1998, and reflect the percentage deviations from the OECD average.

Stimulating job creation may also require easing the entry of new firms on a market. A major impediment to entry often proves to be the existence of a state owned, unduly protected, player in the national market. The presence of such State Owned Enterprises (SOEs) may scare potential entrants away, reduce aggregate investment, and therefore employment. Privatising these firms may thus bring substantial benefits to the economy, through entry (which has the potential of increasing aggregate employment) and increased competition (which forces firms to improve their technology (higher R&D intensity), reduce costs, and increase consumers' welfare thanks to lower prices).

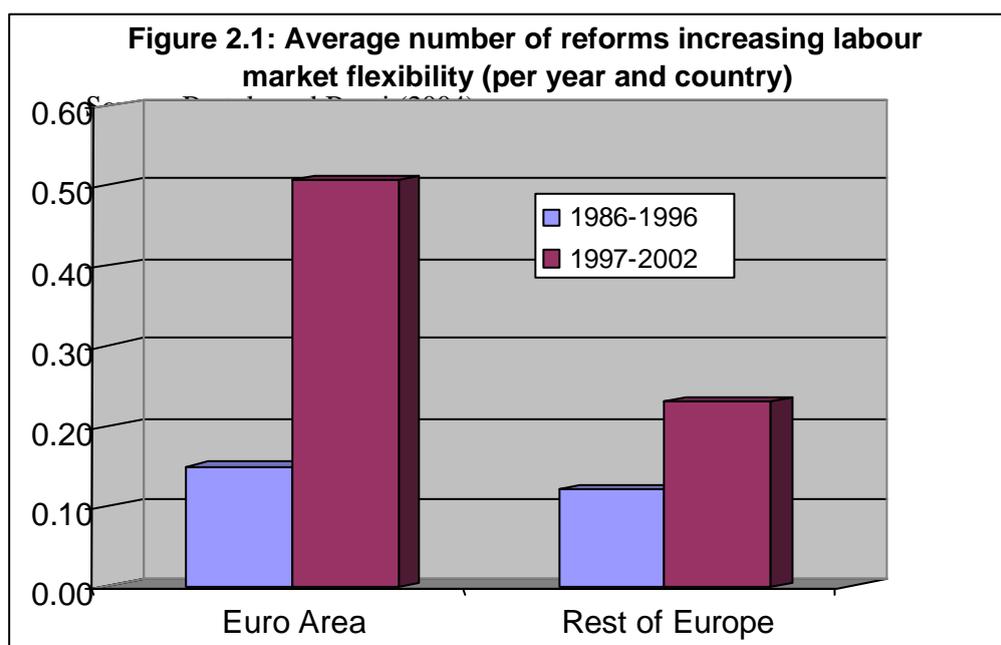
However, any reform that distributes benefits to the many also affects the economic rents acquired by the few. As we shall see repeatedly in the next chapters, to gain sufficiently wide political support, governments must often tailor their proposals to target the groups that may veto the process. Of course, the number and the identity of these groups will depend on the political representation system as well. Think for

instance of the contrasting experiences of Great Britain and of France. In the UK, political representation is majoritarian, which gives rise to strong governments, with the power of *imposing* their reforms. That is, the balance of power is such that only few groups can veto a reform. The government of Mrs Thatcher took advantage of its power in that way: it imposed rapid and deep-reaching reforms in many different markets. Throughout the 1980s, the goods and services markets were liberalized, many state-owned enterprises privatized; the pension system reformed; and flexibility was introduced in the labour market. In so doing, the reforms of the Thatcher government had a deep and lasting impact on the British economy. By contrast, many other countries in the European Union delayed, or simply failed, to implement such reforms. For instance, the Juppé government in France tumbled on its attempt to increase the flexibility of the labour, and so did the first Berlusconi government in Italy onto its attempt to forcefully impose a reform of the pension system.

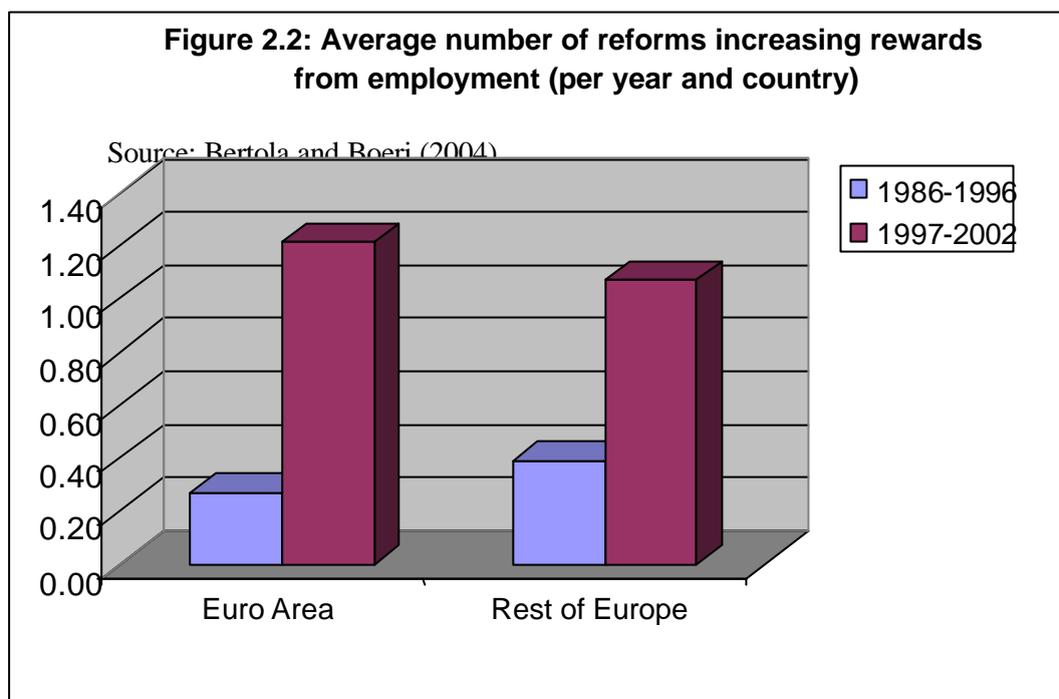
These failed attempts force many governments to scale back their reforms. In a move to reduce oppositions and avoid scaring pressure groups, they often tailor their reforms primarily to target popular support. France, again, is an example worth looking at. Nicolas Sarkozy, who by now became famous for his ability to impose his will, is currently trying to introduce private capital in the French, state-owned, gas and electricity producer EDF-GDF. The national ownership of EDF-GDF already stirred a lot of controversy across Europe, for creating unfair competition with its European competitors. The French government thus faces intense (external) pressures to privatise the company. This privatisation process however also faces intense (internal) opposition from trade unions and from the employees of the company. Nicolas Sarkozy was initially planning to reduce the stake of the government in EDF-GDF down to 60-66%. On the 27<sup>th</sup> of May, 2004, a “blue tide” of EDF-GDF workers “invaded Paris, to oppose this change [... The unions] for a first time associated together [chanting:] ‘Let us save social security’; ‘no hesitation, EDF-GDF belongs to the nation’ ” (Le Monde, 28/5/2004). As a result, N. Sarkozy partially backed down: *I heard the worries of the agents. The State will not go below 70% of the capital in EDF-GDF. There will not be any [privately held] blocking minority stake, and hence no privatisation* (Ibidem).

The French experience thus demonstrates that its main right-wing learnt a lesson from its past failures at reforms. Instead of trying to mimic methods that have proven effective in the UK, it now tailors its reforms to the specificities of the French situation. Similarly, the longevity of the second Berlusconi government demonstrates that it also realised that mimicking Mrs Thatcher is not sufficient to stimulate reforms.

Interestingly, a valuable way to generate support for a given reform might be to start in another market. Changes in external economic conditions also affect incentives in a similar way. The adoption of the Euro is one such reform that altered incentives towards wider support for reforms. As argued by Bertola and Boeri (2004), the increased degree of competition among Euro countries may lie at the core of the accelerated pace of reforms in these countries. As showed Table 2.1, Euro-countries tend to suffer from deeper distortions from EPL. Nevertheless, as illustrated in Figure 2.1, one observes that, prior to 1997 the average number of legislative reforms was similar in Euro and non-Euro area countries. By contrast, reforms accelerated noticeably in the former group of countries as of 1997. The argument of Bertola and Boeri (2004) is simple and powerful: the higher is international mobility, the more salient the weaknesses of a given country become. Therefore, to avoid a massive outflow of firms, these countries are forced into an accelerated pace of reforms, to maintain the attractiveness of the country in the eyes of international investors.

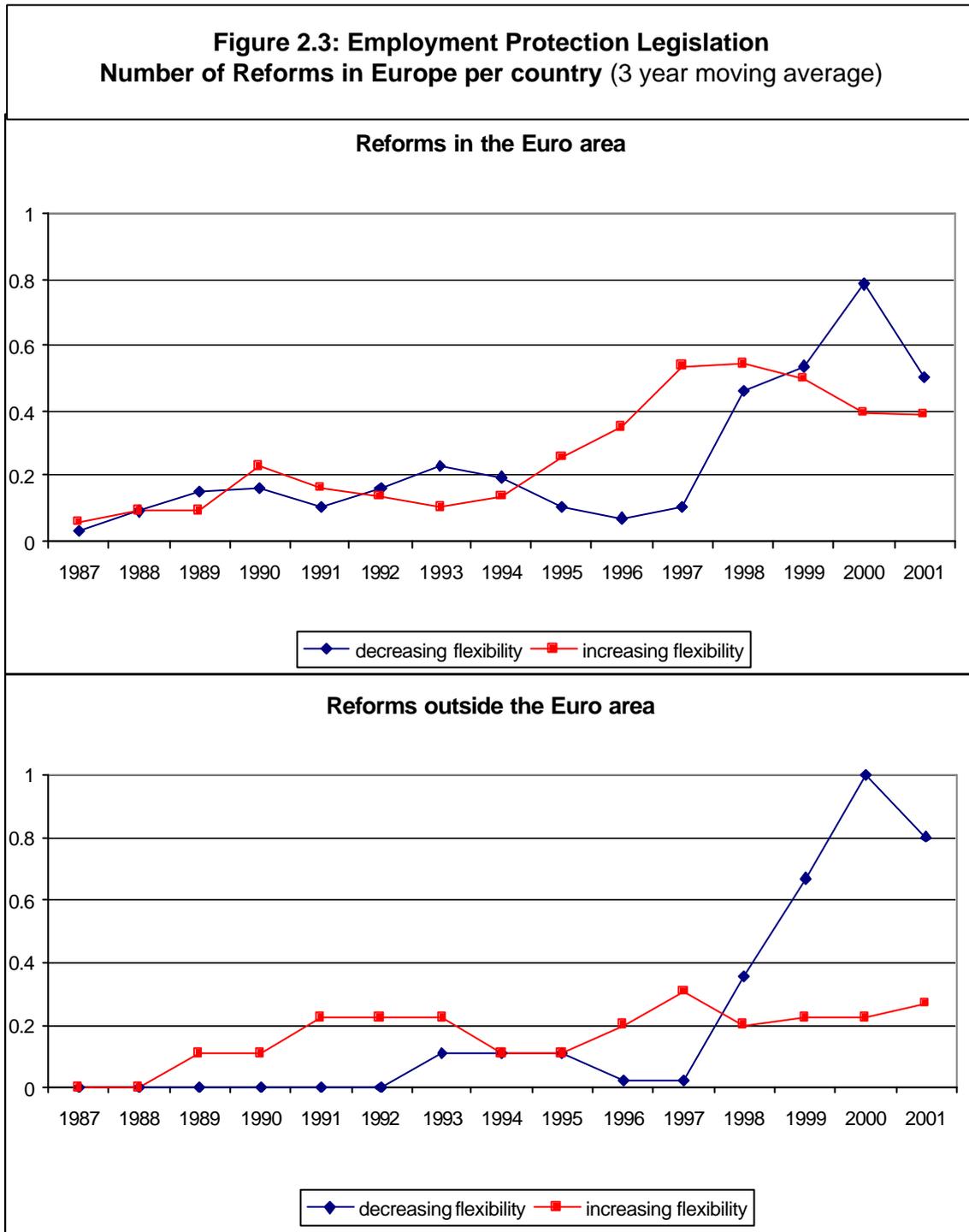


A similar trend can be observed when looking at the number of legislative reforms that increase the rewards from employment (Figure 2.2), either by reducing non-employment benefits or by creating more “active” employment policies: prior to 1997, Euro-area countries were apparently lagging behind. Since 1997, the reform process accelerated so sharply that the former countries are now outpacing the latter.



A first trigger that sparks the reform process is thus the combination of an increased cost of maintaining the status quo, together with a higher value for a reformed market. The combination of the two effects increases the *economic* pay-off of implementing market-oriented reforms. In the two examples here, we see that if the country faces an increased reward from reform, then *political* processes effectively translate them into reforms, even though the reform effort must be tailored to the particular framework conditions faced in the country.

External constraints can also take the form of external changes in legislation. European directives or WTO restrictions, for instance, may force each country to comply with changes that it would otherwise not have implemented. The deregulation of many goods and services markets has often been initiated in this way. Even in these cases, however, economic incentives played an important role as we show in Chapter 5.



As stressed above, many different groups may nevertheless have to be compensated in the process. We observe that when the “average” incentive is in favour of taking back the rents of some to increase aggregate efficiency, the government indeed goes in that direction –e.g. by introducing additional flexibility in the labour market (see Figure 2.2). However, to gain popular support for their reforms, such governments also have to implement countervailing measures targeted at veto players. Figure 2.3 provides a striking illustration of this attempt at compensating specific groups. As we can see in

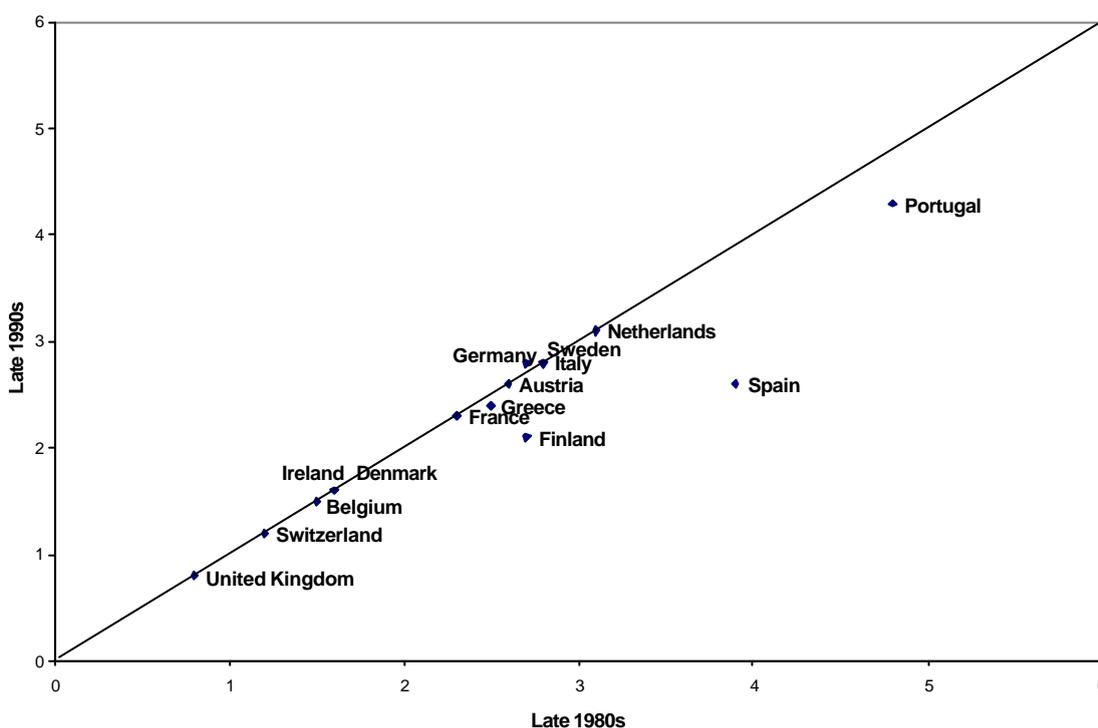
the top panel of the figure, governments that increased flexibility on the labour market also implemented measures that partially undid their main reforms —disaggregating the data by country would provide the same evidence. By contrast, this give-and-take process need not be present when reforms go in the opposite direction. As illustrated in the bottom panel of Figure 2.3, non-euro countries accelerated their reform process toward *decreasing* flexibility (that is: towards giving additional advantages to some groups), and the reform process did not accelerate in the other direction.

A similar pattern can be observed for pensions. Before 1997, Euro-area countries were also intensifying their process of pension reforms. However, despite this intensity, reforms were never unidirectional. There were as many attempts at curtailing the benefits of state pensions, as there were presents being made through increases in generosity. After 1997, however, Euro-area countries sharply accelerated the pace of reforms, towards decreasing the generosity of their systems (see Bertola and Boeri, 2004).

Summing up, this evidence shows that external constraints and economic incentives can be reform-promoting. On the other hand, governments who want to implement reforms in one direction may have to take steps to gain support from specific groups. Taken together, these two arguments suggest that, although the reform process accelerated noticeably throughout the 1990s, the political constraints faced by some countries may have prevented them from deeply affecting the way in which their markets operate. If any, exceptions will have to be found in countries that faced more strenuous external constraints.

Figure 2.4 confirms this insight. This figure reveals how labour markets operate in different countries. The indicator, developed by the OECD, describes how regulated is the labour market. A value of 1 indicates a highly liberalized market, whereas a value of 6 indicates a highly regulated market. Along the horizontal (resp. vertical) axis, one can read the value of this index for the late 1980s (resp. late 1990s). Next to the country points, we also drew a line that indicates a situation in which no change would have occurred over a period of 10 years. Strikingly, most countries remain quite close to this diagonal line, despite the high number of reforms that occurred.

Which are the main exceptions? A first exception, not visible on this figure, is Great-Britain, which undertook its package of forceful liberalization reforms during the 1980s. A second exception is Spain, which suffered from the highest level of unemployment in all Europe (it culminated at about 20% in 1994). Clearly such a high level of unemployment played the role of a major external constraint, by increasing the cost of the status quo. The next two (less striking) exceptions are Finland and Portugal, who had to take steps to adjust their economies to face the single market and avoid lagging behind.



## **2.2. Theories of government representation and reforms: introductory example and framework of analysis**

**Note:** *In what follows, we provide a brief sketch of various theories of government intervention and reforms. The reader who is familiar with these theories may wish to skip this section. However, we hope that it will provide a useful reference glossary for the next chapters.*

By definition, reforms can introduce fundamental changes in the institutional rules governing markets. The aim is often to enhance economic efficiency, usually through

measures that stimulate competition or reduce red tape. However, distributive issues also arise. Reforming institutions typically comes at a cost, as they tend to reduce the rents enjoyed by some economic agents in the market. Despite enhancing economic efficiency, these reforms thus meet the fierce opposition of those agents.

**A basic example.** Consider a market dominated by a monopolist. Being the only seller, this monopolist will take advantage of its market power to extract rents. These monopoly rents are obtained from the other side of the market –the consumers– by reducing output below the competitive equilibrium level, thereby creating scarcity and increasing the equilibrium price level.<sup>1</sup> Since this choice by the monopolist is *voluntary*, it must be increasing its profits, by *revealed preferences*.

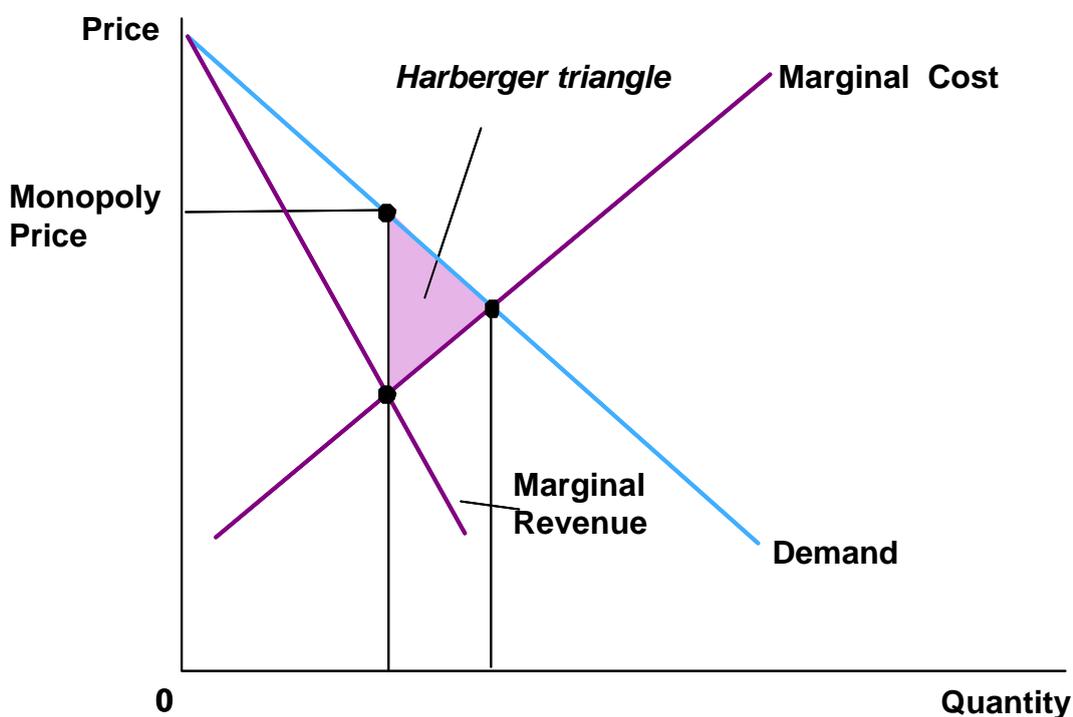
Clearly, consumers have opposite preferences, as they stand to lose from this monopolistic pricing. At a lower price, they would be willing to demand larger quantity; their consumption of the good would increase, and their welfare from consumption –the consumer surplus–<sup>2</sup> would hence be higher.

Under monopoly pricing, the welfare loss incurred by the consumers is larger than the surplus extracted by the monopoly, which means it is economically *inefficient*. This inefficiency stems from the fact that, by reducing output, the monopolist deprives consumers of a given quantity of goods that should have been consumed. Figure 2.5 displays the size of this welfare loss, as measured by the *Harberger triangle*. To achieve efficiency, and hence to maximize the *aggregate* welfare on the market (the sum of the producer's and of the consumers' surpluses), the price level should be set equal to the marginal cost of production. This price level is *socially preferred* to any other level, including the initial monopoly equilibrium (where the price is strictly above marginal cost), as well as to lower levels (which would induce the producer to reduce output or to exit the market).

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<sup>1</sup> More generally, the monopoly can engage in price discrimination. However, unless we make the unrealistic assumption that it can perfectly discriminate across consumers, profit maximization necessarily entails reduced production.

<sup>2</sup> This surplus is measured as the product between the purchased quantity of the good and difference between the market price and the price at which they would have been willing to buy the goods.

**Figure 2.5. The Harberger Triangle**

This basic example illustrates that there may be discrepancies between *market* outcomes –as generated by the existing institutional rules governing these markets, and by the economic behaviour of the institutions or players on the markets– and the outcomes that can be considered “socially optimal”. Moreover, these inefficient outcomes may be preferred by some of the actors –or groups of actors– involved, as it is the case with the monopolist in the above example.

There will thus be strong political tensions whenever a government has to intervene on such a market. If entry by domestic or foreign producers into the market *is possible*, the monopolist would like the government to intervene, e.g. by forbidding entry. This measure would generate monopolistic rents, at the expenses of the consumers’ welfare, and would consolidate the inefficiency in the market. Consumers, in their stead, have exactly opposite demands. If the government had to intervene, they would prefer that it either stimulates competition or that it introduces a price cap, for example. One or another way, they want that the government prevents the monopolist from increasing its price above the marginal cost of production.

**The Coase theorem.** The above example seems to suggest that institutional rules governing markets can unambiguously be classified as “socially better” or “socially worse” than another, and government intervention as socially desirable in some cases, and socially detrimental in other cases. Above, rules or institutions that allow producers to raise prices above marginal costs can be perceived as socially worse than rules that prevent this from happening. This perception is not entirely correct, though.

In the above example, the absence of government intervention implies that the producer can extract rents from consumers by increasing prices above marginal costs. Importantly, the benefits appropriated by the producer are lower than the amount of rents foregone by consumers. As suggested in the seminal work by Coase, this implies that there is room for mutually beneficial side-transfers: consumers would agree to pay a fixed transfer to the monopoly in exchange for optimal price and quantity. The former payment would compensate the monopolist for the forgone monopoly rents, while the price reduction would increase consumers’ welfare.

Therefore, if side-payments are available, the comparison among institutional rules or policies becomes more difficult. The institutional rule allowing for monopolistic behaviour seemed inefficient at first glance. Yet, as soon as consumers can strike a side-deal with the monopolist, this rule generates the same outcome as an optimal intervention by the government. Both rules yield the same efficient outcome. The only meaningful difference lies in the distribution of the surplus: under a laissez-faire rule, the monopolist extracts more rents than under the interventionist rule, and conversely for consumers. The intervention of the government would thus be essentially redistributive and not efficiency-enhancing.

In the real world, the picture stands in between these two visions. In some cases, economic policies or changes in institutional rules have only redistributive effects, as in the cases portrayed above. In other cases, some institutions are clearly less efficient than others, and reforms can be welfare enhancing. For instance, allowing monopoly power but forbidding side-transfers would be inefficient. A reform that allows side-transfers would be welfare improving in this case.

Yet, the Coase theorem relies on fairly strong assumptions. Side-transfers or efficiency-enhancing institutional reforms are only feasible if either existing

institutions or the decision-making authority achieve (at least one of) three important functions: *commitment* (or enforcement), *coordination* and *representation*. We briefly describe these functions below, but shall regularly return to them later in this essay.

**Commitment, coordination and representation.** To implement reforms, or to make mutually improving transactions possible, institutional rules must enable *commitment* from the parties involved: the actors (or “players” in the game-theoretic jargon) must be able to ensure that a deal agreed upon will be respected. That is to say, “contracts” signed by the actors must be enforceable. In our example, if consumers pay a lump-sum amount today in exchange for lower prices in the future, they must be guaranteed that the monopolist will actually not be able to set a price higher than agreed. Clearly, if such a deal *cannot* be enforced, the monopolist would always increase prices despite the initial agreement. In such a case, consumers and producers are simply unable of striking welfare-improving deals, and inefficiencies remain. Weak institutions typically prevent commitment, and may induce reform failures. Examples of this can be found in chapters 3, 6 and, mainly, 7.

Secondly, whenever the institutional reform or the policy involves many different actors, these must be able to *coordinate* their actions. For instance, to compensate the monopolist for reducing the price of its good, consumers must act collectively. If they cannot coordinate their actions, for instance by collecting a tax on every consumer, then each individual would benefit from free-riding on the others. However, if every consumer free rides, that is, if coordination is not feasible, the transfer will not be put in place. Again, different types of institutions, or the voluntary grouping of actors (e.g. into lobbies) may allow for different levels of coordination, thereby exerting asymmetric influence or providing asymmetric bargaining powers to different actors in society. Chapters 4 and 5 provide striking illustrations of these effects. Chapter 7 instead show how coordination failures can disrupt a country.

The body putting forth reforms is generally the government. This brings us to the third function of institutions: *representation*. Since economic policies and reforms affect the well-being of several actors in the population, who may be able to express their preferences in different forms, and since these reforms must be adopted and

implemented by a third party (the government and the legislative assemblies), it is crucial to understand *who* this third party represents. *Direct* democratic voting procedures, such as referenda, provide each participating voter with an equal weight, which prevents or limits direct influence by external lobbies. Instead, delegated decision-making (representative democracy), although generally more efficient, tends to dilute the representation of voters, and allows lobbies or other groups to exert additional influence; or the political elite may force some decision, such as the adoption of the Euro, even though a referendum may have blocked it. Chapter 3 will contrast the experiences of the UK and of Italy, who benefit from different representation systems. Chapters 6 and 7, by contrast illustrate how reforms may evolve when institutions fail to ensure proper representation of citizens. But, coming back to our basic example, if the institution rule contemplates democratic procedures, the electorate will dictate the choice of institutions. Since consumers are typically more numerous than producers, the government will satisfy their demands and impose a price cap. If instead representation is imperfect, the government may be affected by overt pressures from the monopoly, while consumers –facing coordination problems– may fail to exert a countervailing pressure (see also Chapter 5).

**Political economics of reforms: a brief survey.** Political economics studies the role of collective action processes (such as voting procedures, interest groups activity, constitutions) in resource allocation and rent distribution. It also directly relates to the theory of institutions pioneered by Douglass North, which helps understand institutional reforms. Research in political economics covers many different aspects of these collective action processes. Yet, its methodology and message is not yet unified.

The literature can be divided in different parts, each of which tends to focus on one specific problem and type of interaction. Developing an entirely new and all-encompassing way of analyzing these interactions is of course beyond the scope of this survey. More modestly, our goal is to present an overview of the existing analyses, and make it as coherent as possible. To this end, we follow Castanheira and Esfahani (2003) in identifying *three groups of actors* that influence policymaking in a specific

manner; *three types of interaction games* among these actors; as well as the objective of these actors: gain control over (economic or other types of) *rents*.

**A) Actors.** Let us identify three different actors that intervene in collective action processes:

1. *The public*. The population at large can act as *voters* when there are elections or other opportunities to show public (dis)approval of policies or policymakers;
2. *Special interest groups* or *lobbies*. These organized groups can influence policy decisions by other means than voters; e.g. through information provision (such as mass media campaign), demonstrations, or contributions to policy-makers;<sup>3</sup>
3. Finally, *political elites* (or, for short, *politicians*) are identified as the actors who set the agenda, make choices, and can impose their decisions. The objective of these politicians may be to expand their control over policy decisions (if they are ideologically motivated) or to extract rents from office (if they are purely opportunistic). The members of these elites are generally elected representatives but can also be appointed by their peers in several policy-relevant institutions (such as political parties, central banks, or the European Commission). In non-democratic countries these elites can also be self-proclaimed dictators and their clique.

There clearly are close and complex interactions among these different groups. For instance, politicians need external support from interest groups and/or voters to achieve their goals. Yet, institutions, as well as the type of decision to be made, determines the rules that govern these interactions, and thereby the relative power of these groups. *Voters* will for instance have a stronger influence on labour market reforms than on regulatory reforms. Lobby groups will have more power in proportional representation systems, or when representation is weak. Henceforth, the identity of the main actors in a given reform scenario will depend both on the *type* of reform (that determines the *rules* of the game played), and on who are the *main winners and losers* from the reform (i.e. on the *rents* to be gained or lost in the

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<sup>3</sup> Grossman and Helpman (2001) provide an in-depth and enlightening analysis of the role of special interest groups.

process). Therefore, after having identified the actors who can influence reforms, we now turn our attention to the *rules* and to the *rents* that govern their interactions.

**B) Rules.** Institutions provide specific frameworks of interactions among these agents. Again, the literature tends to analyze these different processes separately. It is only recently that theoretical developments allowed us to begin understand how these different processes interfere with one another. We can distinguish at least three different types of interactions: *democratic voting procedures*; *lobbying*, by which special interest groups provide additional information or other means of influencing the decisions of incumbent rulers; and *constitutional arrangements* that regulate the power and the freedom of actions of these incumbents.

#### *Voting.*

One approach to the political economy of public policy is to focus on the interactions among *voters*. Different voters have different preferences over policy outcomes. When voters are offered a variety of policy alternatives, democratic elections allow electors to select the proposal that is supported by a majority of the electorate.

Anticipating on the likely outcome of such elections, which type of proposals do politicians want to make? Addressing this question introduces the interactions between voters and politicians, but that specific interaction is a well-paved issue. The literature showed that office-motivated politicians have an incentive to propose the platform that is most preferred either by the *median voter* (Hotelling, 1929; Downs, 1957; Black, 1958) or by the *average voter* (Hinich, Ledyard, and Ordeshook, 1972; Hinich, 1977; Lindbeck and Weibull, 1987 and 1993). The politician's focus on one or the other depends on certain characteristics of the elections (See also Persson and Tabellini 2000 and Mueller 2003, who survey this literature in *much* greater detail).

#### *Lobbying.*

A different (and complementary) approach is to focus on the role of *Special Interest Groups*. The contribution of this approach is to show how *SIGs* influence policymaking beyond their role as voters. Coordinated actions by *SIG* members allows actors with common interests to interfere with policymaking, by eliciting specific information that favours them, by offering block political support, and/or financial contributions to the politicians' causes. The politicians' decision is then based on a

weighted average of the preferences of different interest groups and of the voters' preferences (See *e.g.* Olson, 1965, 1982; Becker, 1983; Baron, 1994; or Grossman and Helpman, 2001). The weights of these groups can also be endogenized and explained by their relative cohesiveness at the election stage (Lindbeck and Weibull, 1987), their level of organization (Olson, 1982), and by their institutional or relational advantages. This may induce inefficient policy choices when lobbies have unbalanced access to policymakers (Grossman and Helpman 2001). By contrast, efficiency is restored when all lobbies have equal access to the politician's ear and lobbying is socially costless (Bernheim and Whinston, 1986; Krueger, 1974). Below, we shall also see how lobbying and voting can interact one with another.

### *Constitutional arrangements.*

The third approach to political economy modelling is to concentrate on the institutional arrangements that allow the public to constrain ruling politicians. For instance, since lobbies can influence policymaking beyond their voting power, allowing or forbidding campaign contributions will influence the relative power of the electorate with respect to the lobbies. Tight rules also limit the amount of resource that can be diverted by the incumbent politicians. Some institutions are clearly suboptimal in that regard. For instance, Acemoglu, Robinson and Verdier (2003) show how weak institutions may allow dictators to expropriate citizens by using divide-and-rule tactics. Stronger institutions impose constitutional checks-and-balances that limit the rulers' ability to exploit such societal divisions. In short: "*When institutions are strong, citizens demand rights; when institutions are weak, citizens beg for favors*" (Acemoglu et al. 2003, p1). Returning to the functions described supra, we shall see that classifying institutional arrangements according to their ability to generate *commitment*, *coordination* and *representation* will be helpful to explain their performance.

Importantly, the above should not be interpreted as saying that politicians cannot divert any rents in strong democracies. Persson, Roland and Tabellini (1997, 2000, and 2003) and Diermeier and Feddersen (1998) demonstrate that existing constitutions face a systematic trade-off between efficiency and rent-extraction. For instance, Persson *et al.* (2000) show that stronger separation of powers put tighter limits on the amount of rents diverted by the politicians, but also generate suboptimally low provisions of public goods. Conversely, institutional arrangements that generate a better equilibrium

provision of public goods tend to have weaker separation of powers, and therefore larger amounts of rents diverted by the politicians.

**C) Rents.** The motivations of the different actors in their political interactions are certainly many. However, given our focus on economic reforms, it is quite natural for us to focus on a common motivating factor of these actors: *economic rents*. Reaping these rents might be the ultimate immediate goal of only some but it definitely is a necessary instrument for anyone who wants resources to attain his/her political objectives. This is to stress that even though we focus on *economic rents*, the logic of our argument does not preclude ideological motivations.

Be economic rents a final goal or an intermediate tool, each group of actors will have an incentive to gain access to these rents, and this incentive will be proportional to the size of the rents at stake. When the amount of rents that can be appropriated is large and concentrated, groups will better organize themselves to gain access to these rents; oppositions between organized groups will become fiercer, and more resources will tend to be dissipated in the process.<sup>4</sup> This is a reason why farmers are politically more active in countries that receive larger subsidies from the Common Agricultural Policy; this is also a reason why bigger and more cohesive industries manage to effectively lobby for stricter regulatory frameworks, and why it proves more difficult to reform existing pension systems, the more generous and inefficient they initially are.

**The Status Quo Bias.** “*Why do governments so often fail to adopt policies that economists consider to be efficiency-enhancing? [...] The answer usually relies on [the fact that] the gainers from the status quo are taken to be politically ‘strong’ and the losers to be politically ‘weak,’ thereby preventing the adoption of reform*”, is how Fernandez and Rodrik (1991, p 1146) introduce their theory of the status quo bias. This theory is based on the uncertainty that reforms generate: while those who stand to lose from the reform are easily identified, those who stand to gain instead face substantial individual uncertainty. They cannot be identified beforehand. This uncertainty generates a double hurdle for reforms: to attract majoritarian support,

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<sup>4</sup> Evidence demonstrates that the presence of abundant resources often turns out to be a curse for economic growth. This curse tends to be even more pronounced when institutions are weaker, *i.e.* implicitly when lobbying becomes more effective. There are thus strong reasons to believe that abundant resources essentially generate a *political economy curse* (see Acemoglu *et al.*, 2003; Castanheira and Esfahani, 2003; and Robinson *et al.*, 2002)

a reform must attract both *ex ante* and *ex post* support. Let us illustrate this by means of an example: assume the population is divided between two sectors: *L*, which is the sector that will *lose* from the reform and *G*, which is the sector that *gains*. Ex ante, 54% of the population works in sector *L*. Ex post, 64% will be working in sector *G*. Therefore, a majority of the population (64%) gains from the reform process: those who are already present in sector *G* (46% of the population), and the additional 18% who will move from one sector to the other.

**Figure 2.6.** Gainers and losers from reform

Prior to reform		After reform
Sector L: 54%	36% would eventually lose from reform	Sector L: 36%
	18% would change sector and gain from reform	Sector G: 64%
Sector G: 46%	46% remain in sector G and gain from reform	

However, a majority of 54% may block the reform *ex ante*. Indeed, assume that the effects of the reform are the following: it increases the payoffs of anyone in sector *G* by 10, whereas it decreases the payoffs of anyone in sector *L* by 9. Those initially in sector *L* therefore face a probability  $2/3$  of staying in their sector and lose 9, and a probability  $1/3$  of moving and gain 10. The uncertainty as to *who* would be able to change sector implies that anyone initially in sector *L* faces an expected pay-off of  $-8/3$ . They will thus oppose the reform. Since this sector initially represents a majority, the reform can be blocked democratically. This is a typical *status quo bias*: if the government ever managed to *impose* its reform, a majority would also oppose its reversal. Individual uncertainty is thus sometimes sufficient to maintain the status quo, whether it is efficient or not.

**Gradual versus one-off reforms.** There may also be aggregate uncertainty as to the eventual effects of a reform. In the example above, the reform was known to generate a gain of 10 in sector *G*. Assume instead it is equally likely to generate a pay-off of 1 or a pay-off of 19. On average, the *expected* payoff is thus still 10. However, if the reform yields 19, the expected pay-off for a person in sector *L* would become positive! Gradual reforms may in that case help the government gain popular support for its reform. Assume the reform can be divided in two steps. If the first step generates almost no loss for those in sector *L* but, at the same time, elicit information regarding the actual pay-offs of the full reform, even those in sector *L* may support the first step and, eventually, the second. Next, if there are more than two groups in the population, the government can exploit *divide and rule* tactics to buy support from a different majority in favour of each component of the reform. The gradual implementation or an appropriate sequencing of reforms can thus prove an appropriate way of circumventing political oppositions (Dewatripont and Roland, 1992 and 1995).

Interestingly, many of these issues of *gradualism versus big bang* reforms were raised primarily to address the situation faced by Eastern European Countries during their transition to a market economy. However, the lessons learned from their experience now prove to add a lot of value for the reform processes faced by the other countries in the world (Roland 2000).

## Chapter 3

### Pension Reforms in Italy and the UK

#### 3.1 Introduction

Public pension systems represent the most widespread welfare scheme, as well as one of the most pervasive examples of public intervention in the capital and labour market, due to the large effects, for instance, on private savings and retirement decisions. Although the initial introduction of public pension systems often dates back to the beginning of the XX<sup>th</sup> century, most of their current distinguishing features – such as, for example, their unfunded nature – have been adopted after WWII. The enormous increase in pension spending is however concentrated over the last three decades. Economists and politicians have often blamed this hike in social security spending on the demographic dynamics. As populations grow older, the fraction of individuals, who retire and enjoy a pension income, increases. Even if the generosity of the individual pension benefits awarded by the system remains constant, this increase in the number of retirees induces a larger share of resources to be transferred from the working generations to the elderly. Population aging may hence provide an – at least partial – explanation of the rise in pension spending. Even more importantly, however, this alarming demographic process is still well under way, since longevity is expected to keep increasing, while fertility rates are not forecasted to bounds back their post WWII levels, but rather – in such countries as Italy and Spain – to remain low. As widely debated in the literature, these forecasts pose additional concerns for the future financial sustainability of these unfunded systems.

Some fast aging countries – such as Japan – have however been able to limit the growth in pension spending. Aging is thus not the unique culprit of the financial unbalances of these unfunded pension systems; additional reasons have been identified to explain the full magnitude of this phenomenon. In most European countries, the demographic phenomenon has typically been combined with a reduction in the effective retirement rate. Gruber and Wise (1999 and 2003) and Blondal and Scarpetta (1998) have argued that this retirement behaviour is actually induced by some features

built in the existing pension systems. The introduction of generous early retirement since the late 60s, and the widespread use of disability pensions as a early pathway from the labour market, have effectively increased the fraction of workers immediately eligible for a pension benefits. The sharp reduction of the average retirement age for male in virtually all countries but Japan and Canada has thus to be viewed as the optimal response of these workers to the incentives provided by the pension system; yet it has created additional concerns for the financial sustainability of these unfunded pension systems.

Another critical feature, shared by several countries, which has contributed to the rise in pension spending, has been the continuous increase in the pension benefit generosity, achieved by modifying the pension benefit formula. A reduction in the years of contributions required to be eligible to a full old age pension, an increase in the fraction of the worker's pension to be attributed to his spouse as survivor benefit and a plain increase in the pension's replacement rate are some examples of measures that determined the expansion of the public pension programs across Europe in the 70s and 80s.

The political mood, accompanied by a wider recognition of the likely future financial trouble for these pension systems, changed in the mid80s and 90s. A better assessment of the impact of the aging process on the financial sustainability of these unfunded pension systems and a more clear evaluation of the distortions introduced by these large welfare programs in the economy called everywhere for reforms aimed at reducing the size of these public pension systems. As shown in chapter 2, several pension reforms – typically involving parametric rather than structural measures – were proposed. Some of them were indeed successful, as they were approved in the Parliament, and later implement, albeit often with long transition periods, whereas some other reform projects met the fierce opposition of the public – through massive strikes or other forms of protest – and were to be withdrawn.

In this section, we concentrate on two countries, Italy and UK, in which successful reforms aimed at reforming the pension system have indeed been adopted. Both countries have a long history of pension reforms. Until the mid80, in the UK, and the 90s, in Italy, changes to the system were mainly targeted at increasing pension coverage and generosity. However, while in Italy the legislative modifications

intended to increase pension spending were frequent and often even overlapped; in the UK, the enlargement of the system was typically implemented through systematic reforms, such as the 1975 Social Security Act, which increased the role of the state by introducing a public earning-related pension scheme (SERPS).

The reform process started in the mid80s. In 1986, a new Social Security Act, approved by the Conservative government led by Mrs. Thatcher, limited the scope for government intervention in the pension industry, by reducing the size of the newly introduced scheme, the SERPS, through a decrease in its generosity. The season of the Italian pension reforms began in 1992, after a major negative shock to the Italian financial sector, which led Italy out of the European Monetary System. The Amato reform in 1992 adopted several emergence measures to the pension system in an attempt to preserve its short term solvency and to guarantee its long run financial sustainability. A new reform, known as the Dini reform, which introduced a major change in the nature of the system that shifted from defined benefit (DB) to notional defined contribution (NDF), followed in 1995. Between these two reforms, in 1994, the Berlusconi government attempted to pass a pension reform project, which as the two approved reforms aimed at guaranteeing the long term financial sustainability of the existing unfunded social security system. The reform attempt had to be withdrawn due to the fierce opposition of the trade unions, which repeatedly call for general strikes, and ultimately led to the fall of the Berlusconi government.

Our aim is to understand why these major reforms were successfully implemented in the UK and in Italy, and which conditions determined the success of these reforms, as opposed, for instance, to the failure of the Berlusconi proposal in 1994. To discuss these issues, it is useful to classify the pension reform process, as proposed by Orenstein (2000), in three stages: an initial phase of commitment building, a subsequent stage of coalition building and a final implementation phase. This classification will also help to underline some of the institutional differences between UK and Italy, which represent potential candidates to explain the differences among these reforms.

According to Orenstein (2000), the commitment building stage is typically performed by a leading actor in the political arena, which often coincides with the government or more specifically with the Welfare or Labour minister. The main goal at this stage is to

convince the public opinion that – perhaps for demographic or economic reasons, often not under the direct control of the government – a reform has to be undertaken and hence to justify a plan of the reform to the public. In the commitment building stage, what triggers the reform is identified and presented to the public. This represents a crucial, yet critical political move, since – as argued also by Ney (2003) – there are typically few electoral incentives, if any, in democracies to retrench welfare systems. In fact, a clear asymmetry emerges with various instances of the welfare state expansion, since retrenching the welfare state is not likely to be popular among voters (Pierson, 1996).

How the phase of commitment building takes place, and who the relevant actors are, depend on the framework conditions, such as the *rules*, as defined by the institutional features of the countries, and the historical moment. Analogously, what triggers the pension reforms depends on the relevant *actors* on the political and social scene, as well as on the relative power of these players. In Italy, for instance, the 1992 Amato reform clearly represented a policy response to the financial crisis, which took place in September 1992 (see Chlou-Dominczak and Mora, 2003). The main player at the time was a caretaker government with no stable political majority supporting it in the Parliament. Under these circumstances, the government had no choice but to bargain with the trade unions in order to enjoy their cooperation. In the UK, instead, the 1986 pension reform did not follow any financial or economic shock. The Conservative government rather managed the commitment building stage by providing to the public a large amount of evidence on the impact of aging and on the expected increase in pension spending (see Nesbitt, 1995). Through these evidences, the government provide an official justification and tried to build the momentum for the reform to be implemented. According to some scholars, see Pierson (1994) and Jessop et al. (1988), the government was willing to move along with this reform, despite the lack of an urgent need, for ideological reasons, which they refer to as “Thatcherite”.

During the coalition building stage, the relevant actors in the decision process are identified. Due to the commitment showed in the initial stage by the leading actor in the political arena – say the government – the process moves into the second stage, when the government initial proposal is bargained upon in order to meet the agreement of some of the relevant political and social players. Who these relevant actors are, how

they interact and their relative bargaining powers depend on the institutional structure – the *rules* – and on the timing of the events.

In particular, institutional rules may determine the relevant trade-off for the politicians involved in the reform process between concentration of power and political accountability. As argued by Pierson and Weaver (1993), more power to the politicians allows them to implement their most preferred policy measures, with no concessions to possible veto players – both in the political and in the economic or social arena – however, this also leads to more accountability of the politicians with respect to their voters. A broad literature, see for instance Persson and Tabellini (2000) for a review, has suggested that electoral rules typically shape this trade-off. Proportional systems lead to less power to implement policy or reforms, yet to lower accountability and hence are common in Consensus Democracy (see Lijphart, 1999); whereas majoritarian provide more leeway to the politicians in designing their most desired reform, which may however be critically judged by future electors. According to this distinction, pension systems in countries with proportional systems – or consensus democracies – are hard to reform (Crepaz, 1998), as the ruling politicians have to compromise with other actors; whereas they are easier to reform in countries with majoritarian systems, although the electoral incentives to the ruling politicians may keep them from acting in this direction.

In fact, the coalition building phase proved to be quite short – around six months – during the 1986 UK reform, as the government – mainly represented by the Prime Minister, Mrs. Thatcher, by the Secretary of State, Mr. Fowler, and by the Treasury – exclusively consulted with institutions in the private pension industry. In Italy, this coalition building stage – basically between the government and the trade unions – was fruitful in the 1992 Amato reform and in the 1995 Dini reform, whereas it did not take off in the 1994 Berlusconi attempt to reform the system.

A clear difference between the experiences of these two countries is to be found in the dimension and in the type of the social security system in place at the time of the reforms. These characteristics provide some information on the size of *rents* available to the different players and hence on their incentives to oppose or to pass such reforms. In Italy, a large Bismarckian system, with little to none pre-existing occupational or private pension plans, created several concerns with respect to its distortionary effect

on the economy. However, unions and social actors were in principal against any retrenchment of this generous pension system. Their support to the Amato and Dini reforms was mainly reached on the ground that a reform was needed to preserve the short run solvency of the scheme. In the UK, instead, a relatively small Beveridgean system was coupled with large pre-existing occupational plans. In fact, these players – the leading actors in the occupational pension industry – had an important role in the reduction of the role of the state in the pension industry, which occurred with the 1986 Social Security Act.

The last stage of the pension reform process, according to the classification proposed by Orenstein (2000), corresponds to the final implementation phase. During this stage, additional modifications to the reform project are made, the timing is often changed, and new players may emerge, which did not take part in the coalition building phase. In the UK, for instance, changes were made to the original reform plan, as laid out in the Green Paper, which led to a new project, presented in the White Paper, that was then implemented with the 1986 reform, due to the role of the Treasury within the government and of the pension industry institutions.

The next sections describe the 1986 reform process in the UK and Italian reform season of the 90s. A political-economics interpretation of the reforms failures and successes is provided along the lines previously discussed.

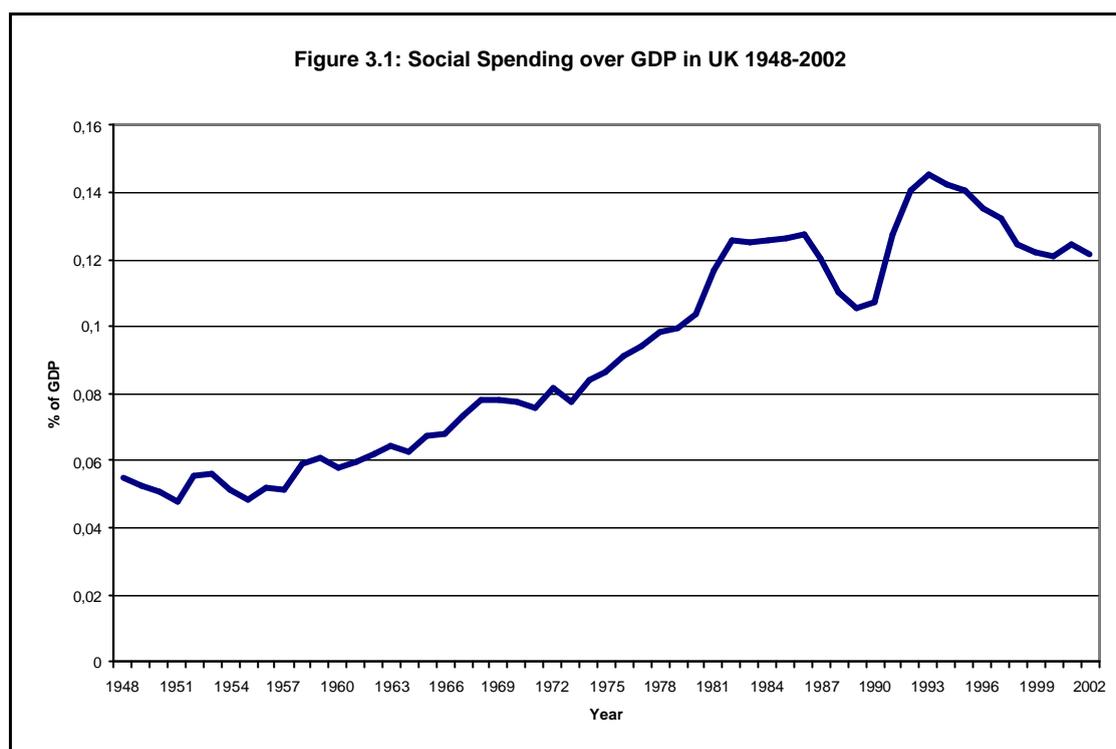
### **3.2. Pension Reforms in the UK**

The first elementary public pension scheme in the UK dates back to the beginning of the XX<sup>th</sup> century. In 1911, with the National Insurance Act, a basic state pension for elderly, disability and unemployment was instituted. This system was means-tested, so that only citizens with extremely low-income could access the scheme, which hence represented a minimal safety net for poor individuals only. A major change occurred in 1946, when the British pension system was re-shaped – following the suggestions put forward by the famous Beveridge Report – in an attempt to provide further protection to the elderly. The report argued in favour of the pension benefits to remain flat, yet it questioned their means-tested nature, on the ground that means-testing created a stigma against those individuals, who draw benefits from the system, and called for the

elimination of this requirement. Contributions were to be not earning related, a feature that was modified in 1959, with the introduction of the Boyd-Carpenter scheme. The 1946 pension reform implemented all these proposals; however, unlike suggested by the Beveridge Report, pensions were immediately awarded, with no transition period.

A peculiarity of the British system, vis-à-vis most European countries, is the existence, since the late XIX<sup>th</sup> century, of a second pillar, which guarantees some income to the workers in their old-age. This private scheme represented by the occupation plans provided by the employees. Established in the late 1800, these occupational pension plans become progressively more relevant over the years. In 1936 they covered 13% of the workforce and they were up to 33% by 1956. However, the period of highest growth for this private provision came in the 50s and 60s, mainly thanks to the measures introduced by the Boyd-Carpenter scheme, which gave them a lot of leeway in the set up of the schemes and in their implementation. In 2001, almost 50% of the employees were covered by occupational plans

Some of the main characteristics of the current British public pension system were introduced by the 1975 Social Security Act, which constituted a major reform aimed at increasing the State intervention in the British pension system. The reform project was initially elaborated in the 1969 White Paper, but carried out only in 1975 by the Labour Party. The main measure was the introduction of a second public pillar in the British old-age pension system: the State Earnings Related Pension Schemes (SERPS). The existing flat benefit state pension scheme – the Basic State Retirement Pension (BSP) – was also retained. While this reform increased the public involvement in the pension sector, since the State took responsibility for providing also earning related pension benefits, on top of the flat pension, the crucial role of the occupational pension plans in the British pension industry was preserved. The 1975 Social Security Act in fact allowed for contracting-out of SERPS into occupational plans. Individuals were allowed to opt out of the State provided earning related pension (SERPS), but they had to guarantee themselves a sufficient retirement income by joining an occupational plan. To ensure that these occupational plans guaranteed a sufficient income, individuals were only allowed to contract-out into plans which provided a guaranteed minimum pension (GMP).



As displayed in Figure 3.1, before the 1986 Social Security Act, the trend in British pension spending was increasing, due to these reform measures aimed at increasing the involvement of the State in providing retirement income particularly for the low-income workers. In fact, the introduction of the SERPS increased the protection mainly for those low-income workers, since medium and high-income workers were typically covered by private occupational pension plans. Unsurprisingly, most medium and high-income workers did in fact contract out of SERPS into occupational pension plans.

**The 1986 Social Security Act**      The retrenchment of the public pension system achieved by the Conservative government of Mrs. Thatcher in 1986 constituted a distinct break with the previous pension policies aimed at increasing the role of the State in providing retirement income particularly to the poor. Indeed, the first change brought by the Conservative government was to index pension to inflation, rather than to wage growth, already in 1980. This measure, which has been adopted in several European countries during the last two decades, needs not have large effects in the short run; however, it has proven everywhere very effective in reducing pension spending over the longer range, as the value of the pension benefits to the retirees

ceases to grow at the rate of the economy. The 1986 reform followed a large swing in the political mood over the pension problem, as well as – more generally – over the role of the State, which took place in the early 80s, and which was clearly present in the pension debate.

In the early 80s, the Conservative government effectively initiated the commitment building phase of the 1986 pension reform, by expressing its deep concern about the future level of pension spending. Two explanations were offered to justify this concern: the expected population aging, with the effect that these demographic changes were forecasted to have on the financial sustainability of the public PAYG pension scheme, and the future completion of the phasing-in of the SERPS scheme, which – once reached its maturity – would have had to pay out pension benefits to a larger fraction of retirees. As argued by Nesbitt (1995), during this phase the government was very active in producing a wide range of evidence on these issues. Already in 1982, for instance, a Report by the Government Actuary provided projections on pension spending. This government behaviour was largely different from the experience of other European countries, in which little information on pension spending and on the impact of the demographic trend on spending was indeed released (see Boeri et al. 2001).

The Conservative government also expressed some concern regarding an additional problem created by the existing mix of public and private pension schemes and related to the retirement income of the “early leavers”. Workers who were to leave their company before retirement – early leavers – enjoyed limited portability rights on their occupational pension plans and had to suffer severe cuts on their pension benefits, with respect to the retirement income they would have obtained by remaining with their company. Clearly, this situation increased the workers’ attachment to their companies – according to the initial goal of the companies offering occupational plans – but reduced competition in the labour market.

A major bust to this commitment building phase of the pension reform process was given by the large victory in the 1983 British election by the Conservative Party. The Conservatives received 42.4% of the votes – down from 43.3% in the 1979 general election – but obtained 396 seats – thus 57 seats more than in previous Parliament (see Table 3.1). The big loser from the 1983 election was the Labour Party, which

experienced a sharp decrease in its share of votes and seats. The former Labour's voters channelled their support towards the Liberal Democrats, which almost doubled their share of votes, and obtained 23 seats.

Institutional features played a crucial role in this circumstance to guarantee the victory of the Conservative Party. The British majoritarian electoral system awards the seat in Parliament for each electoral district to the first candidate to *pass the post*. This system penalizes small or medium size parties that do not have a geographical characterization. In fact, such party may well turn out to be the second in each district and hence to receive a fair share of votes, yet to obtain no seats. On the opposite, a party reaching the relative majority in half of the districts would obtain 50% of the seats in the Parliament with little more than 25% of the votes. In the 1983, the British majoritarian system favoured the Conservative, since the large flow of votes from the Labour Party to the relatively small Liberal Democrats allowed the Conservatives to prevail in several electoral districts and hence win additional seats. Despite the decrease in votes share from 43.3% in 1979 to 42.2%, the Conservative Party enjoyed a more comfortable majority in the Parliament – around 63% of the seats – than in 1979 – around 55% of the seats.

**Table 3.1:** Vote shares and Parliament Seats in British Elections 1979-92

Year	Conservative Party		Labour Party		Liberal Democrats	
	Votes	Seats	Votes	Seats	Votes	Seats
<b>1979</b>	43.3%	339	36.9%	268	13.8%	11
<b>1983</b>	42.4%	396	27.6%	209	25.4%	23
<b>1987</b>	42.4%	375	30.8%	229	12.8%	17
<b>1992</b>	41.9%	336	34.4%	271	17.8%	20
<b>1997</b>	31.5%	165	44.4%	418	17.6%	46

Source: Bonoli (2000)

Backed by a strong majority in the Parliament, in November 1983, the government launched an “Inquiry into Provision for Retirement”, chaired by the Secretary of State, Norman Fowler. The goal of this committee was to analyze the two hot problems of the pension debate: the portability of the occupational pension plans and forecasted

cost of the public pension schemes. Unlike in previous occasions, and contrary to the British tradition, this Inquiry did not constitute an independent committee; but it was rather composed of politicians – namely some ministers in the Conservative government – and by actuarial and insurance industry representatives. Notably, employees, retirees and unions representatives found no place in the committee.

The work developed by this committee was contained in two publications. A background paper (DHSS, 1984) reviewed the issues in the pension debates, which had already been discussed by other political and social players, and provided additional evidence on the importance of the two problems at stake: the limited portability of the occupational pension plans and the expected increase in public pension spending, blamed on population aging.

The former publication, the Green Paper “Reform of Social Security” in 1985, represented a sort of final report, which contained the Inquiry’s main message. The committee strongly supported the view that each individual had the right to a personal pension, not linked to employers’ contribution. They envisage the possibility of opting-out from the occupational plan, but express concerns for setting up clear arrangements not to destabilize the existing occupational schemes. Regarding the public pension system, their bold proposal was to abolish the public earning related pillar (SERPS), which had been introduced by the 1975 Social Security Act. This Green Paper entirely expressed the philosophy of this committee –and hence of the government: the role of the State in the pension industry had to be reduced, by dropping the SERPS; whereas there was scope for more private intervention through the introduction of personal rights to a pension – effectively of personal pension funds. This publication also brought the commitment building phase to an end.

Coalition building phase of the 1986 pension reform lasted only six months and featured a reduced interaction, as only few political and social actors indeed played a relevant role. The government had already made clear its intention to exclude the representatives of the employees, of the retirees and of the unions from the decision process on the pension reform by precluding their participation to the work of the committee on the “Inquiry into Provision for Retirement”. During the coalition building phase, the government continued with this strategy by accepting the critical remarks of few players only.

The most controversial reform measure proposed the committee led by the Secretary of State, Norman Fowler, was the abolition of the public earning related pillar (SERPS). Clearly, the Labour Party, the Unions, and several Charity organizations, such as Age Concerns, fiercely opposed this measure, which largely reduced the State responsibility for providing retirement income for especially for low income workers. Their studies, submitted to the Inquiry, underlined the risk of a large increase of the poverty among the elderly as a consequence of this policy decision, and call for an increase of the state coverage in pensions. Perhaps surprisingly, also the main organizations in the private pension industry, such as the representatives of the National Association of Pension Funds, major life insurance companies and the employers' organization – the Confederation of British Industry) – strongly opposed the abolition of SERPS. According to Atkinson (1991), the private pension industry organizations were not please to open up their industry to low-income workers, while they preferred to continue to target middle and high income individuals. Companies running occupation pension plans, on the other hand, were afraid of possible demographic unbalance in the occupational plans, due to large flows of young workers opting-out of occupational plans in favour of private personal plans.

However, the most influential criticisms to the abolition of SERPS, according to Bonoli (2000), were moved within the government, by the Treasury. Unlike other players, the Treasury was concerned about the cost of abolishing SERPS. In fact, it was argued that, since past obligations to SERPS were to be met, and hence current pensions had to be paid, the abolition of SERPS would have led to a double burden of taxation during the phasing-out period of the scheme, as current workers were to contribute for current retirees' pensions as well as for own future (private) pensions.

A later publication by the government's "Inquiry into Provision for Retirement" Committee, the White Paper "Programme for Action" (DHSS, 1985) concluded this brief coalition building phase. To account for the opposition by the Treasury – and by these private pension industry organizations – the Committee proposed a watered-down reform with a reduction in SERPS coverage, rather than its abolition.

The reform measures proposed by the White Paper were then implemented in the 1986 Social Security Act. This reform strongly re-shaped the mixed of private and public provision in the British pension system. The scope for public pension provision was

reduced, private pension plans were introduced and contracting-out towards occupational plans was made easier.

The reduction in the role of SERPS was achieved by decreasing the replacement rate from 25% to 20% of earnings, by increasing the year of calculation for the average wage, used in the pension benefit formula, from the best twenty years to the entire working history, and by reducing the survival pension benefit to 50% of the retiree's pension.

Regarding the occupational pension plans, requirements to contract-out of SERPS into occupational plans were weakened, as defined contribution (DC) plans were allowed, with a minimum requirement on contribution, but with no guarantee on the final pension benefits.

Private personal pension plans –provided by insurance and financial companies– were introduced with strong financial incentives, consisting of a 2% rebate, for individuals contracting-out from SERPS.

**Political Support for the 1986 Reform** The 1986 reform represented a complete change of direction in the UK pension policy. As shown in Figure 3.1, public pension spending in the UK had been constantly increasing, since WWII. The 1986 reform measures reduced public responsibility for retirement income, while increasing the scope for private and occupational pension plans.

Why did the Conservative government commit to retrench the public pension system? Unlike other countries, such as for instance Italy (see next section), the British system did not face immediate financial solvency or sustainability problems; yet the Conservative government decided to face the pension issue, by setting up a massive information campaign to increase awareness about the forecasted future cost of the public system, vis-à-vis population aging. Although some scholars (see Bonoli, 2000) have suggested that this political move was due to Mrs Thatcher government's underling ideology of limiting public intervention in the economy, other scholars (see Jessop et al, 1988) have instead argued in favour of the existence of a close link between this government economic policy and its electoral success.

Thatcherism –the set of economic policies aimed at decreasing State intervention– might have represented a political strategy. According to this view, the Conservative government proposed a set of policies –among them the 1986 pension reform– which was clearly targeted to high-income citizens. Poor individuals were not presented in the Conservative Party’s platform, perhaps because they were considered as ideologically opposed to the Party, and hence difficult to swing (see Persson and Tabellini, 2000, for a discussion of the relevance of the swing voters in a model with ideological voters).

The key political player in this Conservative strategy was the middle-class. The 1986 pension reform, and all other measures aimed at creating an economy with an “extended capitalism”, had to be beneficial to the middle-income voters. To the extent that the introduction of new instruments for retirement income, such as personal pension plans, and the provision of incentives for the existing ones, such as occupational plans, increased the middle-class economic well-being, this economic strategy would hence have attracted its votes.

This view is broadly in line with the data reported in Table 3.2 on the use of personal plans for individuals in different classes of income in 1996. Ten years after the reform, private pensions were not very relevant for 20% poorest retirees. However, they started to constitute a sizeable part of retirement income for individuals in the fourth quintiles, and, as expected, for the 20% richest retirees, for whom they constitute more than a third of their retirement income. Moreover, as shown at Table 3.1, the Conservative Party did not pay any electoral price to retrenching the welfare state, since the elections that took place in 1987 – the year after the pension reform – they obtained the same share of votes, 42.4%, as in 1983, although their seats in the Parliament went down from 396 to 375.

Another peculiar element of the 1986 British pension reform, as compared to the reform process in other European countries, is the almost complete absence of a coalition building phase. As argued above, the Conservative government was unwilling to compromise with other political or social players. The only criticism, which was incorporated in the implemented reform, was moved within the government by the Treasury.

**Table 3.2: Retirees' Income by Income Group and Composition**

Source	Quintiles				
	1	2	3	4	5
State Pension	71.31	59.89	50.05	38.80	23.37
Means-tested Benefits	9.40	13.48	19.90	11.26	5.49
Other Benefits	6.44	8.27	8.94	12.30	9.56
Private Pensions	7.97	13.41	15.05	26.61	38.11
Investment Earnings	3.84	3.57	3.74	6.72	13.24
	0.97	1.39	2.31	4.31	10.24

Source: Emmerson and Johnson (2001)

The Conservative Party's decision not to make any concessions to the demands by the social actors, such as employees' representative or unions, or by the political opposition, the Labour Party in the pension reform measures, was possible because of the relatively unchecked dominance of the ruling party in the British political system. As shown in Table 3.1, the Conservative Party enjoyed a large majority in the Parliament, thanks to the majoritarian electoral system; moreover, there no written constitution for the British Parliament to limit the scope of the government (see Bonoli, 2000). Hence, because of the institutional design of the British political system, no veto player existed in the political arena, with the notable exception of the members of the government, such as the Treasury.

The only relevant political check for the government was the political accountability at future elections. As argued above, this element was taken into account by the Conservative government, whose 1986 pension reform did in fact target middle-class (swing) voters. Moreover, the structural weakness of Labour Party reduced the political competition in the UK in the 1979-92 period, thereby providing more leeway to the Conservative Party policies.

### **3.3. Reforms in Italy**

The initial Italian compulsory social security scheme for private workers, which dates back to 1919, was a funded system, as revenues from social security contributions

were invested in government bonds, equities and real estate. As the World War II inflation wiped out the pension system's assets, the system became PAYG: workers' contributions were no longer accumulated into a fund, but they rather financed the pension benefits to the current elderly.

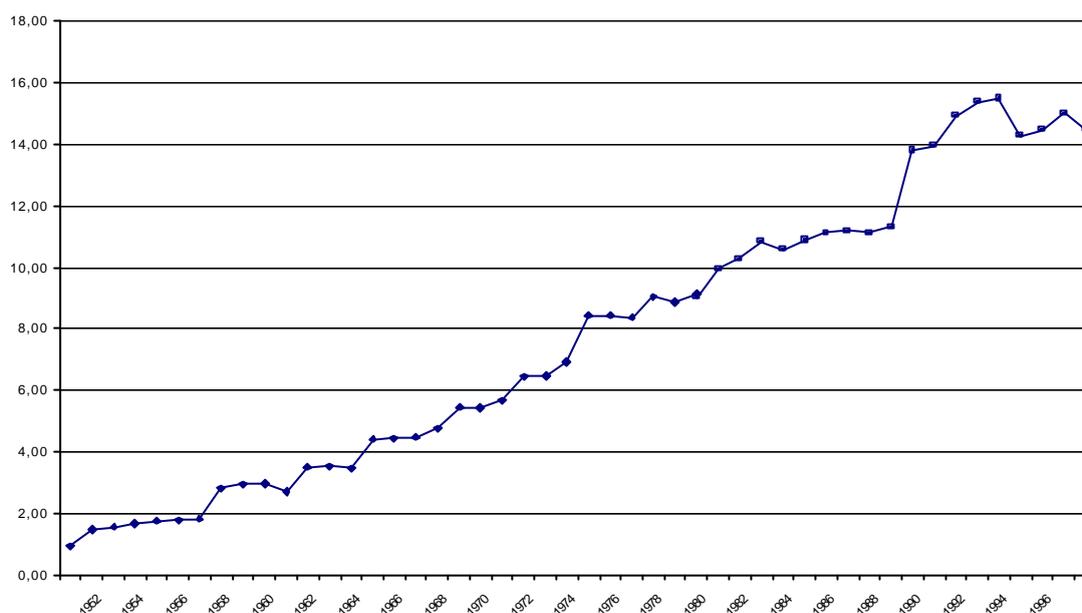
Throughout the mid-eighties, public pension expenditure raised consistently, from less than 1% of GDP in 1951 to above 10% in the mid-eighties (see Figure 3.2); while the fraction of elderly individuals (with more than 60 years) in the population moved from 12% in 1951 to 21% in the mid-eighties. This hike in pension spending was mainly due to an extension of the coverage to self-employed and work-disabled individuals, to relaxing eligibility criteria, and to an increase in the generosity of the pension benefits. Three types of pension benefits drove this expansion: early retirement (or seniority), non-contributive (social) and disability benefits. The early retirement provision, initially introduced in 1956, allowed generous pension benefits to be awarded after a small contributory period, regardless of the worker's age, and became a popular early pathway from the labour market in the late sixties, as labour market conditions worsened and several elderly workers were forced to retire early, in order to avoid unemployment. Non-contributive (or social) pensions and even disability benefits, which were not contingent on physical disability but on inability to earn income (see Franco, 1999), represented instead instruments of income support to elderly people in the poorer regions.

It is worth notice that this rapid increase in spending was not unique to the pension system; indeed the entire welfare state, with all its redistributive programs, as well as government consumption and public employment experienced a sustained growth after WWII. Several scholars have associated this characteristic policy-making by the Italian government with some institutional features of its political system. In particular, its high degree of party fragmentation (see Sartori, 1982) has often been blamed for producing weak coalition government unable to keep control of the spending.

During the 90s, Italy however experienced a season of pension reforms: three major reforms – representing a major breakthrough with respect to the past (see among others Peracchi and Rossi, 1996) – were approved in 1992 (Amato), 1995 (Dini) and 1997

(Prodi), which re-shaped the Italian system in an attempt to provide a progressive stabilization of the pension expenditure over the GDP, and hence to ensure the long run sustainability of the system, as well as its financial solvency in the short run. Moreover, in 1994 the Berlusconi government attempted another major pension reform, which was not implemented, due to the fierce opposition of the union and of other political forces.

**Figure 3.2: Social Security Expenditure over GDP in Italy**



In 1992, in the eve of the reform season, the Italian pension system was a generous, unfunded, defined benefits system. Despite a 26.4% payroll tax on labour earning – paid for a third by the employees and two thirds by the employer – the private employees’ scheme (called FPLD, “Fondo Pensioni Lavoratori Dipendenti”) featured a large deficit, which was financed through general taxation. Old-age pension spending was equal to almost 15% of GDP, while the share of elderly in the population was up to 25%. Mandatory retirement age, under the FPLD scheme, was 60 years for a male worker and 55 for females. Regardless of their age, workers were however eligible for a seniority pension, provided that they had at least 35 years worth of contributions.

The generosity of the Italian pension system was also due to the pension benefit formula, which allowed the pension to replace a large fraction of the worker’s final wage. Under the FPLD scheme, pension benefits were equal to the average wage received by the employee in the last five years prior to retirement multiplied by a 2%

rate of return per every year of contribution up forty years. A retiree with 35 years of contribution would hence receive 70% of her average wage. The existence of an early retirement provision allowing individuals to retire with 35 years of contributions, regardless of their age, and the common practice, in the private sector, of raising workers' wages prior to retirement in order to increase their average wage for the pension benefit calculation, contributed to the high level of the public pension spending.

**The 1992 Amato Reform**                      The Amato reform was named after that coalition government that in 1992 carried out the first reform of the Italian reform season of the 90s. This government, formed after the May 1992 elections – the last political elections to be carried out in Italy with a pure Proportional system – was supported by a coalition composed of four parties – PSI, DC, PSDI and PLI –and was led by a Socialist Prime Minister, Giuliano Amato.

The commitment building phase of this 1992 reform began already in February 1992 – even before the election that led to the Amato coalition government – when Italy, under the government led by the Christian Democrat Giulio Andreotti, decided to sign the Maastricht Treaty, and thereby committing to meet its requirements on inflation and public finances, namely on government deficit and public debt. Faced with these external constraints, upon forming his government, Amato asked the Parliament to be given large powers in order to reshape the public sector, and in particular the pensions system. In September 1992, Italy was hit by a major financial crisis, as the Lira came after speculative attacks and eventually had to devaluate and to exit the European Monetary System. After September 1992, the need of a pension reform became evident to a broad public opinion. The aim of the Amato reform was mainly to guarantee the financial solvency of the pension system in the short run and to stabilize the pension expenditure over the GDP, by introducing less generous criteria for computing pension benefits, and by restricting eligibility, in particular with respect to the retirement age.

The coalition building phase, which followed, was favoured by the wide recognition of these external constraints and by the compromising style of the Amato government (Ferrera and Gualmini, 2004, refer to this situation as to an emergency political

exchange). Indeed unions initially opposed any pension reform, although this behaviour partly changed, after the September 1992 financial crisis. Interestingly, union leaders were contested by the crowd in public occasions in September and October 92 for their willing to negotiate with the government. Amato's key move to obtain the unions' consensus was to design a long transition period for the reform. Existing pension claims of workers with more than 15 years of contributions in 1992 were not touched. The new rules entirely applied only to the newly hired, and in a pro-rata fashion to those workers with less than 15 years of contributions.

With this implementation, the Amato reform produced a gradual tightening of the eligibility requirements, over transition period estimated to last two or three decades. Retirement age was to increase to 60 years for women and 65 for men, and the years of contribution to be eligible for a pension to 20 years. The generosity of the pensions was reduced by modifying the pension benefits' calculation. The reference wage to be considered for this calculation was changed from the average wage over the 5 years prior to retirement to the average wage during the entire working carrier, with past earnings being capitalized at the cost of living index plus 1% per year. Although the replacement rate was not modified – remaining equal to the number of years of contribution multiplied by a 2% rate of return – the average pension decreased, due to a small average reference wage for the typical worker with the new calculation. Finally, pension benefits were automatically indexed to inflation rather than to nominal wages, although the government was allowed to adopt ad hoc intervention through the Budgetary Law. This probably represented the single most effective measure of the Amato reform in containing pension spending and a rather unique case of reduction in the pension benefits of *current* retirees. After this reform, pension benefits differed in real terms according to the year of retirement, and elderly individuals saw the purchasing power of their pensions to decrease over time, thereby raising equity concerns and pressure for redistribution (see Gronchi, 1998, Gronchi and Aprile, 1998, and Rostagno, 1996).

To explain the political support in favour – and the opposition to – this reform, it is useful to identify the effects of the reform measures on the economic well-being, as measured by the net pension wealth, of the agents – workers and retirees – covered by the social security system. The net pension wealth is defined as the discounted value of

the future pension benefits, which an individual is entitled to under the current legislation, minus the discounted value of her future contributions to the system. A reduction in the net pension wealth of an agent measures the costs of such reform to this individual. Beltrametti (1995 and 1996) estimated the variations in the individual net pension wealth by age induced by the Amato reform, as well as by the Dini reform and by the Berlusconi government's attempt.

According to these estimates, the Amato reform was sizeable, as it reduced the workers' net pension wealth by 52.9%. Both workers and retirees had to foot the bill of the adjustment towards a more financially balanced system, although in rather unequal share, since, as shown in Table 3.3, most of the reduction in the net pension wealth was sustained by the young cohorts – more than 100% for the individuals aged 30 years or less, and only less than 5% for the workers and retirees aged 60 years or more. The long transition period designed by Amato was hence crucial to limit the effect of the reform on the elderly workers and on the retirees, which constitute the unions' main constituency<sup>5</sup>, thereby reducing their opposition.

**Table 3.3:** The Effects of the Reforms on the Net Pension Wealth by Age

	Amato Reform <sup>a</sup>			Berlusconi Proposal <sup>a</sup>			Dini Reform <sup>a</sup>	
	Before	After	D	Before	After	D	After	D
<b>15-19</b>	28	- 31	- 59	-48	- 52	- 4	- 56	- 8
<b>20-24</b>	152	- 50	- 202	-101	- 116	- 15	- 128	- 27
<b>25-29</b>	276	- 43	- 319	-112	- 131	- 19	- 145	- 33
<b>30-34</b>	347	46	- 301	-20	- 56	- 36	- 63	- 43
<b>35-39</b>	415	198	- 217	139	71	- 68	99	- 40
<b>40-44</b>	504	282	- 222	227	174	- 53	227	0
<b>45-49</b>	497	349	- 148	306	251	- 55	306	0
<b>50-54</b>	533	441	- 92	402	338	- 64	402	0
<b>55-59</b>	394	360	- 34	339	238	- 101	339	0
<b>60-64</b>	183	177	- 6	168	160	- 8	168	0
<b>65+</b>	79	76	- 3	74	74	0	74	0
<b>Workers</b>	3.407	1.802	- 1.605	1.375	997	- 378	1.225	- 151
<b>Retirees</b>	2.660	2.527	- 133	2.710	2.710	0	2.710	0

Note: <sup>a</sup> in billion of Italian liras in 1992;  
Source: D'Amato and Galasso (2002)

<sup>5</sup> Brugiavini et al. (2001) provided supporting evidence in favor of the existence of a "seniority bias" in the union representatives' behavior in welfare state policy decisions, according to which union representatives tend to put more weight on the interest of the middle-aged and elderly workers.

**The failed 1994 Berlusconi Reform**

Since 1992, the Italian political system had undergone major changes, largely induced by the so-called “Clean Hands” operation led mainly by some Milan-based judges. These judges were persecuting high-profile businessmen and national politicians, because of the discovery of numerous and large bribes being paid by the former to the latter in order their companies to receive preferential treatment in public auctions. The extent of the phenomenon was so massive that a majority of the 1992 Parliament members were being investigated. Meanwhile, and partially as a response to this situation, two referenda had basically reshaped the Italian electoral system. In the next election, held in 1994, three quarters of the Parliament (Lower House) representatives were to be chosen with a majoritarian (one district) system and the remaining part with the previous proportional system.

In the May 1994, the centre-to-right coalition led by a media tycoon, Silvio Berlusconi – who had launched his own political party, Forza Italia – won the general elections. As shown in Table 3.4, the government formed by Berlusconi with its political allies – Alleanza Nazionale, Lega Nord and CCD – enjoyed a large majority in the Lower House. Berlusconi was hence leading a potentially strong, coalition government.

The pension reform’s commitment building stage for the Berlusconi government was again induced by external constraints. Despite the Amato reform in 1992, pension spending had not decreased; meanwhile there was mounting pressure on Italy from international bodies, such as the IMF, the World Bank and the European Commission, to adopt additional and deeper structural reforms in an attempt to satisfy the Maastricht requirements. Expectations in this direction by the international community for a government led by a businessman and with a former Italian central banker as Treasury Minister, Lamberto Dini, were particularly high.

Indeed, the pension reform plan presented by the Berlusconi government – the plan was mainly elaborated by the Treasury Minister, Lamberto Dini – aimed at a further sizeable decline in pension spending, although not as large as in the case of the previous (Amato) reform. The reduction of the net pension wealth of the workers was estimated to be around 27.5%, as opposed to 52.9% in the Amato reform. The spirit of the reform was to restrict eligibility, to reduce generosity and to provide incentives for private pension plans. In particular, the main measures were constituted by the

introduction, for the seniority pensions, of a penalty of 3% for every year before legal retirement age; the decrease of the survivors' benefits for high income recipients; the reduction in the replacement rate from 2% to 1.75% per year (for the workers who were not affected by the Amato reform); the equalization of treatments for private and public employees; the switch for all pensions to programmed inflation; and the introduction of incentives for private pension plans.

**Table 3.4:** Votes and Shares at the 1994 Elections (Lower House)

	Proportional		Majoritarian	Total
	Votes	Seats	Seats*	Seats*
<b>Alleanza Nazionale</b>	13.5%	23	86	109
<b>Forza Italia</b>	21.0%	30	67	97
<b>Legha Nord</b>	8.4%	11	111	122
<b>CCD</b>	--	--	32	32
<b>PSD</b>	20.4%	38	77	115
<b>PPI</b>	11.1%	29	4	33
<b>Rifondazione Comunista</b>	6.0%	11	29	40
<b>Green Party</b>	--	--	11	11
<b>Other (left)</b>	--	--	37	37
<b>Patto Segni</b>	4.7%	13	9	22
<b>Berlusconi Government</b>				360

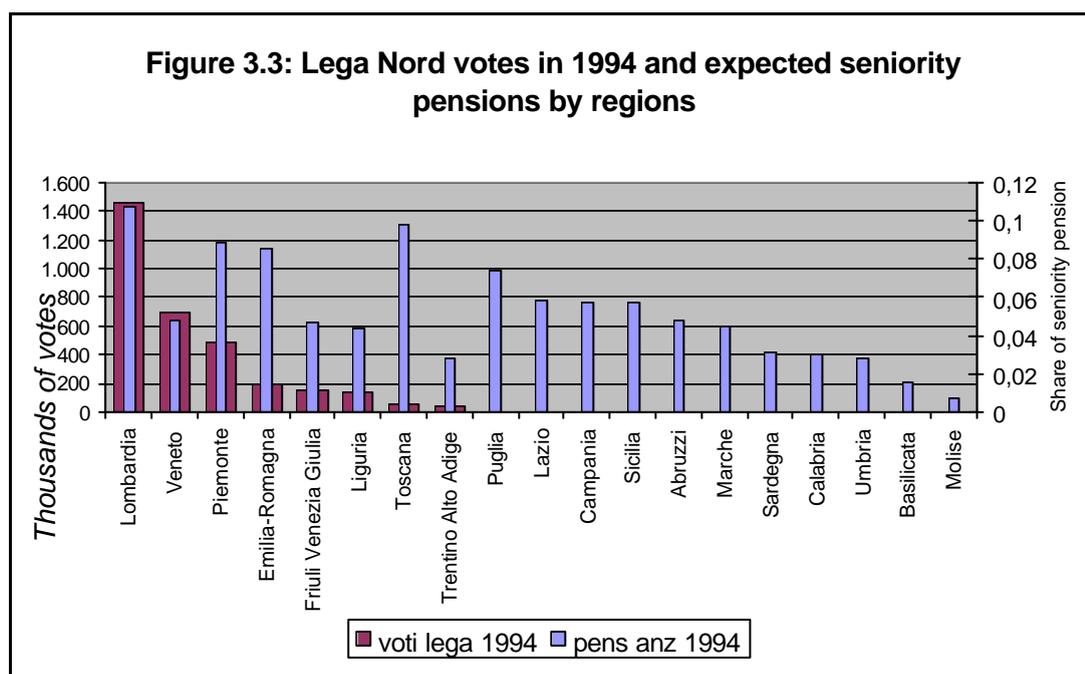
Note: \* Candidates that in the majoritarian districts were elected under the banners of Patto per l'Italia, Polo del Buon Governo, Polo della Libertà and Progressisti are imputed to the different parties.

Source: Cattaneo Institute.

This attempt to retrench the public pension system failed during the coalition building phase, due to the fierce opposition of two crucial veto players: the unions and Lega Nord, a party in the Berlusconi coalition government. Unlike the Amato government in the previous reform, the Berlusconi government decided not to negotiate the reform with the unions or with the opposition. The effects of this move – highly criticized by the Italian Republic President, Oscar Luigi Scalfaro – can be detected in the relatively

even split of the cost of the reform among the different generations chosen by the government. As shown in Table 3.3, middle-aged and elderly voters – those aged 50 years or more – constituting the unions' main constituency, were among those set to experience the largest reduction in net pension wealth. Massive strikes broke out on October 1994, with millions of citizens taking the streets; as the unions fought to protect the vested interests of their median aged members.

However, even more importantly to explaining the failure of the Berlusconi government pension reform attempt, one of the main parties in the government – Lega Nord – decided to renege on the reform, after having participated to its commitment building phase. The reasons for Lega Nord – a right wing party – to oppose the reform were not different from those of the unions, which are historically tied to the centre-to-left parties. Since one of the most relevant measures was to restrict eligibility, particularly for the seniority pensions, the reform was effectively reducing the pension claims of individuals located in the Northern regions, where these early retirement pensions are concentrated, and where the natural political constituency of Lega Nord is located, as shown in Figure 3.3, which displays expected share of seniority pension over the 1995-2005 periods and the number of voted for the Lega Nord by regions. Rather than being political accountable for the loss of the reform to its voters, Lega Nord preferred to abandon the Berlusconi government – a confidence vote was requested in accordance with the PDS – thereby blocking the pension reform.



**The 1995 Dini Reform** As Berlusconi resigned, a technical<sup>6</sup> caretaker government, led by the former Treasury Minister in the Berlusconi government, Lamberto Dini, was formed in January 1995. This government enjoyed the support in the Parliament by some of Progressisti (PDS, PPI, and other parties, but Rifondazione Comunista) and by Lega Nord, which had been elected in the centre-to-right coalition (see Table 3.4).

Unsurprisingly, the Dini government continued with the previous government commitment to reform the pension system –Dini was the Treasury Minister responsible for the reform plan in Berlusconi’s government– in an economic situation characterized by continuous devaluations of the lira. Dini did not renege on the urgency of a further pension reform, which actually represented one of the four institutional goals of its caretaker government; however, he moved to the coalition building phase with a different approach vis-à-vis the Berlusconi government.

Its compromising style resembled the successfully approach of Amato in 1992, and in fact, the unions agreed on negotiating with the new government. According to Ferrera and Gualmini (2004), unions were indeed keener on a government supported by a centre-to-left majority in the Parliament. Additionally, the economic constraints had become more binding, as the economic situation was worsening, as shown by the benchmark interest rate differential with Germany which started to increase.

However, the most relevant factor in obtaining the unions’ support as well as to persuade Lega Nord, which had previously opposed a pension reform, was the long transition period envisaged by the reform. Although the Dini measures were substantially different from the previous reforms, as they introduced a structural change in the Italian pension system, the same transition path as in the Amato reform was chosen. In 1992, workers with 15 years of contributions were shielded by the reform measures, which were then applied pro-rata to the other workers. In 1995, exemption was awarded to workers with 18 years of contributions. As displayed in Table 3.3, however, despite using the same cut-off as in 1992, in 1995 the split of the costs among the different generations was more uneven.

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<sup>6</sup> According to Ferrera and Gualmini (2004) a government is “technical”, as opposed to political, if almost all members are non-elected. They are typically chosen among professionals, in particular institutions, such as the Bank of Italy, and in the academia, because of their specific skills or knowledge, but have no marked political affiliation.

The Dini reform redesigned the architecture of the Italian pension system, which shifted from a defined benefit (DB) scheme to a notional defined contribution (NDC) system. The role of the state in the pension industry remained a dominant one. However, workers were not promised a given pension, almost independently of their previous contributions; on the contrary, with this NDC scheme, individual pension benefits were entirely linked to the worker's lifetime contributions. These contributions were capitalized at an interest rate equal to the average nominal GDP growth, and – once at retirement – the capitalized contributions were transformed into an annuity through a conversion coefficient, which depends negatively on the expected life at retirement and positively on the actual retirement age. Within this NDC context, seniority pensions – whose eligibility was exclusively based on having reached a minimum contribution period, regardless of the worker's age – were eliminated, and more flexibility was provided on the retirement decision, with individuals allowed to retire between 57 and 65 years old, but with pension benefits being reduced accordingly<sup>7</sup>.

Interestingly, the most highly criticized feature of this reform has been the long length of the transition to a new regime entirely shaped by the Dini reform. Several scholars – see Franco (2000) and references therein – have argued that the transition from the pre-1992 to the new regime has been and will continue to be too slow and gradual, thereby inducing only a slow improvement in the financial sustainability of the system, while violating a simple notion of intergenerational equity, since the burden of the transition is mainly postponed onto the younger generations of workers.

Yet this highly controversial measure – both an equity and efficiency ground – represented the key modification in the reform package, with respect to the Berlusconi plan, allowing to gather the necessary political support for reforming the system. Indeed, the Dini reform was also milder, with a reduction in the net pension wealth of the workers of only 11%. However, as suggested by the estimates in Table 3.3, the political success of this reform, as opposed to the Berlusconi's attempt, is mainly due to its placing the costs of the reforms onto the young generations of workers. With a majority of the voting population in 1995 being older than 44 years<sup>8</sup>, the Dini reform

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<sup>7</sup> A full description of the Dini reform measures and an evaluation of its effects is in Brugiavini and Galasso (2004).

<sup>8</sup> See D'Amato and Galasso (2002) for a quantitative appraisal of the effects of population aging on the political representation and hence on the long term political sustainability of the pension system in Italy.

did not touch the vested interests of a majority of voters – workers and retirees. To these middle-aged and elderly individuals, the reform was costless, while ensuring the short run financial solvency of the system, and hence the payment of their accrued pension benefits. Similarly, this reform package did not limit the right to a seniority pension of the current middle-aged and elderly workers, thereby avoiding the opposition by Lega Nord, as well as by the unions.

### **3.4. Conclusions**

Italy, in the 90s, and the UK, in 1986, were able to implement major reforms aimed at retrenching their pension systems. In both countries, these reforms represented a major break with a history of growing pension spending, as displayed in Figures 3.1 and 3.2, and set two – rather different – examples of how political support for unpopular reforms may be obtained.

The Italian reform season of the 90s was triggered by external constraints – the requirements on inflation and public finance aggregates imposed by the Maastricht Treaty and a large speculative attack on the Italian Lira in September 1992 – which imposed the downsizing of a large and generous public pension system in the absence of alternative private scheme for retirement income.

Despite the institutional charges experienced during the 90s – the Italian electoral system was purely proportional in 1992, but become mainly majoritarian in 1994 – Italy can be described as a consensus democracy (see Lijphart, 1999), characterized by unstable coalition governments and with strong unions. In this institutional context, successful reforms had to be agreed upon by a large majority of electorate and to be negotiated with the institutional and de-facto veto players. The experience of the Amato and Dini reforms showed that a consensus for retrenching the system was possible if the negative impact of the reform on current relevant political actors – the elderly workers and the retirees – was minimized. However, the packaging of political sustainable reforms in Italy involved large efficiency and equity losses. Because of the long transition, the new role of the State in the pension industry, as characterized by the NDC scheme, will not be entirely phased in until 2030.

The motivation for the 1986 British reform can hardly be found outside the political arena. Despite the information released by the government on the forecasted costs of the public pension system, due to population aging, the British public pension system was relatively small – by European standards – and coupled by a widespread second pillar, composed of occupational plans. According to several scholars, the ideological and electoral push of the Conservative government – and its desire to take on unions – was the main trigger for retrenching the public pension system, while increasing the scope for private intervention in the pension industry. The strong, majoritarian government led by Mrs Thatcher chose a rather uncompromising style with the other political actors, but had to back up from the original plan of scrapping SERPS – thereby eliminating the role of the state from the earning-related part of the pension – because of the opposition from within the government by the Treasury, concerned with the initial financial cost of the reform.

Interestingly, the Conservative government did not face the typical trade-off between strong political power in the Parliament and large political accountability towards the electors. In fact, despite the decision of imposing, with the brute force of its large majority in the Parliament, a typically unpopular reform, the Conservative Party did not pay an electoral price. Due to a weak Labour Party and to an effort in the reform to target the more mobile voters – the middle-class – by providing them the access to a new saving instrument – the private pension plans – the Conservative Party won the 1987 general election, obtaining the same share of votes, yet not of seats in the Lower House, as in the 1983 election.

## Chapter 4

# Labour Market Reforms: The Political Economy of Workers' Security Systems in Denmark and Spain

### 4.1. Introduction

This chapter focuses on labour market reforms and shows that, in contrast with some of the conclusions we could draw from pension reforms, deep-reaching reforms need not require strong majoritarian political systems to be successful. To the contrary, Spain and Denmark exemplify the key role played by social dialogue in promoting such reforms. In both countries, numerous organizations have the potential to veto reforms. However, precisely for that reason, reforms were drafted consensually, with the help of social partners (employers' and workers' unions). Most of the reforms engineered in this way managed to attract much wider political support than those unilaterally imposed by the government. Admittedly, the process of reform cannot always generate such a consensus. In Spain, for instance, some stages of the reform were imposed by governments with a strong majority in parliament. Yet, the core of the reforms would not –and could not– have been implemented without the promotion of social dialogue. Similarly, political representation in Denmark is highly proportional. But Denmark benefits from a long tradition of social dialogue. Like in Spain, most reforms –even those imposing stronger flexibility on the labour market– could not have been implemented without the support of social partners.

We analyze reforms in these two countries to illustrate that, if the timing of reforms is appropriate, and if the proposed reform is “balanced” in such a way that it takes care of the main actors' key interests, social dialogue can be a key success factor for unpopular reforms. Again, the process of reform cannot always generate such a consensus; vested interests may prove an obstacle for reforms, since consensus between conflicting parties is required. If social *conflicts* come to replace such a social *dialogue* in which social actors genuinely look for a consensus, reforms can prove impossible to pass. That conflict/dialogue dimension alone may thus explain why some countries (such as Spain and Denmark) managed to pass deep-reaching reforms, where

other European countries (such as France) failed. This focus also has policy implications: to improve its capacity to reform its labour market, a country like France may find it easier to modify the way in which social bargaining takes place rather than follow the example of Italy and reduce the proportionality of its representation system. Thus, responses need not be uniform across EU countries.

The chapter is organized as follows. In section 4.2, we review that of the Danish unemployment insurance system; and in section 4.3 that of the Spanish employment protection system. Section 4.4 then synthesizes facilitating and hindering factors for the reform of workers' security system in some European countries. Section 4.5 concludes, with an attempt to draw some lessons for the reform process that is resuming in Spain, but also for the reform process currently initiated in France.

#### **4.2. The 1994-1999 reform of the unemployment insurance in Denmark**

The Danish case exemplifies the so-called “flexicurity” model: strong employment flexibility of long-term jobs but also strong revenue security. Since 1994, this model has undergone a serious reform including complementary elements of social disciplining (cuts of benefits) and social integration (activation of benefits). This reform was challenging since the generosity of the unemployment insurance scheme was considered as the counterpart of employment flexibility.

##### **Historical background on the Danish political and social systems**

The Danish government generally represents a coalition between minority parties. Seats at the Danish parliament are allocated to the parties on the basis of proportional representation, so that the constitution of the “Folketing” closely reflects the diversity of political preferences of the population. Elections take place every four years, although the Prime Minister may dissolve the parliament earlier. Indeed, no single party has had a majority in the “Folketing” since 1909. In most legislatures, centrist parties –especially The Social Liberal Party, but also The Centre Party and The Christian People’s Party– have determined which side was able to form a majority in the Folketing and therefore which party was in power. But governments have been

able to collaborate with both sides of the parliament thanks to the Danish tradition of compromise and consensus.

This tradition is also present among social partners, and the relative instability of coalitions is compensated by their high representativeness. The foundation of social dialogue institutions in Denmark dates back to the late nineteenth century. The industrial Danish Federation of Trade Unions (LO) was founded in 1896, and the Danish Federation of Employers (DA) was established in 1898. The organization of white collars is more recent with the Central Confederation of Salaried Employees (FTF) founded in 1952 and the Central Confederation of Professional Associations (AC) founded in 1972. The labour market organizations have early been in charge of diverse matters such as the work organization, working hours, minimum wage levels (Jorgensen, 2003). Moreover, unemployed workers keep belonging to their original trade union, which enlarges the scope of interest of these organizations (that is why trade union membership peaked at 84% of workers after the recession, in 1995).

The tradition has always been one of stable collective agreements, with the possibility for collective actors to locally adapt rules to circumstances and to the specificities of each branch. Collective agreements are submitted to the vote of members, which gives them some sort of democratic support. Governments rarely interact in a direct way to influence the social dialogue, although contacts between labour market organizations and the political parties are frequent. One consequence is that some workers may not be covered by collective agreements (some 25% of the active population in the late 1990's). Another consequence is that open conflicts between the government and the labour market organizations can happen, such as in 2001 (see *infra*). But overall, compared to other (South) European countries the system of trade unions in Denmark is both highly representative and unitary, with a strong tradition of social dialogue and a strong ability to coordinate at all the levels.

**The Danish system of flexicurity before the 1994 reform**      The OECD (1999) ranks Denmark as one of the more flexible countries in terms of employment protection, close to the UK or the US. In Denmark, economic reasons can easily be invoked for layoff without considerations of age, social condition or tenure. Moreover, employers experience no compulsory training expenses under this motive. Like in the

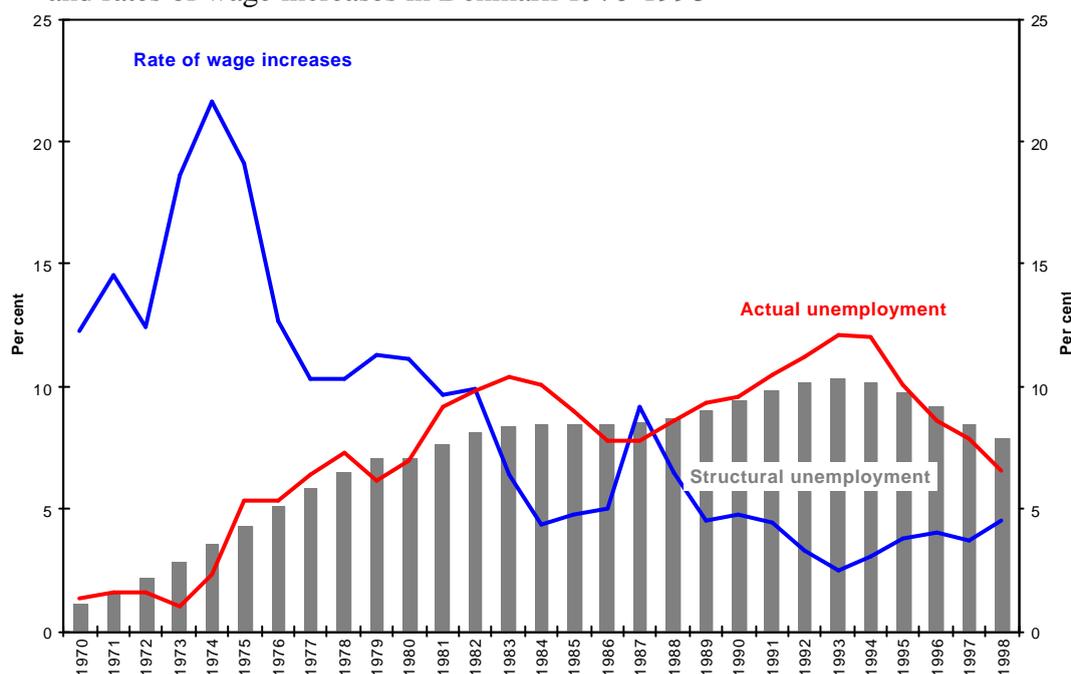
US there is not any general legal provision protecting from unfair dismissal and guaranteeing minimum compensations in that case. Moreover, the legal layoff compensations are minimal: none before 12 years of tenure, and peaking at three months after 18 years of tenure. This framework results into a very small number of trials for unfair dismissal (0.004% of employees, compared to 0.5% in France for instance). These dispositions were left unchanged after the 1994-1999 reform.

This flexibility on the employment side was balanced by a very strong protection on the unemployment side. Before 1994, unemployment benefits could run up to nine years. Training periods and subsidized job offers were usually not proposed before the end of a first period of 2.5 years, and if they were accepted by the unemployed workers, these programmes used to renew the rights for benefits. Moreover, these benefits represented (and still represent) 90% of the previous wage –with a ceiling at approximately 1500 euros per month. This is one of the most generous unemployment insurance schemes among OECD countries, especially for the low paid workers. These rights were opened after a period of contribution of only 26 weeks, which is also very low compared to European standards.

This institutional framework created a strong *constituency effect*, as defined by Saint-Paul (2002): the flexibility of employment was accepted by social partners *because* the unemployment period support was strong and highly mutualised. On one side, employees accept to lose their jobs with little recourse possibilities because they know they would be supported by the unemployment insurance system, and also because this does not mean they would lose any social right (in Denmark, the social security system is financed by the State budget in Denmark, and most of rights are not conditional on the work status). Moreover, trade unions encompass employed and unemployed members. Consequently, they do not only defend the position of employees, nor do they fear to lose members when jobs are destroyed. On the other side, employers do not finance the social cost of the job turnover by themselves. The unemployment system allows them to recruit workers easily, even for short periods, and adjust their workforce in line with the evolution of demand. One could add that the system is not always balanced financially, and the State often has to top up the deficit of unemployment insurance.

**The economic situation of Denmark on the eve of the 1994-1999 reform.** Denmark experienced a trough in the beginning of the 1990's and the economy did not significantly bounce back before the 1994. In 1993 the real GDP increased by only 0.8%. Consequently, the unemployment rate reached a high at 12% and would not start a significant decrease before 1995 (see Figure 4.1), which jeopardized the insurance scheme designed in times of low unemployment.

**Figure 4.1:** Developments in unemployment, structural unemployment and rates of wage increases in Denmark 1970-1998

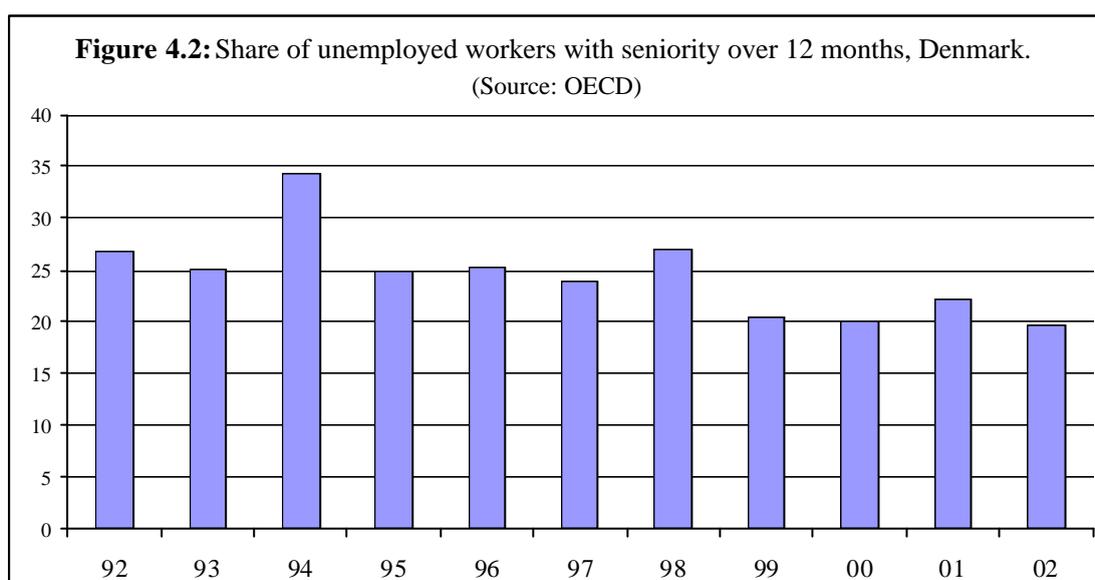


Source: OECD

So, at the time when a consensus was being built for the reform of the unemployment insurance scheme, unemployment was peaking (which means that the population exposed to the reform was largest) and some of the workers still employed were unsure about the future of their job, since the recovery had not started yet. As such, the Danish reform was designed and discussed at a difficult a time and may have turned out much harder to achieve if the social partners did not have a strong consensus ability.

On the other hand, this crisis seems to have stimulated, rather than hindered, the reform momentum. The strong pressure exerted by financial constraints helped the actors reach an agreement on the necessity to reform the scheme and to introduce more financial discipline. But the consensus was also built on the need for more social

integration because the unemployment policy (the unemployment insurance but also the ALMPs) turned out to be ineffective in preventing the rise of long-term unemployment and inactivity (see Figure 4.2). Indeed, the reform was a mix of social discipline (but without altering the level of benefits) and social integration efforts. As such, it also tackled the integration of the long-term unemployed both through financial incentives and active labour market policies. The latter aspect of the reform actually responded to the increased uncertainty for the unemployed.



### **The successful 1994-1999 reform**

The Social-Democratic party took office in 1993 in Denmark and soon started a conciliation phase on the reform of the unemployment benefit system, based on the 1992-report of the “Zeuthen commission”. The main statement was the relative inefficiency of the system, which relied too much on benefits and lacked active policies components. As a result, the system could not prevent the creation of long-term unemployment while many job offers were left vacant. Indeed, before 1993 the activation policies (placement in training programs, short term employment offers, etc.) were offered at pre-determined times during the unemployment period, and just before the end of the initial period of eligibility, which would open a new period of rights. As a consequence, these activation policies were used as a way to extend the initial benefit periods up to nine years.

The first phase of the reform took effect on January 1<sup>st</sup>, 1994, while the unemployment rate was peaking at 12.5%, but also with first signs of recovery from the strong

recession of the early 1990's. This phase relied on three principles: (1) the stress put on individual and regional labour market needs, (2) the regional implementation of labour market policies according to objectives designed at the national level, (3) the participation of labour market organizations to the implementation of policies at the regional level. Moreover and importantly, the participation in activation policies would not open rights for new benefits. The "National Labour Market Council," which is a tripartite council composed of representatives of the social partners and regional authorities, along with the Ministry of Labour, defines the objectives, manages, and administers the activation labour market programmes. Regional Labour Market councils were also set up at the regional level.

Over the 1994-1999 period, the maximum duration of benefits was reduced from nine to four years, and a "duty" of activation was introduced after one year (even six months if under 25), while the level of benefits remained unchanged. The minimum period of contribution was increased from 26 to 52 weeks (6 months for workers less than 25). Besides, training, sabbatical and parental leaves were introduced in order to promote job rotation between unemployed and employed people.

Within the same framework, in 1995 a reshuffling of the initial phase reduced the duration of the insurance to a maximum of seven years, and tightened the obligations of the unemployed: the participation in activation programmes became compulsory (with the threat of cutting benefits in case of refusal). Then in 1996, the second phase started; the compulsory activation phase was advanced to two years after the beginning of the unemployment period (6 months for people under the age of 25 and with no diplomas), the reduction in the maximum duration of benefits was cut down to a maximum of five years including activation programmes. Eventually, in 1999 a third round of measures further advanced the activation phase to one year after the beginning of the unemployment registration, while the maximum duration of benefits went down to four years (3.5 years for anybody under 25), including activation.

Overall, the Danish experience is one example of social disciplining and social integration efforts (Larsen, 2004) jointly decided and implemented by the social partners (from initial commitment through to final agreement). It was a challenging

reform that transformed a generous but passive unemployment insurance scheme into an active device targeted at the least employable workers.

**The 2001-2004 failed reform.** This capacity of reform meets some limits when the conciliation phase is overlooked and its content alters part of the social pact. In 2001, the newly elected Conservative government (Conservative Party and Liberal Party) unilaterally proposed a relatively “targeted” reform of the unemployment insurance system, to cut about 110 million of expenses. Originally, the Minister of Employment outlined four proposals: (1) reduce the eligibility threshold so that only people working less than 21 hours a week (instead of 28) would be entitled to benefits; (2) temporary agency workers, casual workers and freelance workers should no longer receive extra benefits on a permanent basis and a maximum of 52 weeks’ benefit should apply to all employees; (3) employees with a monthly wage over €3360 should wait some time before receiving their first benefit; (4) the rate of benefit should be based on the average salary over the past six months instead of the original three months (in order to stimulate long-term employment relationships).

The employers’ organization stated that measures (1) and (2) would significantly reduce the flexibility of employment (part-time work), and would be critical in building and industrial industries. The Danish People Party (supporting the coalition) was also sceptical about this set of reforms. As a result, the government withdrew proposals (1) and (2), but also proposed to consider the average salary over 12 months instead of three in the measure (4). Also this revised proposal met strong opposition from the employers’ organization, and from two of the three main unions who joined their forces (LO and FTF). The former said this would not promote flexibility while the later stated the change would be detrimental to the philosophy of the insurance system. Eventually, this resulted in the withdrawal of the whole project. Indeed, the collective agreements contained a clause for renegotiation in case the government changes the rules for unemployment benefit (Larsen, 2004).

In 2004, the coalition tried once again to propose cuts in the benefit system, arguing some abuse should be removed.<sup>9</sup> The stress was put this time on supplementary

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<sup>9</sup> Employers and employees would collude in order to take benefit of a system based on revenue taxes (not on wages taxes). In that case potential inefficiency comes from the fact that not only employers do

benefits in case of temporary layoffs, and on the level of insurance for high-paid workers. Again the centre-right minority government had to withdraw the proposals in face of a threat of breaking the upcoming collective bargaining round. Interestingly, the unions threatened to retrieve the possibility of temporary layoff from collective agreements if these measures were passed, which exemplifies the compensatory nature of the unemployment scheme with respect to flexibility, as well as the importance of the coalition phase and the existence of accompanying balancing measures that reinforce the employability of workers.

### **4.3. The 1994-2001 reforms of the employment protection system in Spain**

Compared to Denmark, the Spanish labour market can be considered at the other end of the flexicurity scale: strong employment protection of long-term jobs and relatively weak revenue security (low unemployment benefits and high proportion of short-term jobs). In 1997, the security on long-term jobs was reduced through the introduction of a new type of contract. Again, this reform was difficult to support given the importance of job security for the core of long-term workers in the absence of revenue security outside employment. The negotiations that took place in Spain at that time and later illustrate the re-emergence of social pacts in some of European countries.

**Historical background on the Spanish political system and social dialogue.** The trade union movement in Spain is dominated by UGT (Workers' General Union) and CC.OO. (Workers' Commissions), which have represented a majority of workers (more than 75% with a coverage rate over 80%) since the end of the Franco era in 1975 (Perez-Yruela, 1997). Smaller unions exist but represent a small minority of workers. The UGT was founded in 1888 and maintained, through to 1986, a close relationship with the PSOE (the Spanish Socialist Workers Party). CC.OO.'s origins are to be found in the Franco period when workers created committees to bargain at the workplace level. But these committees had to be dissolved after each bargaining exercise and were not officially recognized. The PCE (the Spanish Communist Party) managed to take control of these committees and the CC.OO. has had close

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not contribute proportionally to their firing behaviour, but also none of labour market actors have to pay directly for the insurance benefits.

relationships with this party until recently. CC.OO. was originally in favour of a unique trade union during the political transition phase (1975-1978) but UGT leaders opposed this proposal. The discussions led to a tradition of joint action between the two unions, although confrontations are not infrequent. This conciliation tradition is reinforced by the fact that not all unions have the right to negotiate at the national level. In Spain, unions get the statute of “more representative union,” which gives recognized negotiating power if they get more than 10% of elected delegates at the national level or 15% at the regional level. Unions receive funds from the state budget on the basis of these performances.

During the political transition and just after unions had to strengthen their positions and political recognition. This created the conditions for the emergence of social dialogue and centralized action strategy involving numerous contacts between governments and employers’ organizations. But the relationship between the UGT and the PSOE deteriorated after the PSOE government’s passed ‘en force’ a social security reform in 1985, and all formal ties were cut after 1989. The relations between the government and unions were tensed from 1986 through to 1993, with a general strike in 1988 against the PSOE Plan for Youth Employment.

But at the beginning of the 1990’s the Economic and Social Council was created to organize the social dialogue at the national level between workers’ unions and the employers’ organizations (CEOE, and CEPYME for small and medium companies). The government wanted to promote social bargaining so that social pacts could emerge, to help moderate wages and lower inflation (in line with EMU convergence criteria). The unions, losing ground at the firm level, reinitiated the dialogue at the national level, partly to avoid being excluded from major reforms. So, since the mid-1990s, unions have followed a pragmatic approach with employers and governments, despite ideological differences, and behaved with more autonomy than in the 1980’s (Hamann 2001). They also keep a strong veto power through the ability to organize national strikes and force negotiation when the government wants to impose its reforms (like the general strike of 2002 against the reform of the unemployment insurance introducing the possibility of cutting benefits if a “suitable” job is refused).

The character of the electoral and party system also affects the way unions influence politics. Lobbying of individual legislators occurs where they represent individual districts or constituencies such as in the English-American tradition. In Spain this is not the case (the electoral system is proportional and quite complex with multimember districts) and parliamentary party groups are very organized and disciplined, which renders parliamentary lobbying more difficult to achieve (Hamann and Kelly, 2003).

The strategic choices of party leaders are also central in explaining the re-emergence of the social dialogue in Spain. As such, Aznar's initiative to launch a social pact negotiation round in 1996 was partly motivated by the desire to build the image of a new Conservative party that can promote the social dialogue. However, this desire is also influenced by the political support received by the government. The first Aznar government was in coalition. As such, the first reform had in some way to rely on consensus and, indeed, the 1997 laws that formalized the accord were approved by a very large majority. The unions might have also feared that, after the 1996 general election, the newly elected conservative party would undergo a more radical reform of the employment protection system, and thus accepted some compromises in order to limit the extent of the reform regarding permanent jobs. But, on that basis, in 2000 Aznar's Popular Party received full support from a majority of the voters, and then tried to impose the 2001 reform without compromise. This led to a national strike and the government had to step back on many aspect of the reform (see *infra*).

**The Spanish system of workers' protection before the 1994 reform.** Spanish permanent jobs used to be among the best protected in Europe before the 1994 reform. Severance payments were offering 45 days per year of tenure, with a ceiling at 42 months; that is 3.5 years of pay in case of unfair individual dismissal. Even after the 1994-1997 reforms the OECD (1999) kept ranking Spain among the more inflexible countries relative to employment protection laws.

This regulation was balanced in 1984 by a reform that liberalized the recourse conditions of temporary contracts. Temporary contracts could be created with a term up to three years, well above the limits imposed on such contracts by most European countries. Little or no termination compensation was offered to workers, and the law created so many opportunities for the opening of temporary contracts that actually

there was no need for the job to be temporary by nature anymore. As a result, the stock of temporary contracts boomed from 11% to 33% and in 1997 they represented 96% of the annual job creation flows.

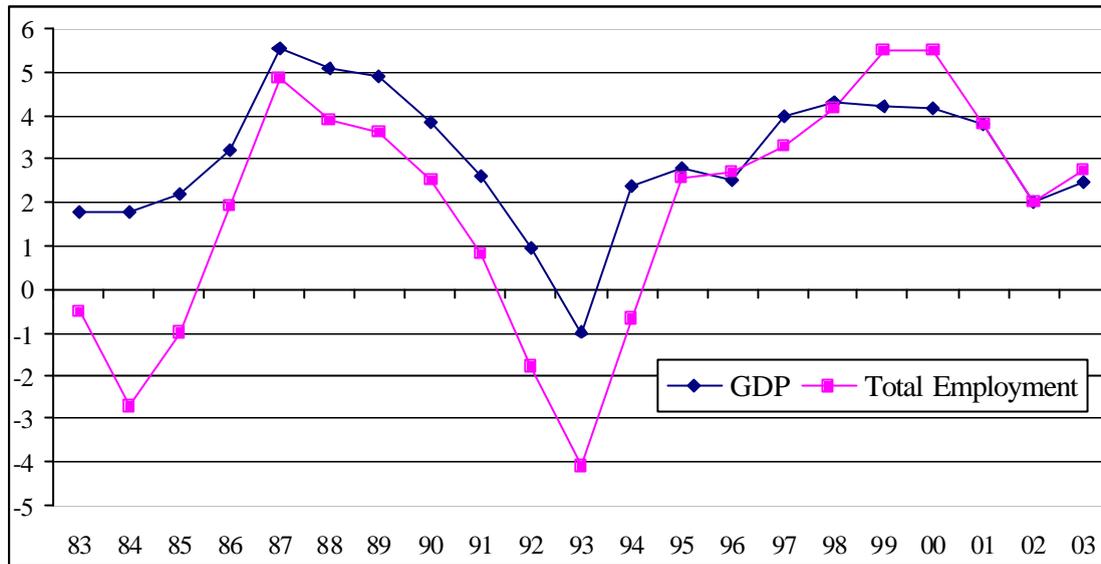
On the unemployment insurance side, the Spanish coverage is quite low compared to other European Countries. With a maximum duration of 24 months, benefits represent 70% of the last wage, and decrease to 60% after 6 months. Moreover, the minimum period of contribution is 12 months over the last 6 years and this only opens a period of 4 months of benefits. To open 12 months of benefits, a worker must have contributed 3 to 3.5 years. The ceiling is 1.75 (2.2) times the minimum wage for a person without (with two or more) children, which is well under the ceiling in France for instance (more than 4 times the minimum wage, not conditional on the number of children). Consequently, many workers, especially those with short-term employment, are not so much protected by the existing system, unlike long-term employees.

This system is quite consistent because permanent workers, who represent two thirds of the employees, and almost all union members, oppose resistance to any change in their protection given the level of assistance provided to the unemployed. Besides, strangely enough the feeling of insecurity of permanent workers is also fed by the observation they make of the instability of work among temporary workers (Postel-Vinay and Saint-Martin 2003). And this dualism was precisely generated by employment protection laws.

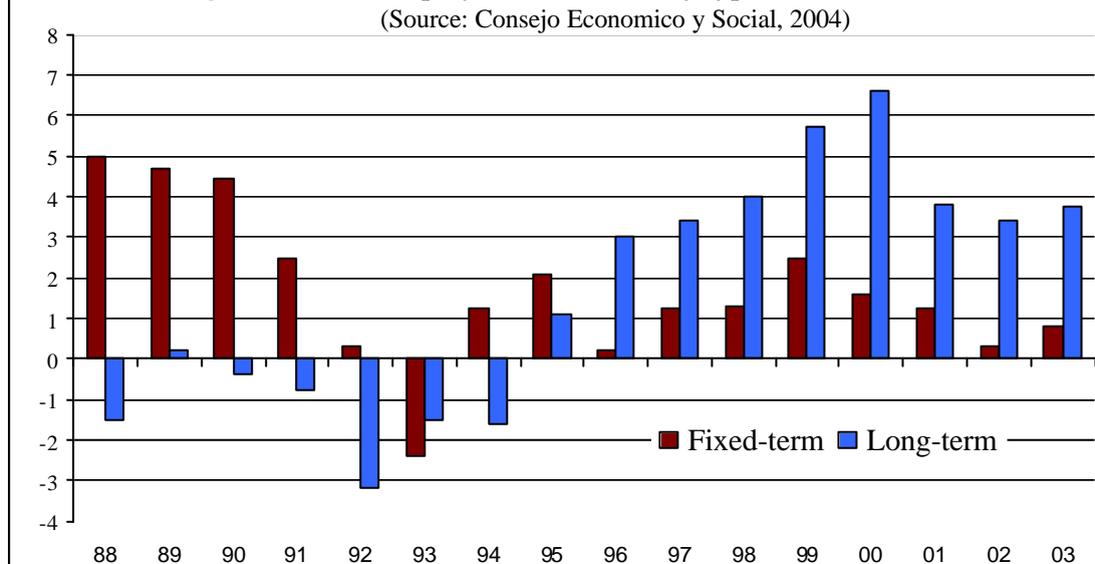
**The timing of the 1994 and 1997 reforms.** In 1992-1994 Spain, like other European countries experienced a serious trough. In 1993 the GDP actually decreased by 1% and total employment by 4% (See Figure 4.3). The 1994 reform, which reduced the cost laying off permanent workers could not receive strong support from trade unions in such a situation. Trade unions in Spain, unlike Danish ones, do not encompass unemployed workers, and not even all workers, as most members are permanent workers. As such, the 1993-trough witnessed a reduction in permanent jobs, so that the core of union members was threatened by massive dismissals (see Figure 4.4). Besides, in 1994, economic uncertainty was still high, while net permanent employment was decreasing again, and this could explain why workers might have felt

threatened by a reform that would even more jeopardize their jobs.

**Figure 4.3: GDP and total employment changes (%) in Spain (Source : INEM)**



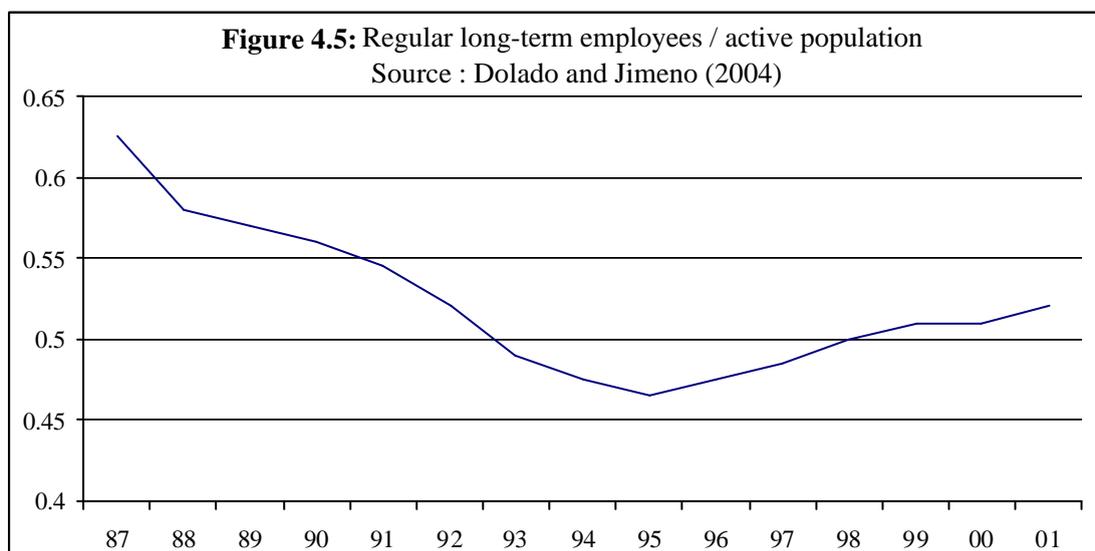
**Figure 4.4: Net employment variation by type of contract (thousands) (Source: Consejo Economico y Social, 2004)**



On this respect, the 1997 reform took place in a very different context. Permanent employment had bounced back, with a GDP growth rate around 3%. This was lower than in the late 1980's, but the economy was clearly recovering, and there was no immediate "threat". The stock of permanent jobs had been cut by 0.8 to 3% in the 1992-1994 period. Net permanent job creations had been large since 1996, partly due to the recovery of the economy and, arguably, partly as a result of the 1994 reform. But still, temporary jobs had peaked at 35% of the employment stock in 1995 and were standing as high as 33% in 1997. So it seems that all economic conditions for a reform

were present: there was a national consensus over the necessity to reduce the share of temporary jobs in the economy, less uncertainty about the future (what Saint-Paul (2002) call the “identifiable effect”), fewer employees were exposed to the immediate impact of such a reform (the “exposure effect”), and the 1994 reform had had some positive impact but obviously did not go far enough (incremental reform process).

But if the timing of the 1994 reform was less favourable than the timing of the 1997 reform, why did not unions strongly oppose the government at that time? One rationalization of this is proposed by Dolado and Jimeno (2004) who investigate the evolution of the ratio of regular permanent employees relative to the active population (Figure 4.5). They assume that unions try to maximize the utility of the median voter in the labour market; its electoral basis being not only permanent workers but also all actual and potential workers. A value above 0.5 indicates that the regular employee represents a median-voter who is an insider. On the contrary, a value below 0.5 means that other workers (temporary, unemployed, or helped permanent workers) can become more important in the union’s objective function. As such, the 1993-1998 period features a ratio lower than 0.5, which can explain why unions might, at that time, have favoured reforms that could enhance the probability for workers to get a permanent job, even though this might mean lower job security for the incumbents.



**The 1994 reform** Initiated by the Socialist government, the *reforma laboral* is the first extensive and deep-reaching reform of labour legislation that took place in Spain around 1994. This reform saw the amendment of many of the precepts

of major labour laws, in particular the Workers' Statute; the rules of which were inherited from the Franco era. But most of all, it is the first attempt to change the system of workers' protection in Spain, acknowledging that with over 33% of workers under fixed-term contracts and over 20% of unemployment, the Spanish strategy for (no) flexibility might not be efficient. So, beside revising numerous regulations like special working hours and laying the foundations for the revised regulation of the collective bargaining system, the reform restricted the conditions of use of temporary contracts to temporary causes, and re-targeted the "employment promotion" fixed-term contracts to the hard-to-place workers. Besides, it reduced the costs of individual dismissal through a restriction of the cases in which back pay is due to workers from the moment they appeal the decision before courts, and it relaxed slightly the rules governing collective dismissal with payments down to of 20 days' pay for each year of service. But unlike the 1997 reform, these measures were approved by the parliament amidst great protest from the unions.

With regard to temporary employment, this reform seemed to have little or no impact on the stability of employment, since the share of short-term contract in the economy reached a peak at 35% in 1995. Obviously the reform which restricted the condition of use of short-term contracts without the means to enforce it did not significantly increase the relative cost of temporary jobs relative to permanent jobs, so the 1997 reform had to tackle the problem the other way around.

**The 1997 reform**                      The 1997 reform was initiated after a long round of negotiation initiated by the Conservative government elected in 1996. At that time the unemployment rate stood at a high 21.5%, and 34% of jobs were temporary. Only 4% of the contracts signed over one year were long-term jobs.

After months of negotiations, the social partners signed three cross-sectoral agreements that dealt with problems remained unsolved by the 1994 reform: "For the employment stability," reforming employment protection system and ratified as Acts by the Spanish Parliament the same year, but also "On collective bargaining" and "On filling the gaps in regulation" which participated to the final agreement by the trade unions and balanced their interest in the reform.

The main goal of the 1997 reform was shared by all actors and consisted into promoting permanent employment and reduce employment insecurity. The so-called “permanent employment promotion contract” was initially introduced for a period of four years and targeted at young (under 30), and older (above 45) unemployed as well as temporary workers whose contract is transformed into a permanent one. It differs from the common permanent contract in that compensation in case of unfair individual layoff and social charges are reduced. When an individual dismissal or multiple individual dismissals for objective reasons (not a collective dismissal or a dismissal for disciplinary reasons) are ruled to be unfair, compensation payable by the employer is 33 days per year of service (instead of 45) up to a maximum of 24 months’ pay (instead 42), that is the same amount of compensation than for the other cases of unfair dismissal. Combined with the 1994 reform that abolished the necessity of administrative authorization and introduced the “objective” reason for layoff, this measure significantly reduced the cost of separation for these new contracts. Furthermore, social contributions on these contracts were cut from 40 to 80% for common contingencies depending (excluding work accidents) on cases.

This reform was balanced by a better regulation of training and part-time contract and discontinuous contracts, and also gave new rights to temporary workers within the company who uses their services. It also attempted to restructure the chaotic collective bargaining structure (agreements coexists at the firm, regional and national levels which all repeat more or less the same content) advising the negotiating areas to respect some sort of specialization (the “On collective bargaining” agreement). Finally, a third agreement (“On filling gaps”) opened the necessity of nationwide negotiation rounds in order to replace the Franco regime’s old “workers’ statute” with sectoral collective agreements on occupational structures, career structures, pay structure and disciplinary systems before 2003.

### **The failed negotiation of 2001**

In the summer 2000, negotiations started in order to review and renew some of the measures introduced for four years by the consensual 1997 reform. But the distance between the social partners turned out to be quite high. On the one side, in order to promote employment stability, unions proposed to tackle the problem of abuses of temporary contracts (especially contracts “for work and services” and contracts “for circumstances of production”). Indeed, temporary

contracts still represented 32% of total employment in 2001, just a slight decrease from the level in 1997 (34%). Thus, they initially proposed to increase the relative costs of temporary employment by creating a specific compensation for workers at the end of their period, and increase their social security contributions. They also proposed to restrict the use of such contracts. On the other side, to achieve the same employment stability goal, employers' organizations wished to further reduce the relative cost of new contracts compared to the old (permanent and temporary) contracts, to stimulate their use. They initially wanted to reduce the cost of unfair dismissal on new open-ended contract down to 25 days, and to eliminate "procedural wages" that is the wage they have to pay during the court or administrative procedures. They also proposed to further increase flexibility for the quite popular new part-time contract –introduced in 1998. But they refused any restriction in the use of temporary employment, although they accepted the principle of compensation up to 12 days per year for these workers.

The social partners failed to reach a consensus after months of negotiations because workers' unions deemed that the new open-ended employment contract had not been successful enough in the month preceding the reform to justify its extension. They also deemed that the introduction of this type of contract had not tackled the core problem of employment instability in Spain, namely temporary employment contracts.

The reform was then decreed by the government and obviously favoured the employers' proposals. Indeed, it prolonged and extended the new permanent contract to more groups of workers. It also introduced greater flexibility in part-time employment through the removal of quantitative limits. So, the tripartite social dialogue eventually broke in 2001 when the UGT trade union confederation posted a negative assessment of the effects on employment of the reform introduced unilaterally that year by the government, and said the government's attitude was only titled in favour of the employers, ignoring the recent re-birth of social dialogue.

#### **4.4 Facilitating and hindering factors for the reform of workers' security systems**

The successful reform processes of workers' security systems in Denmark and Spain have in common that they were both supported by governments with strong

momentum although not necessarily majoritarian in parliament, and by social partners able to compromise and negotiate. They were also initiated at the right time when all actors could share a common objective and stand the cost of compromises. More precisely, we can draw four main lessons from the Danish and Spanish experiences between 1994 and 2003.

### **Defining the margins of support: the constituency of systems**

Systems of regulations generate their own resistance to change. That is what we can call the “constituency effect” which creates a status-quo bias (Saint-Paul, 2002). In the case of Spain more than two third of workers who hold a permanent job were in favour of employment protection, and employment protection laws precisely created this situation. Indeed, these workers do not bear the cost of employment flexibility in a dual labour market. Any attempt to reform this system should take place in a moment where these people fear less the potential impact of such a reform on their situation, while the positive impact on the probability of finding a job after the reform should be revealed as soon as possible. In the case of Denmark, workers accept the flexibility of employment adjustments because there exists a generous and long-lasting insurance that covers the risk in terms of revenue. Moreover, most of social rights are not dependent on the individual status on the labour market and are financed on the state budget. The same logic applies to union membership: workers do not forgo their membership once they have lost their jobs. As such, any attempt to reform the unemployment insurance system has to take into account the constituency of the workers’ security system as a whole. The reforms achieved in both countries are successful to this regard.

### **The role of the political system and the government**

The system of political representation seems to play a lesser role in the case of labour market reforms than in the case of any other market regulation reforms. Indeed, the Danish system of representation is a typical case of proportional representation, with the continuous need for consensus and the continuous threat of veto. The Spanish electoral system is also proportional in nature although more complex and with the possibility of majorities emerging from the poles. In both cases, the rule of proportionality of the system has not prevented the governments and the social partners from realizing significant reforms of workers’ security systems. In the case of

Spain though, the fact that government relied on a strong majority helped to pass some phases of the reform through law when the social dialogue broke down such as in 1994 and 2001, although the authorities had sometimes to step back. In Denmark, social dialogue seem more important in order to get support for labour market reforms as exemplified by the failure of the 2003 attempt to pass a law restricting the incentives of temporary layoffs and tighten furthermore the eligibility conditions of the insurance system. So the will of the government may be necessary to trigger the reform but not always sufficient to achieve it.

### **The role of labour market organizations**

This is precisely because, in the labour market, the organization and the nature of social dialogue are paramount to explain the capacity of successfully designing and implementing reforms. The institutions organizing this social dialogue are the key rules of the game: voters have conflicting interest depending on their status in the labour market and thus have organized a specific system of representation and bargaining. In the Danish case, there has been a long tradition (dating from the late nineteenth century) of social dialogue with strong unions (high density, high coverage, high vertical and horizontal coordination capacity) and disciplined employer organizations. The unemployment insurance reform was centrally discussed between the actors, namely the government and social partners, from 1994 onward. In Spain, after a decline of social dialogue after 1986, there has been a revival since 1994, mainly due to change in the balance of powers and the institutionalization in the early 1990's of a national bargaining system. Indeed, unions losing ground at the firm level seized the opportunity to bounce back at the national level, and employers saw in the negotiations a way to achieve wage moderation (Jimeno, 2002). As a result, many phases of the employment protection reform were negotiated and approved by labour market organizations (especially the major 1997 reform), except twice in 1994 and 2001. But the institutionalization of national bargaining and the accompanying capacity of coordination downward are worthless if actors do not find any interest in the reform.

### **The choice of timing for the reform**

The timing of the reform – when it is initiated and its pace – is essential in order to get support from social partners. It actually determines the “what’s in it for me” for each actor of the reform.

#### 1. The timing in the macroeconomic cycle

In both countries the reforms were initiated in 1994, at the end of severe recessions, and continued through the recovery of the ninety eighties. At that time, in Spain the unemployment rate was relatively high as well as the rate of temporary new jobs. As such, the so-called “exposure effect” and “identifiable effect” were high: voters interested in a decrease in long-term employment protection measures were more numerous and could identify more easily the potential gains of such a reform (the “bad” jobs had been revealed) than before the recession. An additional factor motivated unions: the ability to meet the EMU convergence criteria, especially in terms of inflation. Unions did not want to appear as breaking the path to the EMU. In Denmark, where the reform was about to tighten eligibility conditions and the duration of the unemployment insurance, the exposure effect may have been low (fewer people were not exposed to the harming aspects of the reform), although the parallel reinforcement of ALMP measures (such as training) might have mitigated this impact. In any case, the identifiable effect was also large at that time: people knew to what extent their jobs were threatened, and to what extent they relied on the unemployment insurance. At the same time, in a majority of voters and union members could observe the cost and inefficiency of the insurance system, which in turn gave support to its reform. Finally, in both countries, employers’ organizations recognized the fact that centralized bargaining had been the best way to moderate inflation in the past. Indeed, a positive impact of these reforms and national accords lies in the non-inflationary decrease in unemployment in the second part of the ninety eighties.

#### 2. The importance of gradual reforms

In both countries reforms were gradually implemented, with in some cases compensatory measures which were designed to balance some harming effects and to increase the support of the reform. First, in Denmark the first phase of the reduction of the unemployment insurance duration was compensated by the introduction of several long-term leaves for the workers. Workers saw in these measures an increase in the

possibilities of allocation their time between work, training and leisure. The unemployed considered the potential positive impact of these leaves on their ability to get a job. Progressively, some of these leaves were abolished, considering they were not intensely used, but the reform of the unemployment insurance was initiated and its positive impact on the unemployment level became identifiable. Second, in Spain training contracts and “work experience” contracts for the young workers accompanied the 1997 reform, but the later also opened the possibility of cross-sectoral agreements on collective bargaining, as well as the necessity of filling gaps in regulations among the 23 heterogeneous sectors. This was largely in favour of unions who could regain influence at the national level at a time where they had lost some ground at the firm and branch levels.

#### **4.5 Conclusion**

This chapter has shown that the political support to the reforms of workers’ security systems in Europe (the setting of employment security – EPL, employment protection laws - and revenue security –unemployment insurance and ALMPs, active labour market policies including training) can be found within non strictly majoritarian political systems with the support independent and representative social partners. Such reforms have been achieved in Spain and Denmark despite the constituency of systems that tend to create blockages because actors may find individually no interest in the changes. In both cases, the will of governments associated with favourable economic conditions and the existence of social dialogue institutions opened a window for reforms. Interestingly, these common traits for successful reforms emerge from the experience of countries that are traditionally not considered to be alike from an institutional standpoint (Denmark being considered as a “corporatist country”, and Spain belonging to the group of Southern Europe countries where unions can exert their veto but which lack strong coordination institutions). These experiences also help us understand the potential success of some continuing reform processes in European countries, such as Spain but also France.

The process of reform has been resuming after the 2004 election that brought the PSOE back to government. The Zapatero’s administration recently uttered it had no

intention to override the social dialogue like the previous government did in 2001. There is still a strong consensus on the fact that temporary employment is too large in Spain. Admittedly the 1994-1997 reforms contributed to decrease in the rate of temporary employment from 33 % in 1997 down to 30.6% in 2003, with an even stronger decrease in the private sector (7 percentage points). But this level remains socially hard to sustain and does not promote productivity. Now, despite this tacit consensus on the diagnosis, social partners are more divided on the remedy than they were seven years ago. Indeed, workers' unions declared their hostility to any further decrease in the layoff costs on permanent contracts, while the employers' unions are hostile to further restrictions on the use of temporary contracts. To sum up, the temporary to permanent labour costs ratio must increase but the actors have not reached a consensus on how to achieve this.

Using the line of arguments developed in the previous section, Spain seems in a slightly less favourable situation at the moment to successfully achieve negotiations than it was in 1997. On the one hand, after a reduced growth period in 2001-2002 (but no recession), the outlook is positive for the 2004-2005 period with a growth rate between 3 and 3.5% which also means unemployment should start to decrease again and reach 10.2% in 2005, down from 11.4% in 2003 (OECD, 2004). In terms of exposure, this is a better time for the reform than in 2001, since less people would potentially be concerned by negative the consequences of a decrease in permanent employment protection, or a restriction in the use of temporary contracts. Moreover, the minority government seems ready to tackle the problem of job instability in a consensual way. But, on the other hand, it is not sure that social partners will reach consensus on the appropriate policy. Indeed, there is no clear consensus at the moment on which policy (1994's temporary contracts restriction or 1997's reduced layoff cost) most influenced the rate of temporary employment (UGT 2004, CC.OO. 2004). Moreover, as is clear on figure 4, workers' unions have now more incentive to protect the interest of permanent workers in than in 1997. This, and the fact that the PSEO might pay more attention to workers' interests may suggest that no agreement will be reached if employers refuse to compromise.

France is also currently experiencing workers' security reforms. French employment protection laws lie somewhere in between Spain and Denmark –although somewhat

closer to the Spanish than to the Danish case. The employment protection system combines strong employment protection for permanent workers (especially when dismissals are ruled to be unfair) and various possibilities of short-term contracts up to 18 months. Besides, the unemployment insurance scheme guarantees approximately two third of the last net wage over a maximum of 23 months for workers having contributed for at least 14 months. In 2003 the unemployment insurance scheme has been revised in order to introduce financial discipline, and different ways of reforming the employment security scheme are currently under review.

The challenge seems bigger for France compared to Spain for instance, although the government has recently uttered its desire for such a reform. First, the economic situation in 2003 is less favourable for a reform. The economy stopped growing at the late 1990's rates, but the 2001-2002 trough may not have been strong enough to decrease the exposure of many workers to a loosening of employment protection. Second, and consequently, many workers are still uncertain of the future of their job and such a reform could potentially meet strong opposition. But more importantly, and this may be the main lesson from this chapter, workers' unions are probably not ready to endorse social dialogue on that point. In comparison with Denmark and even Spain, the French political system generates strong majority governments. But workers' trade unions appear more divided than in the two previous countries. Indeed, the history of social relations has left France with five major workers' unions that tend to compete with each other and also undergo the competition of smaller, somewhat more radical unions. This competition for votes and membership does not always provide strong incentives for compromise, consensus building and reform support. As such, one key for the employment protection reform in France might be the reform of the workers' representation system.

## Chapter 5

# The Political Economy of Product Market Reforms

### 5.1 Introduction

Product market reform has a very long history in OECD countries, beginning with trade liberalisation (an unfinished business) and continuing with liberalisation of international financial flows. Besides these external changes, the past thirty years have also witnessed a choral move of *domestic* structural policies towards more reliance on markets. While labour market reform has often been opposed on the basis of first principles, the benefits of competition in product markets have stirred much less controversy. However, in many cases, moving from abstract statements in favour of competition to the actual implementation of liberalisation and competition policies proved to be difficult, especially in non-manufacturing industries.

To what extent was this general pro-market move a mere change in policy rhetoric rather than in policy practice? What triggered regulatory changes in reforming countries? Which were the countries and industries that underwent more rapid and extensive reform? Why did some countries more than others indulge on rhetoric at the expense of practice? Why were some industries reformed earlier and/or more deeply than others? What are the main factors explaining different degrees of resistance to change? Against the background of both the key forces acting on reform policies and their estimated benefits for the economy (see Chapter 2), this section provides some clues for addressing these questions, focusing on market-oriented reforms in the non-manufacturing area. The hope is that these clues will prove useful in designing policies that are not only welfare-improving in theory, but also feasible in practice, because they are able to accommodate and overcome (often legitimate) resistance from those that stand to lose (at least in the short run) from their implementation. Given the breadth of the political economy issues raised by product market reform, our account will be necessarily partial and tentative, providing at best a framework and some evidence that might inform wider policy-oriented research program in this area.

We focus on reforms in non-manufacturing industries essentially for two reasons. First, non-manufacturing is the area of economic activity in which regulation has traditionally been most pervasive and the scope for change is considered to be largest. Indeed, reforms in this area remain (at least nominally) at the top of the political agenda of many governments. However, since non-manufacturing industries are often sheltered from international trade, endogenous forces acting for reform are less evident than in manufacturing. Second, the history of reforms in this area has both bright and dark spots. There are probably as many successful reforms as failed attempts. One reason is that non-manufacturing is where the strongest concerns as to the outcomes of reform were voiced and the stiffest resistance to reform was observed. Thus, it is a privileged viewpoint for analysing the interplay of the different forces acting on reform, such as public and private interests and the political and institutional setting.

## **5.2 Reform patterns**

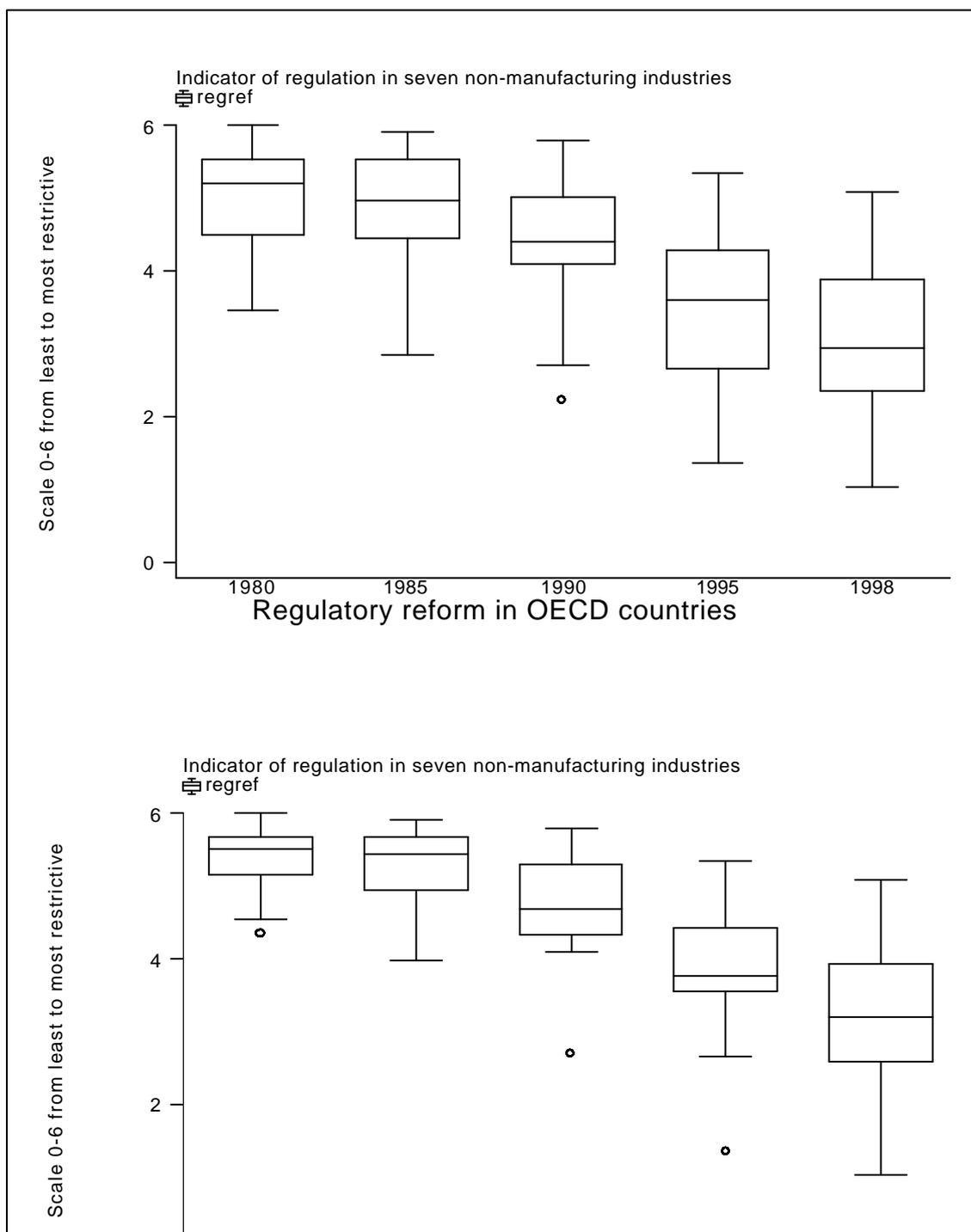
It is useful to begin by taking stock of reforms implemented in non-manufacturing industries over the past decades. Our starting point is a set of data concerning reforms in seven non-manufacturing industries in 21 OECD countries over the 1975-1998 period: air transport, road freight, rail transport, telecommunications, postal services, electricity and gas supply (see the annex for a detailed description of how the data was assembled). The main reforms also include privatisation (see Chapter 6), liberalisation of access to potentially competitive markets, restructuring of vertically-integrated industries and the elimination of price controls in competitively supplied services. The degree of reform in each of these areas, and overall, has been conventionally measured using a decreasing scale (from 6 to 0) from most to least restrictive of competition and private governance. Summarizing reforms in this way is convenient for providing a broad-brush view of developments in different countries and industries as well as for analysing reforms patterns quantitatively. It should be noted at the outset, however, that our data are unable to account for reforms occurred over the past five years.<sup>10</sup> Therefore, our empirical analysis is mainly historical. Furthermore, a more detailed and qualitative account of reforms is needed to better understand the specific factors

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<sup>10</sup> The data are currently being updated, but final results will not be available until later this year.

influencing the general patterns and formulate specific policy proposals. We address these issues at various places in this chapter with reference to specific product market reforms. Finally, it should also be noted that the focus of this chapter is on reforms in the most developed OECD countries. As highlighted in the introduction, the political economy of reforms in transition countries presents distinctive features that merit a separate discussion (see Chapters 6 and 7).

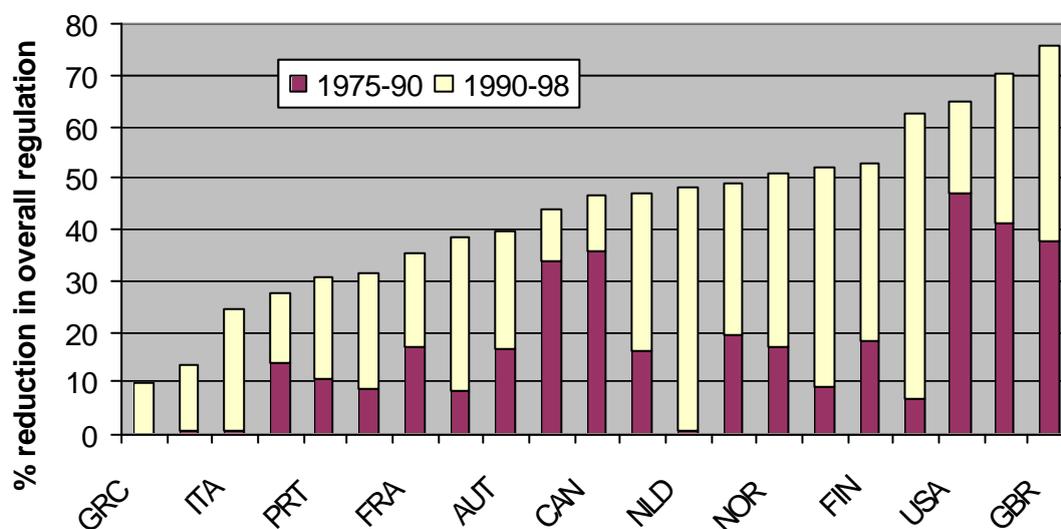
**Figure 5.1. Regulatory reforms**



First, let us illustrate the facts, as recorded by our data. Figure 5.1 suggests that, on average, reform policies have succeeded in lowering regulations that restrict competition and private governance in the OECD area. However, the cross-country variance of the overall regulatory environment remains large, because the scope and depth of reforms varied widely. Strikingly, dispersion is even more accentuated among European countries, despite efforts at harmonisation through the so-called Single Market Programme (more on this below).

Our data suggest that at the one end of the regulatory reform scale we find countries like Greece, Switzerland and Italy, where regulation has barely moved over the past thirty years and, at the other end, countries like the United Kingdom, New Zealand, the United States and Australia where extensive reforms have been implemented in all industries (Figure 5.2).

**Figure 5.2.** Who reformed, and when?

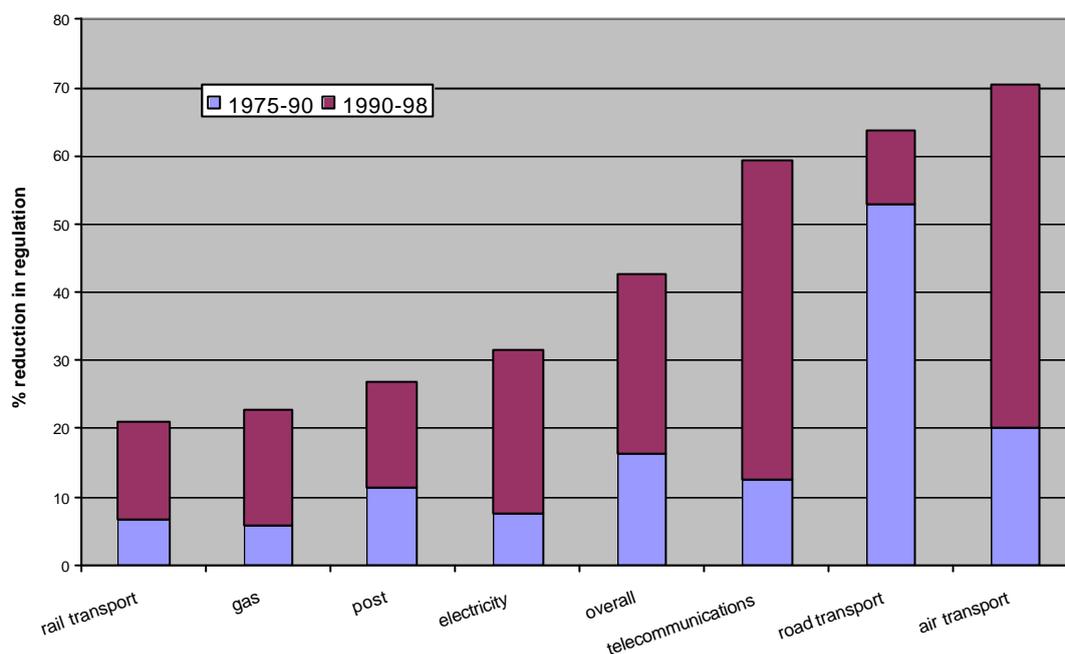


Looking at the extent of reforms across industries (Figure 5.3), one observes that, in some of them –such as road freight, air transport and telecommunications– regulation appears to have been completely overhauled, while in other ones –such as gas, postal services and rail transport– reforms have been minor.

Interestingly, the timing of reforms has also differed widely across countries and industries. Countries such as the United States, the United Kingdom, New Zealand,

Canada and Japan began reforms in the early 1980s, while countries such as the Netherlands, Australia and Sweden followed the movement much later in the second half of the 1990s (Figure 5.2). Industries where reforms were implemented early on include road freight and to a different degree air transport. In the other industries, reforms were implemented much later, if at all: this is particularly evident when comparing the percentage change in regulation over the 1975-89 and 1990-98 periods (Figure 5.3).

**Figure 5.3.** The timing and scope of industry-level reforms



In line with the theoretical arguments put forth in Chapter 2, one observes that industries that are least affected by natural monopoly elements were liberalised first and more extensively across the OECD area. This is where fewer complexities are likely to arise with liberalisation, the need of re-regulation appears to be minor, and the benefits seem more certain. What is less clear is why these industries were heavily regulated in the first place and, especially, why the timing and the extent of liberalisation differed so much across countries. The rest of this chapter attempts to provide answers to some of these issues.

### **5.3 Why reforming?**

Before looking more closely at the determinants of non-manufacturing reform in OECD countries, it is worth briefly addressing two related questions. First, why were non-manufacturing industries regulated in the first place, and why did regulatory arrangements persist for so long? Second, which exogenous factors broke down the regulatory status quo, triggering widespread deregulation and/or regulatory change in some of them?

#### **5.3.1 Understanding the regulatory status quo**

**Public and private interest** Most non-manufacturing regulations have at least some grounding in public interest. Market failures (e.g. due to economies of scale or information asymmetries) abound in many non-manufacturing industries and some form of government intervention is often necessary to ensure productive efficiency and protect consumers (see also Chapter 2). Many authors have extensively reviewed the conditions under which government regulation (and, in the limit, public ownership) of business activities are justified on economic grounds.<sup>11</sup> Nonetheless, public interest explanations of existing regulations have several limitations. First, they fail to balance the expected benefits of regulation with the potential costs of government failure.<sup>12</sup> Second, many regulations seem hard to justify purely in terms of efficiency or consumer interests (Stigler, 1988). Third, public interest theories cannot explain regulatory inertia, i.e. the persistence of regulatory restrictions even when the original reasons for regulation have disappeared. Finally, these theories cannot explain resistance to regulatory reform: if regulations are made by good-willed governments who pursue public interest, why should proposed changes in regulation be opposed so fiercely?

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<sup>11</sup> See, for instance, Laffont and Tirole (1993), Viscusi *et al.* (1997), Hart *et al.* (1997) and, for applications to specific industries in OECD countries, the papers in OECD (2001).

<sup>12</sup> Government failure occurs when good intentioned policies (targeting aggregate welfare) have effects that are costlier than the market failures they aim to correct. The interplay between *politicians* and *special interest groups*; electoral pressures that distort the application of policies; regulatory capture; and unforeseen side-effects of policies (such as disincentives or externalities); etc. help explain such government failures (see Chapter 2).

If public interest is only a partial explanation of non-manufacturing regulation, what are the other forces that have led to establish regulation in the first place, that have maintained regulatory inertia next, and that have opposed regulatory reform lately? Economists and political scientists have focused on two main factors that may act in concomitance with public interest: (i) pressures by special interest groups and (ii) the political and institutional setting in which regulations and regulatory reforms are implemented.

According to the private interest theory (Olson, 1965; Stigler, 1971; Peltzman, 1976 and 1989; Becker, 1983), regulations are shaped, twisted and preserved by the attempt of some economic agents (entrepreneurs, workers, consumers and/or bureaucrats) to maintain or generate political power or economic rents for their own benefit. Agents can do so either by directly controlling the regulatory process or by lobbying politicians and government officials that influence or take regulatory decisions. Interestingly, the influence of special interests on non-manufacturing regulation has distinctive features.

**What is special about non-manufacturing regulation?** The private interest theory often stresses conflicts between different groups of rent-seekers, but there are good reasons to believe that it is *convergence* of special interests that is the overriding factor explaining regulatory outcomes in non-manufacturing industries over the past decades. This can be seen by contrasting developments in non-manufacturing regulation with changes in trade protection for manufactured goods, which are mainly driven by *rivalry* between different private interests.

To a certain extent, trade liberalisation is the endogenous result of the interaction between rival interests (of different industries and different countries) that mutually offset each other to gradually approach a free-trade outcome (Grossman and Helpman, 1995).<sup>13</sup> For this reason, on the whole, the push for trade reform has been strong. In a sense, this is a concrete realisation of the Coase Theorem as described in Chapter 2.

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<sup>13</sup> One way to rationalize this outcome is through models of influence-driven contributions, in which a large number of organized interest groups attempt to influence policy choices by elected officials (see Grossman and Helpman, 1994, and the survey by Facchini, 2004).

Possible explanations for this realisation are that (i) the political clout of industries in favour and against trade liberalisation became increasingly similar across countries (due to convergence in the output mix of trading partners); (ii) a rising proportion of the population was involved in lobbying (both pro and against reform); (iii) foreign lobbies were increasingly active in pushing for tariff reduction (due to deepening FDI penetration); and there is a strong incentive to find cooperative solutions at the international level.

In non-manufacturing industries, these endogenous forces have been much weaker, and there has been little guarantee of a spontaneous move towards welfare-improving regulatory outcomes. This is because, in many of these industries, private interests found a particularly fertile ground for cross-breeding and growing to the top of the political decision tree. As already mentioned, the non-manufacturing sector has traditionally been sheltered from international competition either because it produced intrinsically non-tradable products (e.g. household and personal services) or because its markets had remained mainly domestic until recently (e.g. due to natural monopoly characteristics). Also, some non-manufacturing industries have been sheltered for a long time from foreign equity participation for “strategic” reasons (e.g. air transport, energy, telecommunications; see also Chapter 6).

**The actors.** The resulting long-standing anchorage to resident ownership and the domestic market has favoured close relationships with local or central government officials and politicians.<sup>14</sup> In industries with natural monopoly elements (such as energy, telecommunications or railways) political clout has been strengthened by widespread public ownership, the large size and the dominant market shares of incumbent firms, and by high unionisation rates within them. In more competitive non-manufacturing industries (such as road freight, retail distribution or professional services), where the average size of firms is small, trade associations have been often able to develop effective lobbying bodies, which sometimes took advantage of institutional channels for forwarding the industry’s interests in local or national

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<sup>14</sup> A large share of domestic production in domestic consumption is well known to be conducive to protectionist regulations also for tradable products (Grossman and Helpman, 1994; Maggi and Rodriguez-Clare, 2000).

regulations. This has created influent industry-specific domestic lobbies characterised by a convergence of interests between employers and employees.

Moreover, several factors ensured convergence in interests also of large portions of intermediate and final consumers. In many non-manufacturing industries, industry lobbies were able to gather support from consumers by arguing that regulation was essential to guarantee service quality, safety and/or security of supply.<sup>15</sup> In natural monopoly industries, the widespread subsidisation of some of the industries' products (such as local communications, passenger transport or electricity consumption above or below certain thresholds) naturally rallied consumers towards existing regulatory arrangements. In sum, regulatory arrangements in non-manufacturing industries have been sustained by compact interest blocks cutting across different categories of economic agents.

### **The role of institutions**

The convergence of interests that perpetuated suboptimal regulatory outcomes in non-manufacturing also generated a particular type of relationship between special interest groups and the political and institutional setting. The political theory holds that political systems and institutions are relevant for explaining both regulation and regulatory reform (Dixit, 1996; Williamson, 1996).<sup>16</sup> First, systems and institutions affect the mechanisms and channels through which private interests can bear on policy. Hence, private interests are partly endogenous to them. Second, systems and institutions are also a vehicle through which other factors, such as ideology or political leadership, can play a role (Kalt and Zupan, 1984; Poole and Rosenthal, 1996).<sup>17</sup> In particular, as illustrated in previous chapters, electoral systems may be more or less prone to overcoming resistance to change by organised interest groups.

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<sup>15</sup> These arguments in favour of existing regulations were voiced particularly loudly in air and rail transport, energy and professional services, but also played a role in rallying support for regulations in road freight and retail distribution.

<sup>16</sup> A sub-brand of institutionalist theories is the so called legal-origin hypothesis, according to which regulatory settings are heavily influenced by the origin of the inherited legal code (common law, French or German civil code, etc.) (La Porta et al., 1998). Apart from being devoid of policy content, since a country's change in legal traditions cannot be envisaged, these theories have a hard time explaining radical changes in regulatory frameworks, such as for instance that from a statist/corporatist model to a laissez-faire model in the United Kingdom (and other common law countries) over the 1980s.

<sup>17</sup> It is not clear, however, if ideology can be defined and measured independently of private economic interests.

Clearly, institutions also play an important role in shaping the way special interests affect non-manufacturing regulation. For instance, corporatist traditions in the Netherlands were crucial in shaping regulation that favoured segmented, protected and collusive markets in many services industries (OECD, 2004) and dirigist traditions in Japan were instrumental in creating incestuous relationships between economic ministries and market players, with “administrative guidance” often replacing explicit regulation (OECD, 2003). Hence, understanding how institutions make it easier or more difficult for private interests to influence regulatory outcomes is important for the design of durable regulatory reforms, which may need to be accompanied by institutional changes to be sustainable.

However, interest groups supporting the regulatory status quo in several non-manufacturing industries include a vast array of social groups (ranging from bureaucrats to consumers and from entrepreneurs to workers). This suggests that the role of electoral systems in encouraging reform may not be as crucial as in other policy areas. This is because these interest groups are spread across the electorates of many parties rather than being divided along traditional party lines. Consider for instance the two polar cases of labour market and telecommunications reforms. A majoritarian electoral system may find it simpler to circumvent the social dialogue when deemed necessary by the party in power. However, neither system has an obvious advantage in handling telecommunications reforms, because they imply the elimination of rents and the redistribution of resources among potential voters of all the parties across the political spectrum.

### **5.3.2 What triggered reform?**

If convergence of private interests backs so strongly the regulatory status quo, why did sweeping non-manufacturing reforms eventually take place in many countries? Why did governments push for regulatory changes that broke interlocked private interests and reduced or eliminated rents? Private interest theories suggest that this happens when changes in economic structure alter the value of regulations for rival interest groups, affecting their relative size, strength and organisation. Regulatory arrangements reflect the balance between the size of rents earned by certain groups and

the costs of regulation for other groups. They are stable when rents justify lobbying efforts that compensate for the opposite efforts of those that bear the costs. If the size and diffusion of costs is significantly increased, pressures for changing regulations may become overwhelming. In other words, as the deadweight losses of regulation rise, groups that benefit from it face greater opposition, and their drive for preserving existing regulatory arrangements becomes less successful.<sup>18</sup> But which underlying economic and political factors triggered and sustained the movement towards reform in OECD countries? While there is no one-size-fits-all explanation across countries and non-manufacturing industries, a certain number of common elements can be tentatively identified.

**Technical progress.** First, technical progress has been a powerful force that disrupted decades-old regulatory arrangements. By muting or reducing substantially scale economies, capacity constraints, and sunk costs, technical progress was instrumental in changing the value of regulations in several non-manufacturing industries, notably by increasing the leverage of potential new entrants and reducing consumer concerns. Moreover, in many industries, information and communication technologies (ICT) created opportunities to provide services and organise logistics in ways that also altered the value and the costs of regulation for different interest groups. More generally, the increased use of ICT has brought light on the cost (both for industry interests and for the public at large) of regulations that inhibit their development.

For instance, in telecommunications, the possibility to undercut the international tariffs of incumbent telecom providers through call-back services provided cream-skimming opportunities for new entrants. These threatened the financial balances of incumbents, who were constrained by strict tariff regulations on local and long-distance calls.<sup>19</sup> The costs of entry regulation in international and business services therefore became evident for users, and competition increased the burden of tariff regulation for

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<sup>18</sup> This line of reasoning has led some to argue that, eventually, regulatory arrangements have an inner tendency towards minimising the deadweight cost of regulations (Becker, 1983). However, there are good reasons to believe that convergence towards minimum cost regulations may not occur in practice (Rajan and Zingales, 2000).

<sup>19</sup> It is worth noting that these cream-skimming activities were initially made possible by loopholes in an otherwise strict domestic regulatory environment. Loopholes were sometimes opened up by liberalisation in other countries.

incumbents. Similarly, the development of airwave communications provided a way around the incumbent's local loop for alternative service providers, and digital technologies created the room for a plurality of communications providers where only one, or at best a few, could previously be operating. This tamed natural monopoly arguments in favour of entry restrictions and created enormous pressures for opening access to networks and frequencies; at the same time lowering the value of these restrictions for network and frequency providers, i.e. incumbents and governments who now saw unused revenue opportunities under existing regulations.

Similar developments occurred in transport and energy industries. In road freight, ICT (e.g. electronic data transfers and satellite tracking systems) made it possible for large haulers to fully exploit economies of scale and scope, undermining support for regulatory devices aimed at preventing price competition and imposing quantitative restrictions on entry. In air transport, ICT made air traffic control, reservation systems and ticket management better able to meet a steeply rising traffic, increasing pressures for deregulation and shifting competition from quality to prices. Finally, while ICT also encouraged reform in the electricity supply industry (by easing the management of transmission flows and the functioning of a wholesale electricity market), another technological breakthrough –so-called Combined Gas Turbine (CGT) electricity generation– increased pressure for easing entry regulations in electricity supply by significantly lowering sunk costs in electricity generation (Steiner, 2000).

**Globalisation**        Second, there are obvious linkages between developments in trade policies and non-manufacturing regulatory reform. As international competition in tradable goods and services widened, domestic producers sought lower prices for non-manufacturing intermediate inputs. At the same time, participation in trade agreements typically required ending government subsidies to these inputs. Hence, there was little alternative to reforms that promote efficiency and lower costs.

For instance, deepening trade integration generated pressures for regulatory changes aimed at increasing efficiency and demand-responsiveness in transport. Thus, the EU Single Market Programme is likely to have been instrumental in spurring reform of road freight regulations over the late 1980s and early 1990s, and rail freight regulations subsequently. In large countries, such as the United States, the same kind of pressures

for road freight reform may have arisen from increasingly severe competition among domestic manufacturing firms.<sup>20</sup> Moreover, efficient supply of telecommunications services was increasingly important for meeting international goods trade competition in the wake of the ICT revolution.

Finally, the very rise of trade in services over the past two decades (through cross-border supply, consumption abroad or establishment of foreign affiliates) also created pressures for further opening up and improving efficiency in non-manufacturing markets, not least because trade in services depends heavily upon efficient and competitive transport and communications industries (Mirza and Nicoletti, 2004). The link between services trade, FDI and regulatory reform will be further explored below, with reference to specific industries.

**Supranational constraints and new domestic institutions** Third, in a number of countries, supranational legal constraints (related to trade agreements) and newly-created domestic institutions put mounting pressure on anticompetitive non-manufacturing regulations over the past two decades. The clearest examples are the role played by the EC in fighting regulatory barriers to the internal EU market and the advocacy and/or judicial role played by competition authorities in several OECD countries, often in the wake of the creation of new and more incisive competition laws.

Beginning in the mid-1980s and with increasing strength in the run up to the 1993 Single EU Market and beyond, the EC has vigorously enforced provisions of the Treaty of Rome (e.g. against state aid and other barriers to competition) that had been “sleeping” for decades. Moreover, cogent pressure was put on EU member states to reform non-manufacturing regulations by means of EC directives (e.g. in telecommunications, rail and air transport, gas and electricity), which imposed precise timetables for reform and, eventually, court action in case of delayed implementation. While the complex reasons for the delayed activation of EC competition provisions (that had existed for decades) and the drive for imposing reform through legally-binding directives fall beyond the scope of this chapter, it is clear that EC action significantly altered the balance of power between partisans and opponents of the

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<sup>20</sup> In the US, increasing rivalry between rail and road transport may also have played a role in eliminating regulations that had originally be established partly to protect the rail freight industry.

status quo. Moreover, it provided politicians influenced by pro-reform interest groups with a formidable tool for shifting responsibility for the collateral damages generated by reforms to groups benefiting from the status quo, thereby minimising the electoral cost of reform.

The domestic legal and institutional framework also sought actively to break the regulatory status quo in a number of OECD countries. According to information collected by the OECD, 26 member countries either established or substantially improved their competition laws over the past two decades, essentially in the second half of the 1990s. Two examples will suffice. In Australia, two strong independent organizations (the Productivity Commission and the Competition and Consumer Commission) were created over the 1990s. The Productivity Commission is an influential review and advisory body on microeconomic policy and regulation that made credible most regulatory reforms implemented by the government over the past decade.<sup>21</sup> The Competition and Consumer Commission supported regulatory reforms by enforcing a new (1995) competition law that provides ample scope for curbing anti-competitive behaviour and ensuring competitively neutral access conditions to non-manufacturing markets.<sup>22</sup> In Italy, a new competition law and competition authority (Autorità Garante della Concorrenza e del Mercato), equipped with both advocacy and law enforcement powers, was instrumental in encouraging half-hearted governments to push forward and, eventually, accelerate the implementation of EC directives in non-manufacturing industries as well as, more generally, in promoting reform in service industries. In some of these industries (e.g. electricity and gas) this drive was also relayed by newly-created independent regulatory authorities. More generally, sector-specific or multi-purpose regulatory authorities became widespread among OECD countries by the end of the 1990s (OECD, 2002).

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<sup>21</sup> The Productivity Commission, created in 1998, is the last incarnation of a series of pro-reform institutions that stem from a body attached to the Industry Ministry whose original task was (paradoxically) to set tariffs and duties for protecting Australian products. Arguably, a series of external shocks (e.g. the fall in the world price of commodities and raw materials) and domestic developments (e.g. the need to provide manufacturing production with larger economies of scale than those offered by the internal market) created the political conditions that led to the progressive transformation of the original institution into a pro-reform body.

<sup>22</sup> The ACCC is a unique case among OECD countries of a competition authority that also has responsibility for regulation of network industries, which are usually assigned to ministries or separate regulatory authorities in other countries.

#### **5.4 Policy convergence or divergence?**

If reform was largely triggered by global economic changes and widespread institutional reform, one would expect reforms to be largely synchronous across countries. Thus, the first issue raised by OECD-wide reform patterns is that of convergence: to what extent has the general movement towards reform made product markets more alike across countries? One way to look at this would be to estimate the tendency of the indicators of reform, accounting for different initial conditions across countries. However, this is too demanding, since there are a host of country-specific factors, some independent of political economy influences, which may lead countries to converge to *different* levels of regulation in the long run. For instance, common arrangements may be impossible due to differences in the technologies used for supplying some non-manufacturing services (in turn reflecting differences in natural resource endowments or past political choices), in income inequality or in the balance between rural and urban areas or in the size and/or geographical location of the countries.

Political economy factors themselves can influence the level of regulation which is viable in the long run in a specific country or industry. For instance, widespread public ownership can make it more difficult to liberalise a market, not least because the incumbent (and stakeholders in it) has a more powerful “voice” than potential new entrants, and that soft budget constraints may make it easier to buy support. By contrast, reforms implemented by trading partners can stimulate domestic interest groups to lobby for them more forcefully, due to both the demonstrative effects of foreign reforms and the need to maintain the relative competitiveness of domestic firms.<sup>23</sup> A similar influence can be also exerted in a specific industry by reforms implemented in other industries, some of which can share the same structure and raise the same concerns among the users of their services (e.g. gas and electricity): success (or failure) to solve the complex regulatory issues arising after liberalisation in an industry can make reform more (or less) likely in another related industry. As

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<sup>23</sup> Moreover, as already mentioned, liberalisation in one country may provide a loophole for escaping strict regulation in another country, offering the opportunity to cream-skin the rents earned by incumbents in the regulated country. This may encourage cross-country convergence towards reform. Examples in telecommunications and finance abound.

explained in more detail below, cross-industry reform spillovers can also be related to input complementarities, such as between financial and communications services.<sup>24</sup> Finally, as mentioned above, the acceptable level of reform can be influenced by supranational rules, such as EC directives. All these effects influence the regulatory environment that is structurally or politically affordable in the long run.

**Table 5.1:** Convergence in regulation, overall

<b>Dependent variable</b>	<b>Regulation net of public ownership</b>			
<b>Explanatory variables</b>				
<b>Regulation<sub>t-1</sub></b>	0.06	0.07	-0.13	-0.12
	<i>7.14</i>	<i>6.58</i>	<i>-5.56</i>	<i>-5.39</i>
<b>EU membership</b>	-0.03			
	<i>-1.8</i>			
<b>Regulation<sub>t-1</sub>*EU membership</b>		-0.003	-0.004	0.001
		<i>-0.32</i>	<i>-0.52</i>	<i>0.14</i>
<b>Public ownership</b>			0.06	0.05
			<i>2.71</i>	<i>2.37</i>
<b>Regulation in trading partners</b>			0.21	0.15
			<i>8.38</i>	<i>3.98</i>
<b>Common time trend</b>				-0.01
				<i>-1.92</i>
<b>Country fixed effects</b>	No	Yes	Yes	Yes
<b>Period</b>			1975-1998	
<b>Countries</b>			21	
<b>Observations</b>	483	483	479	479
<b>R<sup>2</sup></b>	0.1	0.12	0.26	0.27
<b>F-test</b>			3.23	2.01
<b>Variance inflation factor</b>				5.03

T-statistics in italics. All regressions include a constant term

(Results are based on average regulation in 7 non-manufacturing industries)

Controlling for country-specific effects and some of the political economy factors that may affect long-run levels of regulation, Tables 5.1 and 5.2 report the results of convergence equations concerning both overall and industry-specific levels of product market regulation.<sup>25</sup> We first report simple OLS regressions checking for absolute convergence among OECD countries (a negative coefficient for Regulation<sub>t-1</sub> indicates absolute convergence). We then look for *conditional* convergence by means of fixed effects panel regressions, controlling for public ownership, reforms implemented in the

<sup>24</sup> Another source of inter-industry reform spillovers are related to competition across services, such as competition between the insurance and banking industries (Kroszner and Strahan, 2000). Efficiency gains by one industry may spur requests for liberalisation in the other industry as well.

<sup>25</sup> IMF (2004) has also analyzed convergence in regulatory frameworks, using a different set of regulatory indicators and explanatory variables. Their focus was only on economy-wide developments in product market regulation and mainly on political and conjunctural factors affecting them. Some of their results (e.g. on the influence of reforms in trading partners) are similar to ours.

three main trading partners and in other industries of each country, and participation in the Single Market Programme (SMP). The overall variance explained by the convergence equations is low. However, several conclusions stand out.

Confirming the results suggested by visual inspection of Figure 5.1 above, over the 1975-98 period there was no absolute convergence in regulation among OECD countries, with the notable exception of road freight. There even appeared to be absolute *divergence*, particularly so in the telecommunications industry. However, controlling for country-specific effects and other political economy influences suggests that there was *conditional* convergence, strongest in air transport and weakest in the gas industry. These results are robust to the inclusion of a common time trend.<sup>26</sup>

The political economy effects operate as follows:<sup>27</sup>

- Participation in the SMP tends to lower overall regulation in the long-run, though this effect can only be detected in air transport. However, what is most surprisingly is that SMP participation not only did *not* speed up convergence to lower levels of regulation. To the contrary, it tended to slow it down in industries such as road freight, air transport, post and telecommunications.
- As expected, public ownership tends to raise long-run levels of overall regulation (though this effect is sensitive to model specification), with the effect being particularly strong in network industries such as post, electricity and rail transport.
- Reforms in trading partners stimulate reforms at home, even controlling for the effect of participation in the SMP and a common time trend across countries.
- Reforms in other industries within a country appear to have a positive influence in all industries, suggesting a tendency for reforms to spill over across industry.

These results have some policy implications: (i) the timing of SMP implementation has been too slow and out of line with developments in non-EU countries, especially in competitive industries; (ii) the viability of reforms would have been increased by more extensive privatisations, especially in network industries; (iii) reforms in other

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<sup>26</sup> At the industry level, a common trend towards reform appears to be particularly strong in competitive industries such as road and air transport.

<sup>27</sup> The effects reported below do not appear driven by multicollinearity among the explanatory variables. The variance inflation factor remains well below the rule-of-thumb critical level of 10 in all regressions.

countries and industries set up a virtuous circle which make liberalisation easier: information and international benchmarking can play an important role in gaining support for reform. Some of these implications are further explored in the next section.

**Table 5.2. Convergence in regulation: industry-level**

Dependent variable	Regulation net of public ownership											
	Telecoms			Post			Electricity			Gas		
Explanatory variable												
Regulation <sub>t-1</sub>	0.06	-0.24	-0.23	-0.02	-0.22	-0.22	0.04	-0.16	-0.17	0.002	-0.1	-0.1
	<i>3.74</i>	<i>-8.47</i>	<i>-8.18</i>	<i>-1.49</i>	<i>-6.6</i>	<i>-6.95</i>	<i>2.14</i>	<i>-5.82</i>	<i>-6.05</i>	<i>0.3</i>	<i>-4.1</i>	<i>-4.13</i>
EU membership	-0.03			0.04			-0.01			0.02		
	<i>-0.77</i>			<i>1.17</i>			<i>-0.02</i>			<i>0.94</i>		
Regulation <sub>t-1</sub> *EU membership	0.06	0.06		0.05	0.05		0.04	0.03		0.02	0.02	
	<i>3.66</i>	<i>3.89</i>		<i>2.75</i>	<i>2.67</i>		<i>2.05</i>	<i>1.48</i>		<i>1.76</i>	<i>1.47</i>	
Public ownership	0.04	0.04		0.23	0.24		0.09	0.1		-0.01	<i>_.01</i>	
	<i>1.9</i>	<i>1.5</i>		<i>4.22</i>	<i>4.01</i>		<i>2.22</i>	<i>2.51</i>		<i>-0.88</i>	<i>-0.079</i>	
Regulation in other industries	0.41	0.36		0.17	0.17		0.23	0.3		0.09	0.11	
	<i>10.95</i>	<i>6.96</i>		<i>6.08</i>	<i>4.3</i>		<i>7.76</i>	<i>5.99</i>		<i>5.75</i>	<i>4.34</i>	
Common time trend		-0.01			0			0.1			0.003	
		<i>-1.29</i>			<i>0.1</i>			<i>1.68</i>			<i>0.92</i>	
Country fixed effects	No	Yes	Yes	Nb	Yes	Yes	Nb	Yes	Yes	No	Yes	Yes
Period		1975-98			1975-98			1975-98			1975-98	
Countries		21			21			21			21	
Observations	483	483	483	483	483	483	483	483	483	483	483	483
R <sup>2</sup>	0.03	0.29	0.3	0.01	0.17	0.17	0.01	0.17	0.18	0	0.12	0.12
Variance inflation factor			3.96			3.59			3.66			4.53

Dependent variable	Regulation net of public ownership								
	Road			Air			Rail		
Explanatory variable									
Regulation <sub>t-1</sub>	-0.04	-0.2	-0.22	-0.005	-0.41	-0.42	-0.004	-0.25	-0.25
	<i>-3.36</i>	<i>-7.62</i>	<i>-8.31</i>	<i>-0.27</i>	<i>-12.88</i>	<i>-13.73</i>	<i>-0.29</i>	<i>-8.16</i>	<i>-8.15</i>
EU membership	0.04			-0.11			0		
	<i>0.7</i>			<i>-1.54</i>			<i>0.03</i>		
Regulation <sub>t-1</sub> *EU membership	0.14	0.15		0.18	0.18		0.02	0.02	
	<i>6.12</i>	<i>6.6</i>		<i>8.11</i>	<i>8.41</i>		<i>1.53</i>	<i>1.41</i>	
Public ownership				-0.06	-0.06		0.1	0.09	
				<i>-1.48</i>	<i>-1.64</i>		<i>4.12</i>	<i>4.09</i>	
Regulation in other industries	0.2	0.08		0.84	0.71		0.15	0.16	
	<i>4.91</i>	<i>1.36</i>		<i>11.62</i>	<i>8.46</i>		<i>7.89</i>	<i>5.31</i>	
Common time trend		-0.03			-0.02			0.002	
		<i>-3.33</i>			<i>-2.87</i>			<i>0.41</i>	
Country fixed effects	No	Yes	Yes	Nb	Yes	Yes	Nb	Yes	Yes
Period		1975-98			1975-98			1975-98	
Countries		21			21			21	
Observations	483	483	483	483	483	483	483	483	483
R <sup>2</sup>	0.02	0.15	0.17	0.01	0.33	0.34	0	0.18	0.18
Variance inflation factor						3.3			3.4

T-statistics in italics. All regressions include a constant term

### **5.5. Explaining differences in reforms patterns**

As highlighted in previous sections, product market reforms imply transitional costs and redistribution, and hence spur resistance from interest groups. Therefore, the cross-country pattern of reforms is affected by a number of factors, including the influence of the main actors that stand to gain or lose, the amount of rents to be earned or foregone, and the framework conditions (e.g. rules and economic structure) in which reforms are implemented. Apart from politicians, the main actors are consumers, workers (both insiders and outsiders), firms (both incumbents and new entrants) and public entrepreneurs. Rents include those deriving from both market power (markups) and bargaining power (wage premia); and, apart from political systems and leadership, framework conditions include technology, the institutional setting, the size of initial market distortions and the external constraints under which policy is implemented.

To study how these factors interact at the level of country aggregates is daunting because many of them differ depending on the market to which reform policies apply. It is useful therefore to take an industry-level approach to the analysis of the political economy of product market reforms. We first look at measures of the gains to be reaped by consumers and firms, assuming that reforms tend to lower the prices of both final products bought by consumers and intermediate products used as production inputs by firms. We then turn to the evidence concerning the losses that incumbent firms and insider workers can expect from reforms, assuming that these tend to reduce rents as well as market or bargaining power. Finally, against the background of potential gains and losses to be expected by different actors, we examine in more detail the framework conditions that are likely to facilitate or impede reforms.

It is important to keep in mind that this analysis can only be very rough and patchy because cross-country data on features that could potentially affect the extent and the timing of reforms are not widely available. In particular, much of the available data cover three broad industry aggregates –electricity, gas and water, transport and storage, post and telecommunications– generally for a single year and a subset of OECD countries. Moreover, the fact that the subset of countries covered varies according to the indicator and the industry makes multivariate econometric analyses impossible and,

therefore, one is confined to looking at simple bivariate relationships.<sup>28</sup> The reader should be warned at the outset that this also makes it impossible to address the obvious endogeneity and causality issues that arise when comparing regulatory reforms to the economic outcomes associated with them.

### 5.5.1 Factors affecting perceived gains

The attitude of final and intermediate consumers of the products that are being liberalised is crucial for the success of reforms. Workers and entrepreneurs are first of all final consumers acting to maximise their own welfare. So, one would expect that consensus for reforms depends on their perceived repercussions on the purchasing power of consumers, as well as on the expected fall in input costs (or enhancements in quality and variety of the goods or services). Moreover, the intensity of their preferences for reform will depend on the *share* of the consumers' and final producers' expenditures that are affected by reforms. From this point of view, it is not surprising that, of all reforms, liberalisation of trade for manufactured goods was the front-runner and the least controversial (at least until recently): it was a relatively secure way to increase purchasing power and the range and quality of goods for a majority of consumers as well as to reduce the cost and increase the range and quality of inputs for a majority of firms.

When looking at non-manufacturing, matters are more complex, though the same logic should broadly continue to apply. On the final consumer side, part of the increased complexity stems from the fact that, in many of these industries, the uncertainty of reform outcomes –which we have ignored so far– becomes much larger. This is especially true in areas where the existence of natural monopoly elements or other market imperfections makes outcomes heavily dependent on the ability of policy-makers to design regulation that accounts for information asymmetries, and mimics competitive outcomes. Furthermore, while trade protection generally distorts relative prices in favour of a very limited part of the population, restrictive non-manufacturing regulation often translates into substantial subsidies given to a relatively large part of

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<sup>28</sup> A detailed description of data sources, definitions and coverage is contained in the annex, p 122.

consumers (e.g. prices well below cost in local transport, low electricity use or local fixed telecommunications). Thus, there can be powerful forces pushing final consumers towards a status quo bias (See Chapter 2). On the side of intermediate consumers, things are complicated by the fact that entrepreneurs in non-manufacturing industries often operated in a “closed-loop” until recently. They formed, therefore, a solid (and in some industries large) social block against change, opposing the widespread support for reform among manufacturing entrepreneurs. Due to these complications, in utilities and service industries, the influence of the share of final and intermediate consumption concerned by the reform is likely to be more ambiguous than in manufacturing.

Figure 5.4. Regulatory reform vs. intermediate and final consumption  
(by country and industry)

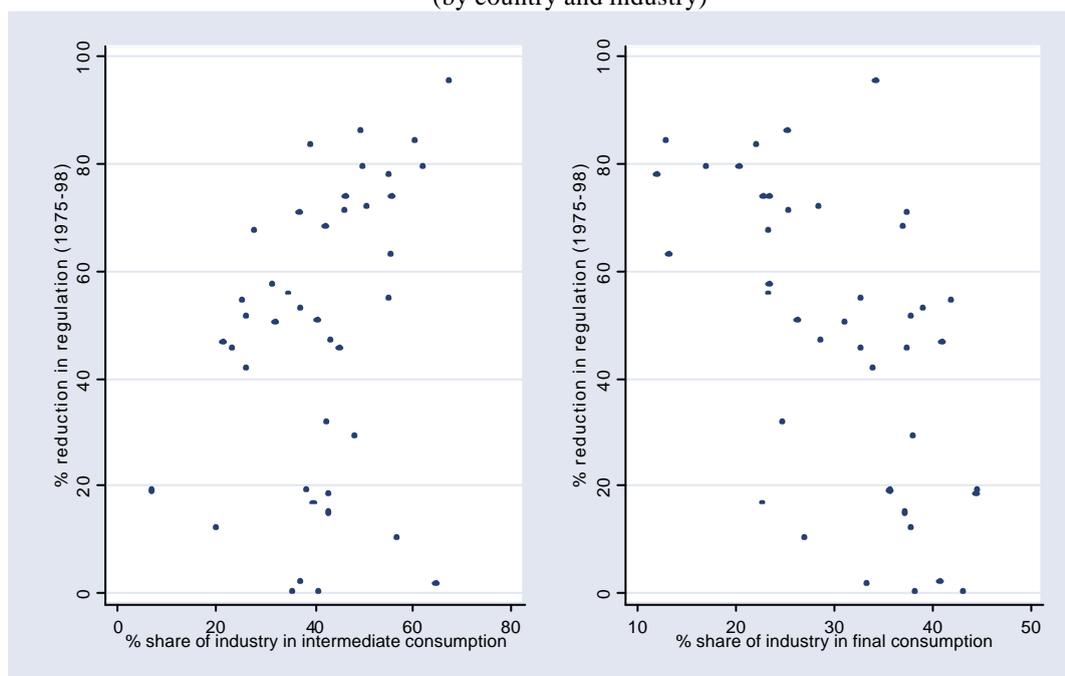


Figure 5.4 (Panels A and B) plots a measure of country-specific reform in three broad non-manufacturing aggregates (the percentage change in the corresponding indicators over the 1975-98 period) against the shares represented by these aggregates in intermediate and final consumption (respectively) in the early 1990s.<sup>29</sup> These simple bivariate relationships can only give a suggestive feeling of the underlying phenomena,

<sup>29</sup> Here and in the remainder of this section, summary indicators of reform for industry aggregates were obtained by weighting the indicators for the individual industries (shown in the previous section) with the average OECD shares of each industry in total business sector employment

not least because they fail to properly account for potential endogeneity problems.<sup>30</sup> However, judging from them, it appears that larger shares in *intermediate* consumption are indeed associated with wider *changes* in regulation, while larger shares in *final* consumption are associated with a greater regulatory *persistence*. Put differently, industries that undergo deeper reforms are those accounting for a larger share of firms' inputs and a smaller share of consumers' budget. This suggests that economy-wide pressures for reform are stronger when these are likely to affect significantly economy-wide production costs, but opposite pressures come from the consumers' side (more on this below).<sup>31</sup>

Given the cross-industry reform spillovers identified in the previous section, the implication for policy could be to reform first industries that produce important intermediate inputs but do not represent significant shares of consumer expenditures. This could contribute to explain why road freight was among the industries to be reformed earliest in most OECD countries. Another implication is that communication campaigns aimed at carefully explaining the expected benefits of reform, possibly supported by the successful experiences of other countries or industries, and reducing unjustified fears concerning the consequences of reform, are likely to increase the political viability of reform. Where these fears are justified, reform policies should contemplate compensation mechanisms for consumers that are likely to be harmed. For instance, as telecommunications services were being liberalised, several OECD countries created mechanisms through which the costs related to universal service obligations imposed on incumbent operators (or new entrants alike) could continue to be financed even after the necessary realignment of tariffs on costs and the elimination of state aid to telecommunications companies (for examples, see Gonenç *et al.*, 2001).

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<sup>30</sup> Of course, there is also an obvious endogeneity problem when one tries to relate consumption or input shares to reform, since these shares may change over time precisely as a consequence of reform.

<sup>31</sup> By and large, the same kind of bivariate relationships continue to hold at the level of the single industry aggregates. However, the negative link between consumer shares and regulatory reform appears to be most evident in the energy sector.

### 5.5.2 Factors affecting perceived losses

What distinguishes true product market reform from other redistributive policies is that it involves taking away rents (often reducing or modifying perceived “acquired” rights) across social groups, including those accruing to the natural constituencies of the political majority in power –for example, competition policies affect the rents of both entrepreneurs and their workers that share the same rents. Therefore, resistance from the beneficiaries of such rents or acquired rights is the major stumbling block on the road to reform.<sup>32</sup> Of course, the strength of resistance in an industry is affected by the size of rents and by the ability of workers and firms to organise and coordinate (see Chapter 2). This relates both to the intrinsic characteristics of the industries and to the degree of market and bargaining power allowed by product and labour market institutions. Clearly, *ceteris paribus*, the higher the actual and prospective rents, the larger are the incentives to preserve and/or increase market or bargaining power.

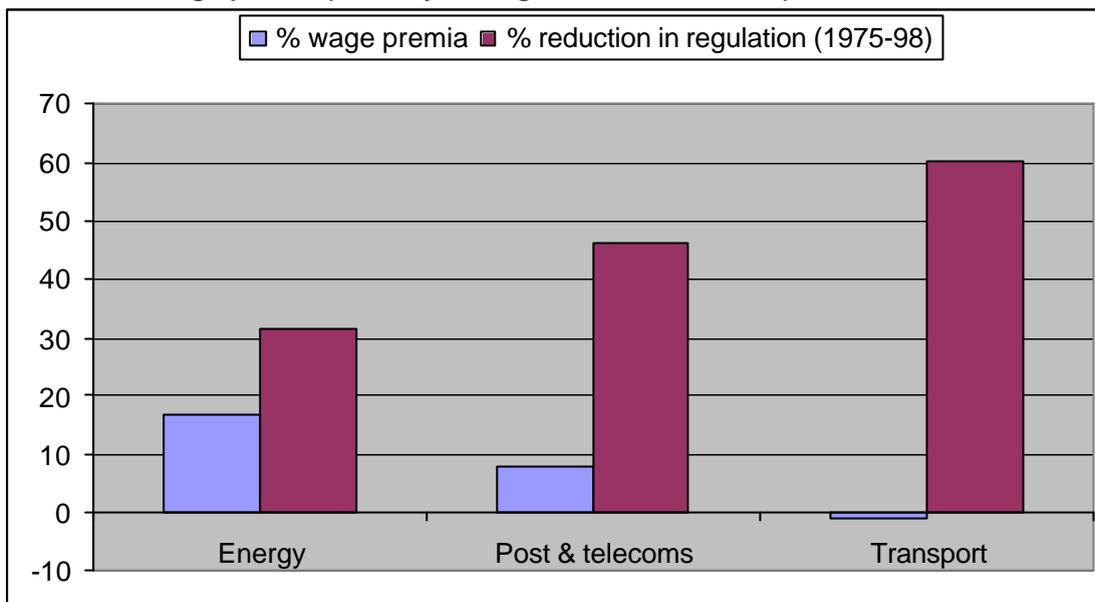
**Workers’ rents and resistance to change** While it is difficult to account empirically for all the factors described above, information on some of them is available on a cross-country cross-industry basis. Wage premia in the 1990s for non-manufacturing industries, for instance, have been recently estimated by Jean and Nicoletti (2001). Premia, however, do not exhaust the description of rents accruing to workers in sheltered markets, because a large part of them can take non-pecuniary forms (such as lower work effort, job security, etc.). In fact, Jean and Nicoletti (2004) show that, especially in industries in which public ownership is significant, non-pecuniary rents can be more important than wage premia, leading to a non-monotonic relationship between premia and product market regulation (including public ownership). Non-pecuniary rents are difficult to measure, but a very imperfect proxy for them can be job tenure: long job tenures could both reflect these rents and contribute to maintaining the bargaining power by increasing the influence of insiders.

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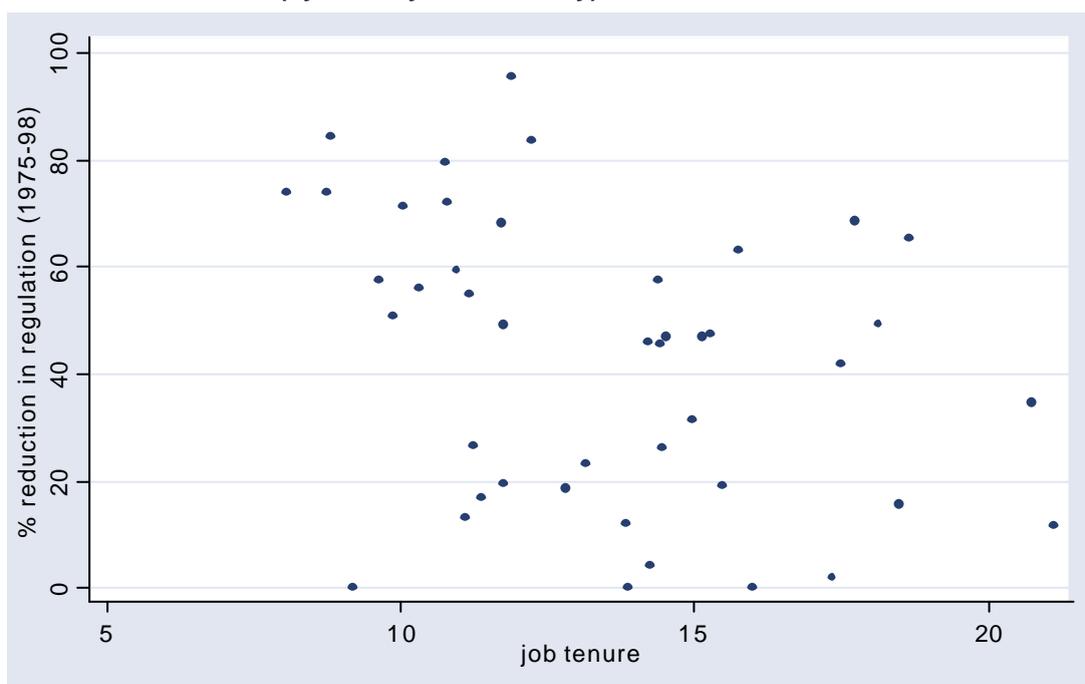
<sup>32</sup> This resistance is further enhanced by the fact that some of the rents are “capitalised” out of the economic system (the “taxicab medallion problem”), so that they are embodied in the price of assets or factor incomes of some agents, even though they did not originally benefit from the redistributive policies (e.g. subsidies, discretionary licensing systems, etc.) that generated the rents. In these cases, natural resistance against reforms that eliminate rents is compounded by a feeling of unfairness *vis-à-vis* policy outcomes that makes the political viability of reforms even more difficult. [We owe this point to Koromzay, 2004].

**Figure 5.5. Workers' rents and regulatory reform**

**Panel A. Wage premia (industry averages across countries)**



**Panel B. Job tenure (by country and industry)**



For the reasons explained above, there is no simple cross-country relationship between estimated non-manufacturing wage premia and industry-specific regulatory reform outcomes. At a more aggregate level, Figure 5.5 (Panel A) shows that, on average, reforms have been inversely related to the size of premia, with the low-premia transport sector undergoing the deepest (and earliest) changes. It should be stressed

again that causality could very well run in the opposite direction, with large reforms succeeding in reducing product market rents. The correlation is also negative (across countries and industries) between the extent of reform and job tenure –our measure of non-pecuniary rents (Figure 5.5, Panel B). Thus, it would seem that, where these rents are higher, it has proved more difficult to implement reforms.

Naturally, workers' rents can take a host of other forms, which are embodied neither in tenure nor in estimated premia. Important examples are reduced workers' effort, special contractual arrangements concerning working conditions, or privileged pension schemes. In state-owned non-manufacturing enterprises, these are sometimes compounded by public-law work contracts which ensure a degree of job protection much higher than in the private sector. These favourable conditions provide insiders with a powerful incentive to lobby against attempts to change the legal status and/or the ownership structure of the firm or to open up the market to new entrants when the incumbent enterprise has a monopolistic or dominant position.

There are two main reasons for this resistance to change. First, corporatisation and, even more so, privatisation necessarily lead to a convergence of work contracts, working conditions and retirement arrangements towards private sector practices. The differences among state-owned enterprises of some EU countries provide striking examples of this link. For instance, at the beginning of the 1990s, telecommunications workers in the fully state owned and public-law French telecommunications company (France Telecom) were hired on public-law contracts and had privileged retirement schemes, while workers in the state-controlled (but corporatised, partially private and listed) Italian telecommunications companies (STET-SIP-Italcable) had private contracts and were part of general social security arrangements. Similarly, workers in the fully state owned and public-law French gas company (Gaz de France) had public-law contracts and special retirement schemes, while workers in the publicly controlled (but corporatised, partially private, and listed) Italian gas companies (Italgas-Saipem) had ordinary contracts and social security schemes. Second, with market liberalisation, new entrants will typically provide contractual conditions aligned on those implemented in other industries rather than sticking to the special arrangements characterising public monopoly sectors. Over time, the lower labour costs of new entrants will put pressure on incumbents for changing their labour practices as well.

For instance, over the 1990s, new entrants in Italian mobile telecommunications or domestic air transport markets have refused to adhere to special collective agreements previously covering telecommunications or air transport workers. Faced with the risk of losing market shares to competitors that enjoyed lower labour costs, incumbents have progressively adapted their industrial relations arrangements.<sup>33</sup>

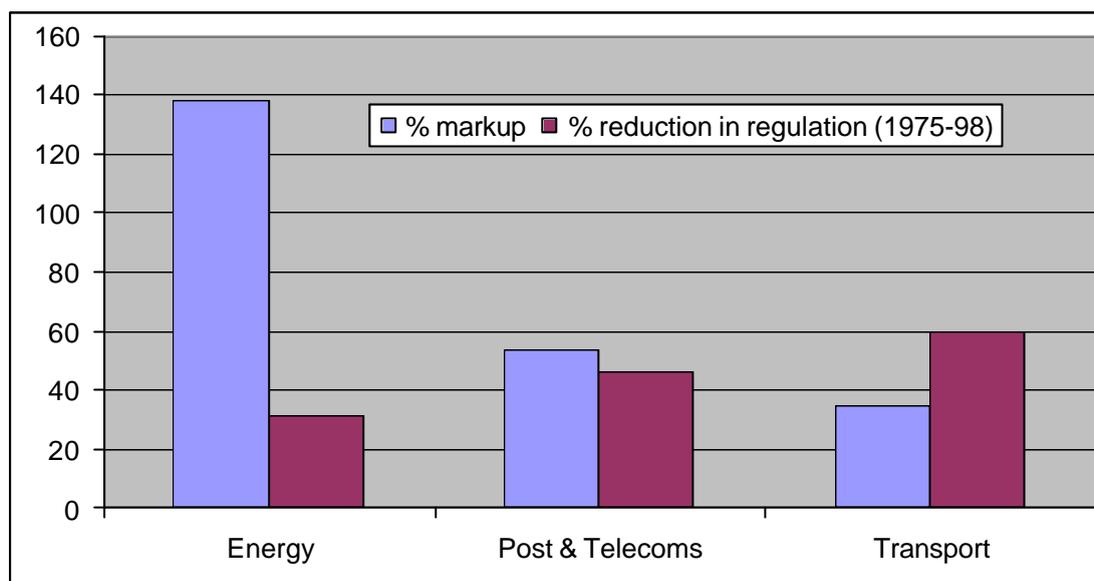
Thus, cross-country differences in non-manufacturing companies' ownership structure, legal status, stock market listing and industrial relation systems can go a long way in explaining differences in regulatory reform outcomes. The degree of resistance to change by workers in these companies crucially depends on these institutional arrangements, and inheriting one or the other can seriously impair or significantly facilitate privatisation and liberalisation efforts. Keeping with our previous country examples, one cannot help relating to different initial conditions the striking differences between the French and Italian attempts to reform the telecommunications, energy and air transport markets. Successive Italian governments have managed over a few years to first significantly corporatise (when needed), privatise (completely in the case of telecommunications) and liberalise these markets facing almost no workers' resistance and offering relatively little compensation to incumbents. By contrast, attempts by several French governments to do the same (admittedly, in a more half-hearted way) have met fierce resistance from trade unions concentrated in these sectors, and had either to back off on original proposals or to compensate the little forward steps with complicated compensatory packages. These ranged from disembodied special pension schemes from the privatised companies, with the provision of full guarantees by the state, to keeping incumbent employees under public-law contracts and apply new private-law contracts only to new hires (so-called "grand-fathering rights").<sup>34</sup> As a result, public control and restrictions to competition are still stronger in France than in Italy in these industries, although the two countries shared until recently a similar tradition of aversion to private governance and market mechanisms.

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<sup>33</sup> Notably, corporatisation and privatisation of air transport services has led to increased differentiation of collective agreements that used to be closely linked to those of airline workers. In some cases (e.g. Aeroporti di Roma), compensation for the loss of implicit rents had to be paid in order to win resistance to changes in contractual arrangements, even though the privatisation deal ensured unchanged employment levels.

<sup>34</sup> Similar pension scheme arrangements have characterised the recent corporatisation and partial privatisation of telecommunications and railway companies in Germany.

**Figure 5.6: Product Market rents and Regulatory Reform**  
(industry averages across countries)

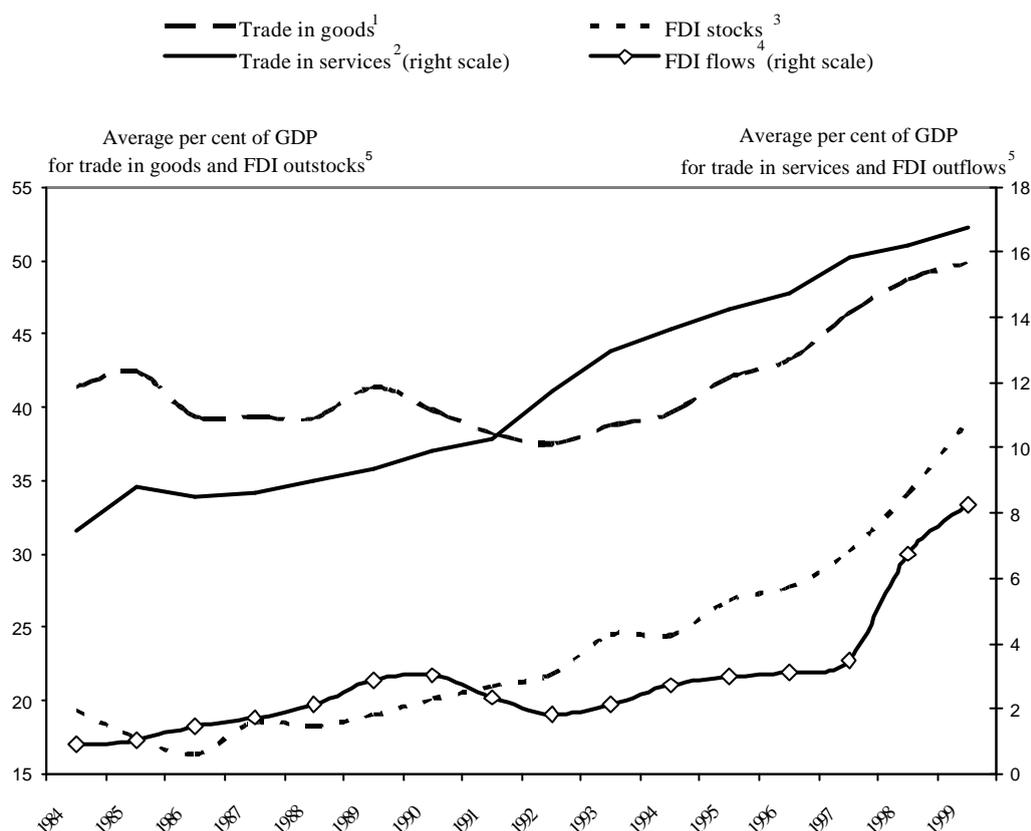


From the point of view of policy, the interplay between institutional arrangements and workers' resistance to change suggests that, in countries where non-manufacturing markets are dominated by public monopolies sharing pecuniary and non-pecuniary rents with their employees, viable reform trajectories require early corporatisation, followed by partial privatisation as well as partial liberalisation of market segments in which new entrants can bring competitive pressures to bear on the dominant company's entrenched industrial relation habits, eventually leading to a harmonisation of labour practices with private sector standards. In cases in which incumbents enjoy legally enforceable privileges related to the type of contract or pension arrangements, there would seem to be little alternative than designing compensatory mechanisms of the kind described above.

**Market power and reform** Indicators measuring potential resistance to non-manufacturing reform by entrepreneurs are scarce. Only very scattered hard evidence is available on product market rents in utilities and services industries. Using the few internationally-comparable estimates of non-manufacturing markups in the 1990s, Figure 5.6 suggests that (on average across countries) there is an inverse relationship between market power and reform outcomes. Market power is lowest in transport, where reforms have been deepest, and it is highest in energy, where reforms were fewer, while the communications industry holds an intermediate position. However,

country-specific data shows that extensive telecommunications reforms have been associated with moderate markups, low concentration ratios and high entry rates, suggesting that market power has decreased significantly over time in reforming countries.

**Figure 5.7.** Trade and FDI patterns in the OECD



1. Trade in goods is defined as the sum of exports and imports of goods realised between a reporting country and the OECD area.
2. Trade in services is defined as the sum of exports and imports of services realised between a reporting country and the world (due to the lack of OECD-specific data, services trade cannot be defined relative to the OECD area).
3. FDI stock is the sum of inward and outward positions of the average country in the OECD area.
4. FDI flow is the sum of yearly investment inflows and outflows of the average country to the OECD area.
5. Simple average of the ratios of OECD countries.

Source: Nicoletti et al. (2003).

Overcoming resistance of incumbents to regulatory change in non-manufacturing industries requires putting pressure on their rents, their market shares and/or their governance systems. As already mentioned, this is partly a by-product of increased globalisation of trade and investment flows. Increasing trade in goods and tradable services (such as financial, communication and transport services) puts pressure on regulatory arrangements that damage efficiency and raise costs for intermediate and

final consumers. As noted above, liberalisation of services in other countries also provides ways around restrictive domestic regulations by creating cream-skimming opportunities for international competitors. This tends to compress rents and erode the market shares of regulated firms in markets that tend to become contestable. Moreover, liberalisation of international investment flows, and the associated wave of mergers and acquisitions, puts to stress rigid governance systems (such as public ownership) that circumscribe corporate strategies to domestic markets, leading to losses in competitiveness and market leadership. Thus, in some cases, globalisation has pushed incumbents themselves to join the ranks of those in favour of privatisation and reform, at least to the extent that this would not jeopardize their dominant position in the market (Levy and Spiller, 1999; Noll, 1999).

Indeed, in concomitance with the major drive for product market reforms, the intensity of trade in both goods and services rose sharply in the OECD area over the 1990s, and FDI (another form of services trade through commercial presence) almost doubled (Figure 5.7).<sup>35</sup> Interestingly, available cross-country evidence suggests that both services trade and FDI intensities are inversely related to the stringency of domestic regulations (Figure 5.8).

Clearly, the direction of causality could go both ways: relatively stringent domestic regulations could deter services trade and FDI,<sup>36</sup> but weak services trade and FDI intensities might also be discouraging efforts at (or undermining support for) reforming regulations in a competitive sense. To the extent that the latter channel is operating, opening up trade in services industries where opposition to reform is lowest can have positive repercussions for the viability of reform in other services industries where vested interests are stronger. This kind of mechanism seems to have linked, for instance, early reforms in international financial flows and later reforms in telecommunications: interest groups related to the financial industry have been a powerful source of consensus for telecommunication liberalisation in many countries (Li *et al.*, 2001). One channel through which this may be explained is through input

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<sup>35</sup> It should be noted, however, that only part of reported FDI flows translates into an increase of the activity of foreign affiliates in the non-manufacturing industries. Much of them are related to manufacturing activities, M&A activities, minority equity participations or reinvested earnings. The available data on foreign affiliates, however, tend to confirm the picture provided by FDI data.

<sup>36</sup> See Nicoletti *et al.* (2003) and Mirza and Nicoletti (2004) for multivariate empirical analyses of the linkages between product market regulations and bilateral FDI and services trade.

complementarities. Communication is a crucial complement to other inputs in producing many financial services. Thus entrepreneurs in the financial industry have a strong incentive to lobby for the removal of distortions in communications flows.

The presence of foreign affiliates, enjoying forward technology and knowledge spillovers from their home companies, can also contribute to switch attitudes among domestic producers as regards the desirability and the benefits of reforms aimed at improving production flexibility and efficiency. Of course, foreign affiliates also constitute interest groups of their own, whose attitudes towards reform are not necessarily univocal. To the extent that they enjoy market power, they may join the ranks of those that oppose reform. But, if they are “challengers” of incumbent firms they will also directly lobby with the government to remove restrictions that impinge on their ability to compete effectively.<sup>37</sup>

Thus, another way in which consensus for domestic product market reforms could be strengthened is by removing protections against foreign ownership of domestic firms or creating wedges in domestic markets where foreign services providers can force in. Indeed, removal of FDI restrictions has been an important element of product market reform in the OECD area (Figure 5.9, Panel A), and regulatory reform appears to have been deeper in industries and countries where the share of foreign affiliates in output grew larger (Figure 5.9, Panel B).<sup>38</sup> Moreover, there are several examples of wedges used by foreign providers, which during the 1990s were instrumental in stimulating wider non-manufacturing liberalisation. As already mentioned, in telecommunications, call-back services for international long-distance communications put pressure on incumbent operators and had a demonstrative effect on consumers, notably in EU countries. In air transport, opening up routes to cabotage by low cost airlines had similar effects. In electricity, certain regulatory authorities (e.g. in Italy) widened access by foreign producers using “direct lines” –independent of the national transmission grid– as a means to increase competitive pressures on the domestic market.

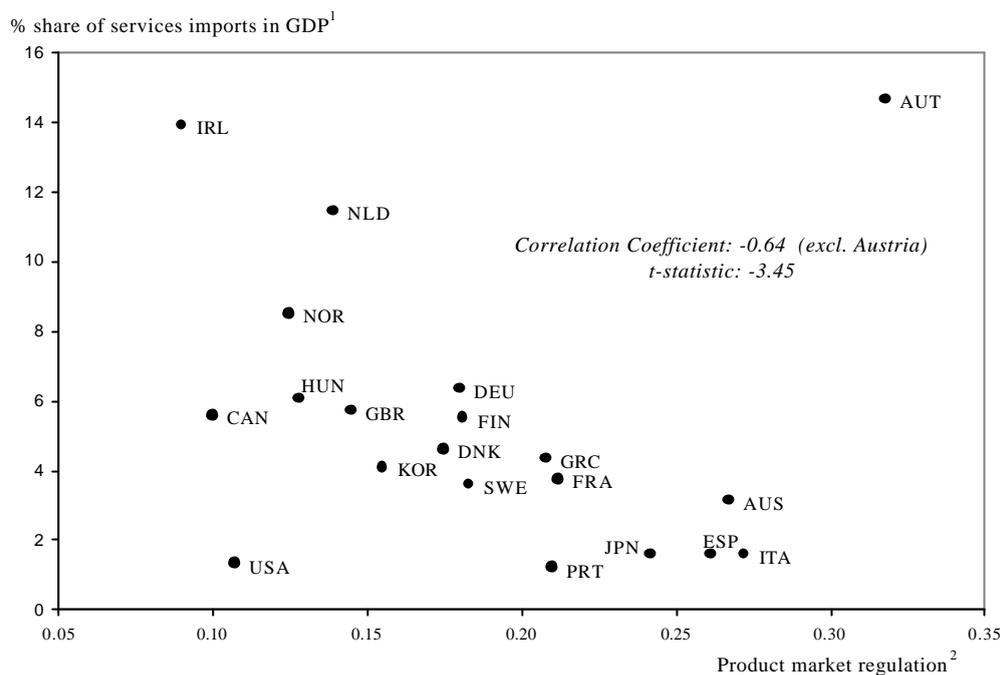
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<sup>37</sup> As noted above, the attitude of foreign affiliates towards trade openness is less ambiguous, since (save for special cases) they will tend to lobby for trade liberalisation (Gawande, Krishna and Robbins, 2001).

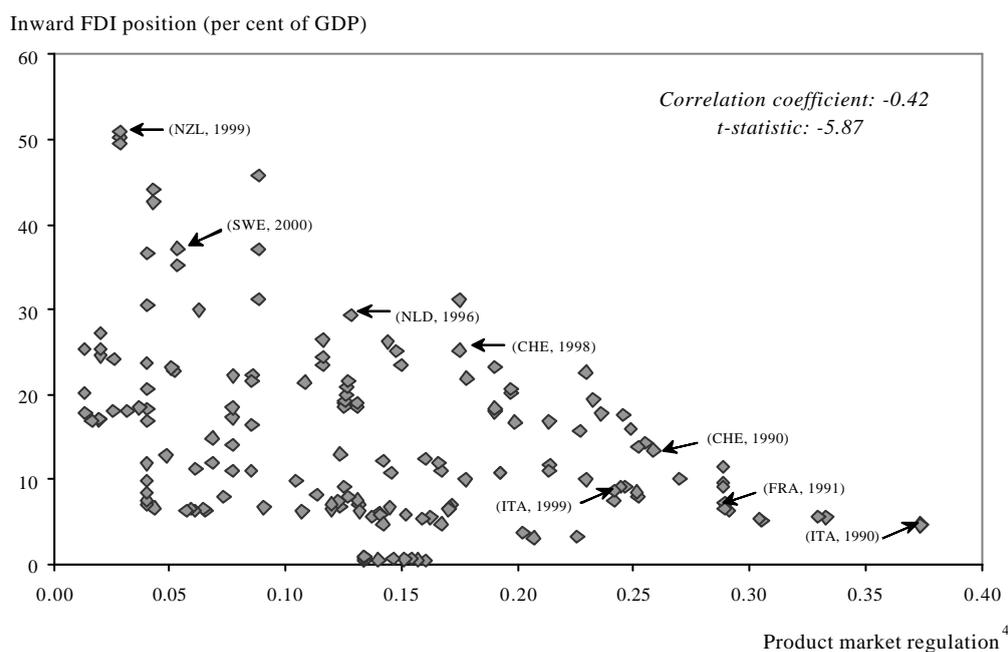
<sup>38</sup> A related issue is what determines the attitude of domestic and foreign lobbies towards FDI policy. While research in this area has not been extensive, Facchini and Willmann (2001) stress the role played by factor complementarities. They note that a factor will have the incentive to lobby for the removal of any distortion in the flows of its complements, since its marginal productivity is increasing in it.

**Figure 5.8.** Non-manufacturing regulation, services imports and inward FDI, 1998

**Panel A. Services**



**Panel B. FDI<sup>3</sup>**

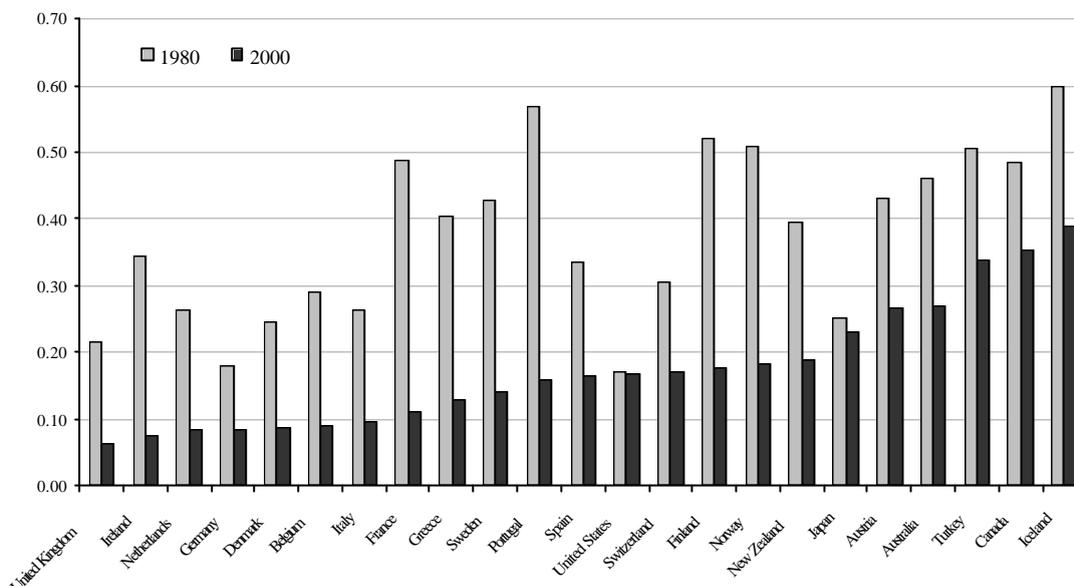


1. The position of Austria reflects the exceptionally high share of service trade accounted for by tourism.
2. Weighted average of regulatory indicators in 12 non-manufacturing industries.  
0-1 scale from least to most restrictive of competition.
3. Each point shows the combination of regulation and FDI in a given country and period. Some of these country/period contributions are shown for illustrative purposes.
4. Product of the indicator of economy-wide regulation in 1998 and the indicator of barriers to entry in seven non-manufacturing industries over the 1980-1998 period. 0-1 scale from least to most restrictive of competition.

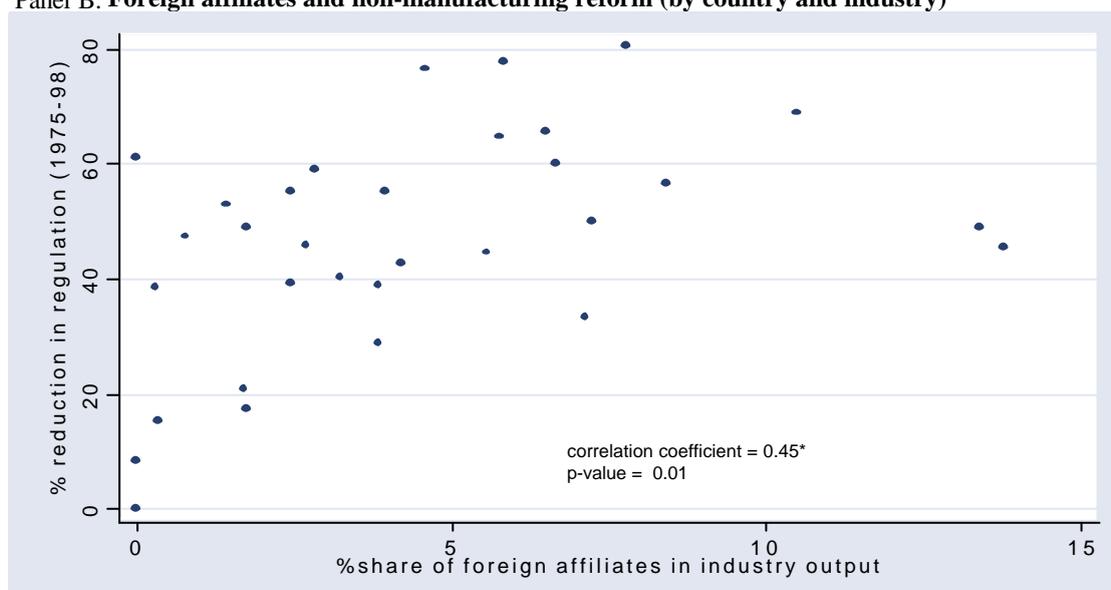
Source: Nicoletti et al. (2003).

**Figure 5.9. Regulatory reform and FDI openness**

**Panel A. FDI restrictions in OECD countries,<sup>1</sup> 1980-2000**



**Panel B. Foreign affiliates and non-manufacturing reform (by country and industry)**



1. The indicator ranges from 0 (least restrictive) to 1 (most restrictive). The most recent year for which data are available varies across countries between 1998 and 2000. For details, see Golub (2003)

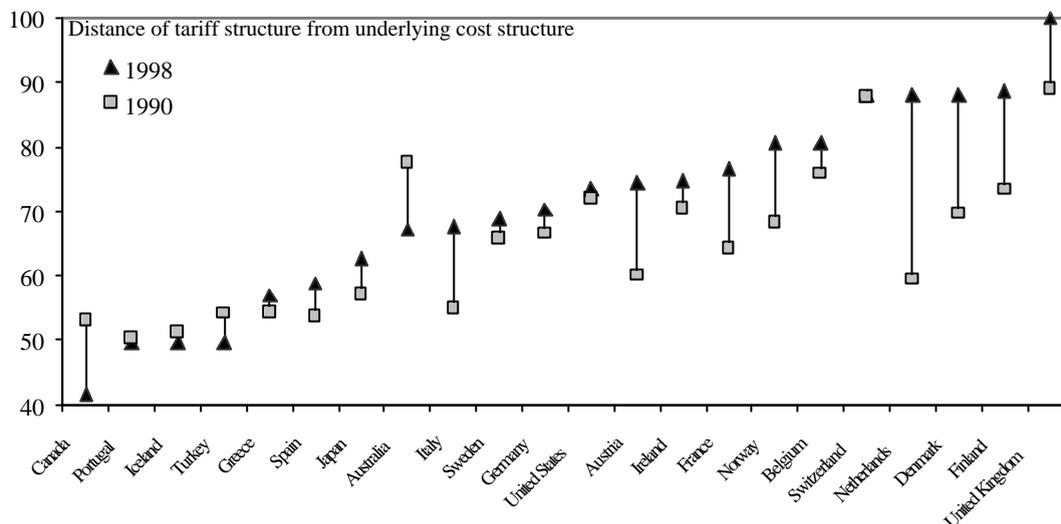
### 5.5.3 Other facilitating or impeding factors

At several places in this chapter we have stressed the role played by “framework conditions” in facilitating or impeding product market reforms. As mentioned above, the most important factors playing against the regulatory status quo in the non-manufacturing sector are technological advances, trade openness and external (treaty-

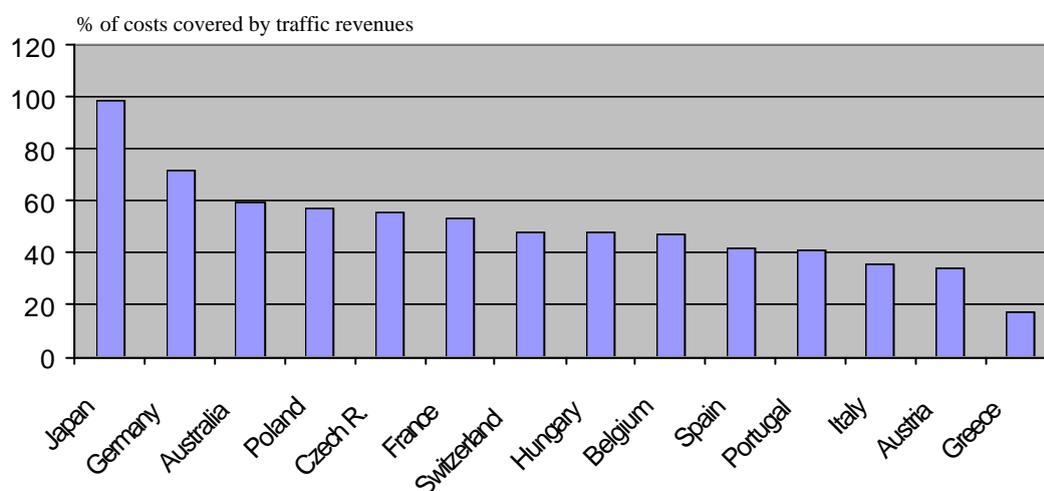
related) constraints. Two additional factors are likely to be important for product market reforms: (i) the size of initial price distortions implied by regulations; and (ii) the institutional setting that supports the regulatory status quo or, promotes reforms.

**Figure 5.10: Measures of price distortions**

**Panel A. Tariff rebalancing in fixed telephony, 1990 and 1998<sup>1</sup>**



**Panel B. Cost-coverage ratio in railways<sup>2</sup>**



1. The rebalancing indicator measures the distance of the tariff structure of a country from the tariff structure of the United Kingdom in 1998. The assumption is that the United Kingdom had achieved by 1998 a tariff structure more reflective of underlying costs than in other countries. The tariffs included in the calculations concern local service and long-distance service (at 27 km, 110 km and 490 km). An upward movement of the indicator means that the tariff structure has become more similar to the structure existing in the United Kingdom in 1998.  
 2. The cost-coverage ratio is computed dividing total operating and financial costs by total traffic revenues reported by the mai  
 Source: Gonenç et al. (2001) and Union Internationale des Chemins de Fer (2002)

**Initial distortions** Initial distortions are important because they are a measure of the potential redistribution of resources implied by regulatory reform. For instance, in many network industries, the pre-reform tariff structure deviates

significantly from underlying production costs. As a result, several categories of consumers are *de facto* subsidised either by the company providing the product – through a cross-subsidisation scheme across consumers groups– or by the taxpayer, who finances the government transfers that cover the company's. Figure 5.10 shows two different proxies of these distortions for telecommunications and railways –the tariff rebalancing gap and the cost coverage ratio, respectively. Taking the 1998 structure of tariffs in the United Kingdom –the front-runner in telecom liberalisation– as an approximation for the underlying structure of costs, the first indicator shows the average distance of tariffs to costs in 1990 and the tariff rebalancing effort made by 1998. The second indicator shows the share of total operating costs covered by traffic revenues in railways in 2001. Both measures suggest that the size of distortions differs significantly across countries.

*Ceteris paribus*, the larger the redistribution implied by the realignment of tariffs on costs after the reform, and the stronger should be the resistance to reform from the beneficiaries of the pre-reform regulatory arrangements. Indeed, many of the 1998 laggards in liberalisation are found among the countries that had or still have the largest distortions, such as Austria, Greece and Portugal in telecommunications, and Southern European countries, Austria, Belgium and Switzerland in railways. A corollary of this is that maximising support for reform in industries where the tariff structure is distorted may require a gradual approach and/or compensating mechanisms for consumers that may suffer real income losses. In this respect, it is interesting to notice that, faced with the deadline imposed by EC directives (e.g. the 1998 limit for complete liberalisation of telecommunications), a gradual approach has been adopted in many countries. For instance, empirical evidence suggests that, on average, tariffs of trunk and international communications, which generally exceeded costs before the reform, began falling several years before 1998 in anticipation of liberalisation (Boylaud and Nicoletti, 2001), while at the same time the fixed cost of local communications was generally raised.<sup>39</sup>

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<sup>39</sup> Of course, in this case tariff rebalancing before liberalisation was also in the interest of incumbent network operators, who otherwise would have lost significant market shares to competitors in the trunk and international communications markets in the wake of liberalisation.

**“Voice” institutions** Several institutions can amplify the “voice” of interest groups in favour or against reform affecting their potential influence on policies. The most obvious example is when the institutional setting is such that incumbents in an industry directly participate in regulatory decisions. This has been the norm for a long time in network industries of most OECD countries where, typically, the regulated incumbent –the public telecommunications operator, a vertically-integrated electric utility, a state-owned railway company or a flag carrier– would take up regulatory tasks, closely collaborating with the relevant ministry on decisions concerning entry, pricing or standards. Recent institutional changes often delegated these tasks to new independent regulatory authorities, breaking up the incestuous relationship between the regulated and the regulator, thereby reducing the risk of regulatory capture.<sup>40</sup> However, the confusion of roles that persists in the regulatory arrangements of some network industries (e.g. the allocation of slots in rail and air transport) still provides scope for incumbents to preserve and exercise their market power.

A variant of this is the tradition of self-regulation in the professions. In many countries, the right of professional bodies to set minimum prices, entry conditions and other business practices (such as restrictions on the type of company or the range of services that can be provided) is enshrined in national or local legislation, sheltering them from competition law provisions. Often these self regulations go well beyond the stated defence of quality standards, facilitating or encouraging collusion and pre-empting the emergence of domestic and, especially, foreign competitive pressures. Recent surveys by the OECD and the EC show that unnecessarily restrictive regulation in the professions is widespread throughout industrialised countries (Paterson *et al.*, 2003). However, perhaps also due to the large number of professionals sitting in national and local legislative bodies, resistance to reform in this area has been stark even in relatively liberal countries (e.g. Canada, the Netherlands). While self-regulation may still have a role to play, it would seem that a useful first step towards reforming this industry could be to gradually eliminate the legitimacy of restrictive practices, exposing them to the hardships of competition law enforcement. This would open up a channel through which pro-reform interest groups could navigate.

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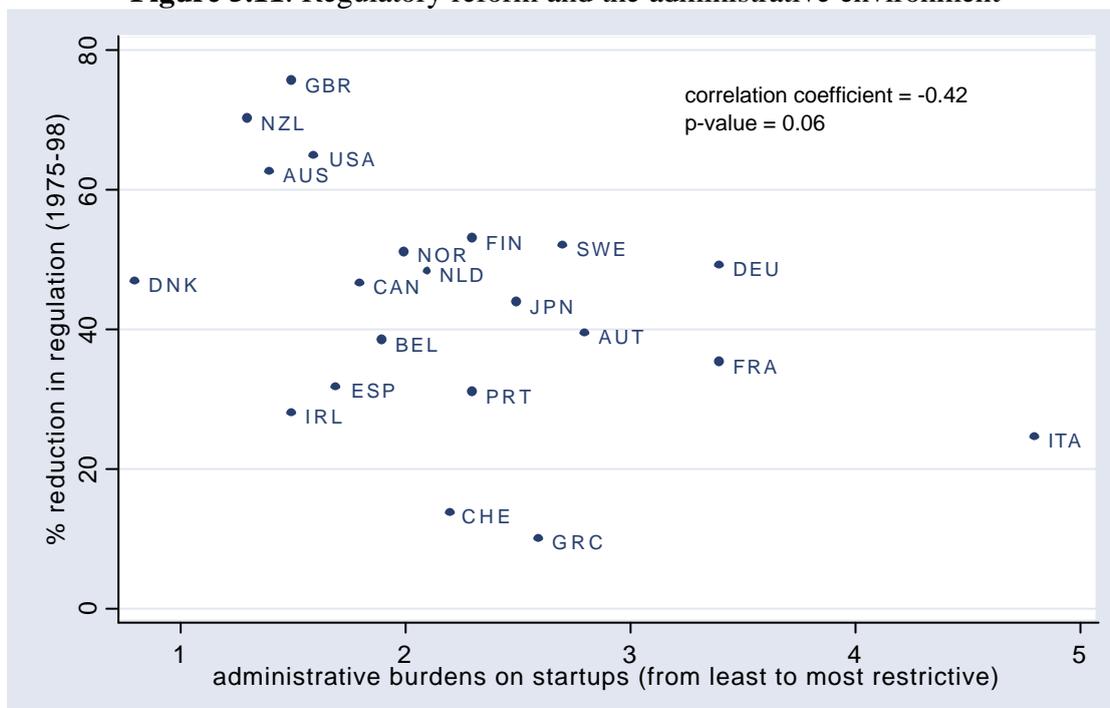
<sup>40</sup> The political economy of independent regulatory authorities – why were they created? How resilient are they to pressures of interest groups? How does this resilience depend on different kinds of organisational structures? etc. – is ground that has not been travelled much by researchers.

Another way in which institutions can be “spongy” to special interests is when they explicitly provide for representation of incumbents in local bodies that take regulatory decisions. This “lighter” form of confusion between the regulated and the regulator is common, for instance, in the road freight and retail distribution industries of several OECD countries. A recent survey unveiled that in fourteen OECD countries professional road freight bodies were associated to decisions concerning prices or entry (in some of them, including Italy and Spain, they participate in both decisions) and in eight countries (including Denmark, France, Italy, Sweden and the United Kingdom) professional bodies of retailers participated in decisions concerning new licenses (Boylaud and Nicoletti, 2001). As expected, there is a strong cross-country correlation between the possibility given to professional bodies to influence local market regulation and the overall level of barriers to entry in the industry. Thus, any national policy aimed at liberalising access to these industries should start by eliminating these channels of professional body representation at the local level.

Local implementation of policies established at the national level is also crucially affected by the structure of the public administration and the burden and opacity of administrative procedures. Recent research has shown that, rather than serving the public interest, heavy administrative procedures make the public administration permeable to special interests, notably because they increase the leverage power of bureaucrats (Djankov *et al.* 2003). Thus, absent an effective policy of administrative simplification, even good-willed governments pushing for reforms can see their efforts nullified in areas where national policies need to be implemented by local administrators. More maliciously, one may wonder whether reforms may sometimes be designed precisely to be emptied of their innovative content at the ground level. This would ensure “reformers” with electoral prestige at the national level without harming their local constituencies. The recent history of reforms in OECD countries provides several such examples. In both the Netherlands and Italy, the local implementation of reforms in retail distribution limited significantly the actual liberalisation of the industry (partly due to the persistent influence of the local lobbies of retailers on decisions concerning entry, see above). In Italy, administrative simplification itself was delegated to the local level. With no clear system of incentives in place, the results of this widely-publicized national policy were largely

disappointing mainly due to the persistence of heavy administrative practices on the ground. Since there is a tendency for burdensome administrative environments to slow down regulatory change (Figure 5.11), successful administrative reform would seem to be a necessary prerequisite for other types of product market reforms.

**Figure 5.11.** Regulatory reform and the administrative environment



Source: Nicoletti *et al.* (1999)

### **5.6. Pulling the strings: is there a road to product market reform?**

Our analysis of the patterns and underlying political economy determinants of product market reforms in non-manufacturing industries is far from being exhaustive. However, it provides a number of insights on specific features of the interplay between framework conditions and the main actors influencing policies.

First, our analysis suggests that the key to reform is to unbundle private interests. A “divide and conquer” strategy seems to be most appropriate in this sector. Specifically, the history of past reforms shows that targeted (and sometimes marginal) changes to existing regulatory arrangements can open up new opportunities for market players, breaking up entrenched coalitions (for instance separating employers from employees

or entrepreneurs in different parts of the vertical chain of production) and providing strength to potential supporters of reform (e.g. new entrants).

In this process, an important role can be played by collateral policies, such as increasing openness to trade. In particular, freeing first trade in services where opposition to reform is lowest (like for financial services) may increase the viability of later reforms in other services. Similar effects can be achieved by removing FDI restrictions and opening up wedges through which foreign providers can penetrate the domestic market. Pressures from this side can not only increase the political influence of new entrants but also change the very attitude of incumbents towards reform.

Particular attention should also be paid to interactions between product and labour market conditions. Certain marginal reforms can pave the way for deeper regulatory changes by breaking the coalition between employees and managers within incumbent firms. This is achieved as contractual or bargaining outcomes that generated pecuniary or non-pecuniary rents for workers become unsustainable in the new governance and market environment created by reforms. At the same time, initial conditions characterised by legally enforceable acquired rights can make it necessary to offer compensation to special interests that otherwise would oppose the reform.

Second, we detected the presence of “band-wagon” effects, in which reform in one industry spills over to other industries (either due to increased inter-industry competition or to demonstrative effects), and input complementarities, through which support for reform increases as market conditions in other industries change. Hence, a piece-wise reform strategy may lead to progressively larger areas of liberalisation, without stirring as much resistance as an all-encompassing one. This is not to say that “packaging” is not necessary. But packages should be aimed at creating the conditions for a smooth and continuous reform drive rather than imposing a shock therapy.

This brings us to the third insight: framework and initial conditions should be carefully looked at before pushing ahead with reform. Policies should be designed to adapt to these initial conditions. Concretely, this translates into making sure that (i) major price distortions are progressively eliminated, so that the redistributive effects of reform are diluted over time (and possibly offset by compensation mechanisms); (ii) institutions

(or legal provisions) that provide voice (or shelter from competition law enforcement) to special interests opposing reform are phased out, while channels through which pro-reform interests can express themselves are created or reinforced; and (iii) bureaucratic impediments to an effective ground implementation of reform are removed, notably through prior administrative reform.

Our final advice concerns communication strategy. The analysis suggests that uncertainty is a particularly important driver of status quo biases, and that demonstration and peer pressure (e.g. from reforms enacted in other industries or countries) can be effective in soothing these concerns. Therefore, an appropriate pedagogy on the expected effects of reforms supported by benchmarking tools (e.g. international comparisons) and forwarded by credible and independent institutions can be crucial to gather the necessary support for policy.

In conclusion, there is no compelling reason to believe that only “radical” and all-encompassing changes can accommodate reform in product markets (Boeri, 2004; Alesina, 2004). On the contrary, in a democracy, a big-bang approach to reform can be a recipe for failure, because it runs the risks of compacting opposition to reform from all the interconnected interest groups that benefit from the regulatory status quo in non-manufacturing industries. Also, there appears to be little scope for institutional engineering aimed at changing electoral systems to facilitate product market reform. Though these changes can be desirable on other grounds, the interest bundles supporting the regulatory status quo in non-manufacturing industries cannot be easily undone by moving from proportional to majority rule.

Clearly, a “divide and conquer,” gradualist and piece-wise approach to product market reform requires time and political persistence. Unfortunately, both of them are scarce goods. The time of domestic politics often does not match the rapid developments of the global economy. The time horizon of politicians is often inconsistent with a continuous drive for reform. But failure to reconcile viable strategies for reform with the constraints of the political game can easily lead a country to decline. One can only hope that making governments aware of this could contribute to speed up regulatory change in countries where reforms are lagging behind.

## Methodological appendix for Chapter 5.

### Coding assumptions for indicators of regulation used in empirical analysis

Sector	Item in indicator	Weights	Description	Weight	Coding
<b>Electricity</b>					
	Entry	1/3	Average of three indicators: existence and features of third party access (TPA), existence of a liberalised power market (PM), thresholds for free choice of supplier (FC).	1/3	TPA = Regulated:0, Negotiated:2, Single Buyer:4, or None:6. PM = Yes: 0, No = 6 FC = 0GW: 0, <251GW: 1, <501GW: 2, <1001GW: 3, =1001GW: 4, no choice: 6
	Vertical integration	1/3	Average of two indicators: vertical separation between generation and transmission (GTS); and overall vertical separation between generation, transmission, distribution and supply (OS)	1/2	GTS = integrated: 6; accounting separation: 3; separate companies: 0
	Public ownership	1/3	Share of government in major companies	1/2	OS = integrated (incl. accounting separation): 6; some segments unbundled: 3; complete unbundling: 0 Private: 0; mostly private: 1.5; mixed: 3; mostly public: 4.5; public: 6
<b>Gas manufacture and distribution</b>					
	Entry	1/4	Average of indicators of degree of entry regulation in gas production (P), transportation (T) and distribution (D)	1/3	In each industry segment = regulated: 6; partly regulated: 3; unregulated: 0
	Vertical integration	1/4	Degree of separation between competitive and non-competitive activities		Full separation between P, T and D: 0; full separation between P and T/D: 1.5; some separation between P and T/D: 3; some separation between T and D: 4.5; no separation: 6
	Public ownership	1/4	Share of government in major companies		Public owned: 6; mixed private/public: 3; private: 0
	Market structure	1/4	Market share of dominant operator		No dominant market player: 0; one participant has more than 50% market share in relevant market, or many local de facto monopolies: 3; one participant has more than 90% market share: 6
<b>Railways</b>					
	Entry	1/4	Average of legal barriers to entry in passenger and freight businesses	1/2	Legal monopoly or compliance with EC directive: 6; Regulated entry or open tendering franchise: 3; Free entry: 0
	Vertical integration	1/4	Degree of separation between competitive and non-competitive activities		Fully separated: 0; Full separation anticipated but not fully undertaken yet: 1.5; Legal separation: 3; Accounting separation: 4.5; Fully integrated: 6
	Public ownership	1/4	Share of government in major companies		Public owned: 6; mixed private/public: 3; private: 0
	Market structure	1/4	Market share of dominant operator		No dominant market player: 0; one participant has more than 50% market share in relevant market, or many local de facto monopolies: 3; one participant has more than 90% market share: 6
<b>Road freight<sup>1</sup></b>					
	Entry		Legal barriers to entry		Free entry: 0; partially liberalised: 3; regulated entry (restrictive licensing): 6
	Prices	1/2	Extent of price regulation		No regulation: 0; guidelines given to companies: 3; regulated: 6
<b>Air transport<sup>3</sup></b>					
	Entry	1/2	Average of indicators for entry in domestic routes (DR) and international routes (IR)	Share of international traffic in total	DR = Domestic market liberalised: 0; domestic market not liberalised: 6 IR = No regional aviation market, no open sky agreement: 6; regional aviation market, no open sky agreement: 3; no regional aviation market, open sky agreement: 3; regional aviation market and open sky agreement: 0
	Public ownership	1/2	Percent share of government in major airline (SH)		6*SH/100
<b>Post</b>					
	Entry	1/4	Average of indicators of degree of entry regulation in basic letter, basic parcel and courier services		In each activity = regulated: 6; partly regulated: 3; unregulated: 0
	Public ownership	1/4	Average of indicators of degree of public ownership in basic letter, basic parcel and courier services	Revenue shares of	In each activity = public owned: 6; mixed private/public: 3; private: 0

**Industry-specific time-series indicators of product market regulation (1975-1998):  
coverage and sources**

Industry	ISIC code Revision 3	Regulatory and market dimensions covered <sup>1</sup>	Industrial segments covered	Main sources <sup>2</sup>
<b>Electricity and gas</b>	<b>40</b>	E, PO, VI, MS	Prod., Trans., Dist.	OECD, EC, PI, WB
<i>of which:</i>				
<i>Electricity</i>	401	E, PO, VI	Prod., Trans., Dist.	OECD
<i>Gas manufacture and distribution</i>	402	E, PO, MS, VI	Prod., Trans., Dist.	OECD, EC, PI, WB
<b>Transport</b>	<b>60</b>	P, E, PO, MS, VI		OECD, ECMT
<i>of which:</i>				
<i>Railways</i>	601	E, PO, MS, VI	Passenger, freight	OECD, ECMT
<i>Road freight</i>	602	P, E		OECD
<i>Air transport</i>	62	E, PO	Passenger	OECD, EC
<b>Post, Telecommunications</b>	<b>64</b>	E, PO, MS		OECD
<i>of which:</i>				
<i>Post</i>	641	E, PO	Letter, parcel, express	OECD, EC, UPU
<i>Telecoms</i>	642	E, PO, MS	Fixed, mobile	OECD

Note 1 :

- P = Price regulation
- E = Barriers to entry
- PO = Public ownership
- MS = Market structure
- VI = Vertical integration

Note 2 :

- ECMT = European Conference of Ministers of Transportation
- EC = European Commission
- WB = World Bank
- PI = Privatisation International
- UPU = Universal Postal Union

## Chapter 6

### How to gain political support for privatisations?

#### The experience of OECD and Transition countries

In this chapter, we analyze the various privatisation processes that took place in Europe. We distinguish privatisations that took place in Western Europe, where the government could select the extent as well as the timing of privatisations, from those in Eastern Europe, where the transition from a command to a market economy called for massive and rapid privatisation programs.

Throughout the world, privatisations became a phenomenon of extraordinary size since the end of the 1980s, as witnessed by Table 6.1. But, what *is* exactly privatisation, and what is its purpose? It can be *‘broadly defined as the deliberate sale by a government of state-owned enterprises (SOEs) or assets to private economic agents’* (Megginson and Netter 2001, p321 –MN henceforth), and is therefore directly associated to a disengagement from production by the state, which induced a fall in the share of SOEs in GDP from 10.5 to just 4% in upper middle income countries and from 6% to 4% in high income countries (Sheshinski and López-Calva, 2003).

**Table 6.1:** Change in SOEs’ activity as a percentage of GDP

<b>Countries (by income group)</b>	<b>1980</b>	<b>1999</b>	<b>Change: difference between 1999 and 1980</b>
<b>Lower Middle income</b>	11	4	-7
<b>Upper Middle income</b>	10.5	4	-6.5
<b>High income</b>	6	4	-2

Source: Sheshinski and López-Calva (2003, table 1)

There are at least two reasons why privatisations became so prevalent. First, developments in economic theory and in the way in which markets operate imply that

there are new efficiency gains to be grasped. Second, as we shall see, political motivations may also induce governments to divest from production.

To understand why it may be *efficient* that governments divest from production, one should first detail the *economic* rationales for privatisation. Section 6.1 shows that these are quite compelling but hinge upon specific conditions that relate to the way in which markets operate. Actually, as shows Section 6.1, many firms were initially nationalized because these conditions were not met. In Section 6.2, we outline the *political* rationales for initial nationalisations, and subsequent privatisations. Taken together, economic and political rationales help disentangling the actual economic value of these extensive privatisation programs. Section 6.2 also reviews the empirical evidence about the relative performance of state and private firms, and Section 6.3 describes how governments can actually implement their privatisation programs. In Section 6.4, we turn our attention to the particular conditions that surrounded the mass privatisation programs in formerly planned economies, and Section 6.5 provides a case study for the privatisation of two car producers: Škoda in the Czech Republic and AvtoZAZ in Ukraine.

Importantly, one must also realize that state intervention need not be synonymous to state *ownership*. Actually, privatisations in Western European countries have generally been associated with waves of re-regulation (see Chapter 5). We therefore also want to shed light on why populations or government shifted their preferences from one type of state intervention to the other.

### **6.1. Economic rationales for privatisation**

Whether they use them appropriately or not, governments generally rely on economic theory arguments to justify privatisations. They would frame their proposals in such a way that their privatisation program is felt to improve economic and allocative efficiency, strengthen market disciplining effects, or produce other substantial benefits. To judge whether such economic justifications are appropriate or not, we therefore need some theory. We must identify why SOEs should yield worse outcomes than private firms, and why keeping these firms into public hands would generate inefficiencies that privatisation could correct. Next, we must pinpoint under which

conditions these results hold; that is *when* markets can be expected to generate more “efficient” outcomes than state-controlled production.

Though of primary importance, economic efficiency is however not the *only* rationale for divestment by the state. Sometimes, *budgetary* reasons induce governments to privatise. Indeed, when the government faces increasing needs to narrow the public deficit, it may be tempted to look at whatever means of raising fast cash. Liquidity constraints alone may thus induce governments to consider privatizing state firms, even though this need not improve overall efficiency.

These two economic rationales for privatisation (efficiency enhancement and deficit reduction) may, or not, coincide. Why should privatisation enhance efficiency? Microeconomic efficiency relates to two different dimensions. First, given the cost structure of the firm, the output of the firm should be sold at a price close to the marginal cost of production (see Chapter 2). Second, the management of the firm must have appropriate incentives to reduce operating costs. These incentives are typically provided by market competition, appropriate governance structure (when managers become residual claimants on the profits made by the firm), hard budget constraints, etc... However, SOEs tend to be largely shielded from these constraints. *Incentives* are thus less pressing in SOEs (see also Schmidt 1997, Shleifer 1998, or Sheshinski and López-Calva 2003). In addition, *political* factors may also induce the enterprise to maintain *X-inefficiencies*. The government may derive strong benefits from maintaining inefficiently high levels of employment or from serving more customers than economically profitable, for instance. State ownership paves the way to stronger lobbying pressures; to a convergence of objectives between *politicians* and specific *lobby groups*. MN argue that, over time, these costs become even larger than those that state ownership were initially supposed to correct (see below). State ownership may thus be a cure that adds pain to injury in the long run, which justifies the eventual privatisation of many SOEs.

To tie an SOE on its toes, a possible (intermediate) step is to transform it in a corporation that is legally separate from the state (See Chapter 5 for more detail). However, although such *corporatisation* may help harden the budget constraint faced by the SOE, there are reasons for which such an intermediate step may still be unsatisfactory. First, the convergent links between politicians and lobbies are not

broken. Second, since the firm is not *sold*, the revenues of the government are not increased.

On the other hand, X-inefficiencies do generate rents for some groups. Implementing efficiency-enhancing privatisations therefore requires either that oppositions be bought off or that the different groups that would benefit from the privatisation can coordinate sufficiently. That is, privatisations require shifting the political balance against the lobby groups that benefit from state ownership: even though the privatisation of a given firm might be desirable from an economic efficiency standpoint, it may be difficult to pass politically. Voters must be offered sufficiently high benefits from the process. To this end, offering voters the choice between higher taxes and the privatisation of a particular firm helps bringing down political objections: the two economic arguments in favour of privatisation reinforce one another. Still, the eventual choice by the government will always be political. As state Boycko *et al.* (1993, p147): *“privatisation is always and everywhere a political phenomenon. The goal of governments that launch privatisation always is to gain support for the reformist (or conservative) politicians. [...] By creating a class of supporters of reform and reducing the power of its opponents, privatisation can change the political balance in the country”*.

At this stage, one realises that economic rationales were sometimes a mere marketing device to justify choices that would have been made in any case. Some markets clearly match the conditions for efficiency-enhancing privatisation. Some others do not. Yet, privatisation programs were still pushed in the latter markets, for political or ideological reasons. Again, this shows that economic policies cannot be disentangled from the political support that can be gained from one or another type of action.

In the meantime, we have understood the value of using *efficiency* as a measuring rod to assess the actual value of privatisation. In this way, we have an “objective” rationale for divestment that isolates ourselves from other *political* rationales that we cover below. Let us then identify theoretical conditions under which privatisation *should* be efficiency-enhancing. Given that theoretical arguments alone are not sufficient to judge the value of privatisation policies, we also provide a brief overview of the empirical evidence on the productivity of SOEs prior and after privatisation. Next, we present

political arguments that are orthogonal to these economic rationales, and that may explain why privatisations became so prevalent.

### **6.1.1. The “perfect market” benchmark as an ideal privatisation platform.**

Economic theory teaches us that markets can yield outcomes that are both *efficient* and *Pareto optimal*. However, such an ideal outcome can only be obtained under the specific conditions that portray a hypothetical “perfect” market. Namely, *i*) competition must be perfect (monopolistic and oligopolistic markets do not satisfy such criterion); *ii*) the characteristics of the goods sold must be observable to both the sellers and the buyers (many goods do not satisfy such conditions); *iii*) complete contracts must exist (they rarely do); *iv*) production and consumption must not generate any externality; <sup>41</sup> *v*) the goods produced cannot be public goods (i.e. goods that can be consumed by several consumers even though only one purchases it).

Hence, when a market is –or becomes close to– perfect, the government should simply pull out. Megginson and Netter (2001) summarize it in the following way: “*if there are no externalities in production and consumption, the product is not a public good, the market is not monopolistic in its structure, information costs are low etc...*”, then there is no reason for any form of state intervention. In particular, any SOE in that market should be privatised. Indeed, as noted by Brickley, Smith and Zimmerman (2000), “*the price system motivates better use of knowledge and information in economic decisions [...] it provides stronger incentives for individuals to make productive decisions*”.

More relevant for our topic is that, when markets *cannot* perform efficiently, state intervention does have the potential to improve efficiency. In the nineteenth and early in the twentieth century, it was often felt that the inefficiency costs associated with private ownership could justify nationalisations: With the exception of formerly Communist Countries (which we cover separately), nationalised firms were generally *not* operating on perfect markets. SOEs are thus a particular subsample of the firms

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<sup>41</sup> An externality is a side-effect of production or consumption that affects the welfare of other individuals than the producer or the customer. For instance, wood production may entail deforestation which may reduce the welfare of farmers living around the (disappearing) forest. This is called a negative externality. When a household renews its house, the value of the real estate in the neighbouring area may increase. This is a positive externality. Typically, state intervention should aim at curtailing activities that generate negative externalities, while promoting that entail positive ones.

operating in the economy. However, one must remember that nationalisation was just *one* possible option (as opposed to regulation for instance). Gonenc et al. (2000) summarise the trade-off between public and private ownership as follows:

**Table 6.2.** Key factors influencing the scope for public ownership

Internal Factors				Preferred ownership structure
Incentives	Transaction costs			
Non contractible quality	Innovation	Agency costs	Cost due to rent-seeking	
Limited	Important	Lower in private firms	Lower in private firms	Private
Extensive	Not important	Lower in public firms	Lower in public firms	Public
External Factors				Preferred ownership structure
Transaction costs	Market Structure			
Legal and institutional environment	Product market competition	Reputation	Capital market (governance)	
Developed	Strong	Important	Developed	Private
Underdeveloped	Weak	Unimportant	Underdeveloped	Public

Source: Gonenc et al. (2000, p76)

### 6.1.2. Market failures may justify state intervention.

Admittedly, many –if not all– markets suffer from one or another such imperfection. The more severe the imperfections on a given market, the higher the value of government intervention can potentially be. Yet, state intervention can introduce other types of inefficiencies as well, and need not be synonymous with nationalization (See also Chapter 5). Often, nationalisations were (rightly or wrongly) used to improve upon the outcomes that result either from:

- the markets' lack of competitiveness. In that case, nationalisation was meant to generate price and quantity outcomes closer to the first best;
- the lack of private investment in the sector, as compared to the perceived “social optimum”. In that case, the enterprise is state-owned simply because the government was the first one to initiate investment, and not because of the repurchase or confiscation of existing private firms.<sup>42</sup>

These two rationales for nationalisation could hold in isolation. However, they generally cumulated one with another. For instance, many airlines, electricity companies or postal and telecommunication services were nationalised for both reasons (in addition to the first political rationale we cover below). The development of the airline required heavy investments, both in infrastructure (airports) and in equipment (airplanes), that the private sector alone might not have been willing to pledge (underinvestment motive). In addition, when the social surplus generated by the activity is lower than the economic profits an enterprise can extract, markets might generate substantial undersupply compared to the social optimum. Clearly, the same type of argument was used to justify the nationalisation of railways, postal services, or electricity provision. Yet, the very same markets seem to require large waves of privatisations since the 1980's.

Several economic changes can explain this reversal in fortunes. First, worldwide market liberalisation led to the so-called “globalisation” phenomenon (in particular in Europe with the Single Market Program, or *SMP*).<sup>43</sup> This increased the number of firms on each market, and reduced the incentives to maintain enterprises in public hands.<sup>44</sup> Such changes are observed precisely in transport, electricity, telecommunications, etc... that were traditionally dominated by a natural monopoly in

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<sup>42</sup> Note that a government could promote investment by subsidizing it, rather than invest by itself. However, promoting private investment is not always simple. Stiglitz (2002, pp54-55) documents for instance an example, in Morocco, where the state withdrew from servicing a market in the anticipation that private investors would take over. The result was simply that the market ceased to exist.

<sup>43</sup> Despite the SMP, however, political processes have not always been able to grasp these potential benefits and translate them into accelerated liberalisations and privatisations, as highlighted in the previous chapter.

<sup>44</sup> Unsurprisingly, many nationalisations took place in periods when private investment was collapsing and that waves of protectionism were shutting down countries away from international competition (the Belgian railways were nationalised in 1870, the French railways in 1934 and the British in 1948). By contrast, when economies open and competition stiffens, the room for privatisation widens.

many countries. Again, airlines are an example that springs to mind, in particular with the Belgian SABENA company, which can be opposed to the much better performances of the privatised British Airways or the still state-owned Iberia. Second, many national companies tended to rely continuously on soft budget constraints to remain afloat (Kornai 1980, 1986; Dewatripont and Maskin 1995; Roland 2000, chp12). This was a clear sign that state ownership was introducing more inefficiencies than it could correct.

In parallel, the recent development of capital markets helped private investment progress in markets where it used to be absent, thereby correcting some of the initial inefficiencies that had initially motivated nationalisations. Loss-making or inefficiently managed firms thus became ideal candidates for privatisation. Besides, new results in the theory of regulation (see e.g. Laffont and Tirole, 1993) helped improve the contracts offered to the buyers of the firm, which made it possible to protect even the few who could have lost from privatisation (e.g. universal service became easier to price and to control, thereby protecting customers against reduced provision of goods or services).

For these reasons, regulation and licensing contracts became more prevalent. They are now felt to provide better ways to resolve market imperfections than state ownership, even though regulating monopolies or oligopolies remains difficult because of information and monitoring problems. By contrast, nationalisation allows saving on the incentive premia that are associated with asymmetric information. Yet, to repeat, other incentive issues are associated with state ownership. Nowadays, since better regulations can be developed, state ownership often generates larger costs than the ones associated with appropriate regulation.

### **6.1.3. Relative performance of State-Owned Enterprises, prior and after privatisation**

There has been extensive empirical research about relative performance of SOEs as compared to their private counterparts. It is not the purpose of the present chapter to cover this empirical evidence *in extenso*, and we refer the readers to the excellent

surveys by Gonenc et al (2000, section 3), Megginson and Netter (2001), Megginson *et al.* (2001), or Sheshinski and López-Calva (1999 and 2003), as well as to the book by Galal *et al.* (1994) for a more detailed overview. Here, we only provide a summary review of their main findings.

The empirical evidence shows a consistent, and most of the time substantial, difference between the performance State-Owned and Privately-Owned firms. In line with theoretical predictions, SOEs appear to be less-well managed, to maintain too high employment levels and often to be largely loss-making. This confirms the validity of the theoretical arguments raised above, that predicted lower performance of SOEs: the *incentive view* predicted that, because of weaker monitoring, SOEs would develop stronger *X*-inefficiencies, and the *political view* predicted among other things that SOEs would tend to maintain excessively high levels of employment.

Concretely, Boardman and Vining (1989 and 1992) find that private enterprises are significantly more profitable than both SOEs and Mixed-Ownership enterprises. Ehrlich *et al.* (1994) develop a theoretical model that they test empirically. Both theoretical and empirical findings suggest that long-run productivity growth is higher under private ownership (empirically, it is as high as 2% per year). However, privatisation may induce a *transitory slowdown* in productivity growth. Finally, Dewenter and Malatesta (2001) report that “*the average return on sales for private firms is [...] more than twice the value for government firms*”.

Such evidence must however be read with caution. First, because there are exceptions. For instance, Stiglitz (2002) reports that the most efficient steel mills in the world are state-owned. Similarly, Kole and Mulherin (1997) report a case in which productivity was basically independent of ownership. They focus on a particular subsample of firms that were nationalised by the US government during WWII, for security reasons. The selection bias for nationalisation is therefore absent here. In any case, these exceptions prove that SOEs have the *potential* to produce as efficiently as private firms.

A second reason for caution is that the data used to perform comparisons are sometimes of weak quality or inappropriate, which may generate significant selection biases (see MN for more detail). That is, since firm ownership is generally not random

but instead chosen on purpose, we may be observing that some firms are public *because* they are less profitable economically (presuming that its social value has been ascertained). Similarly, the private firms used for these comparisons are generally the one listed on the Stock Exchange (so that data become available). Put differently, comparisons can only be made with the particular subsample of those private firms that have been successful. The picture might be different if all failed initiatives were also taken into account.

Therefore, one cannot expect that privatising any firm will systematically induce it to increase its productivity and profitability. Other analyses have however compared the performance of SOEs before and after privatisation. That methodology helps evaluate whether privatisation actually improved efficiency or not. Again, selection biases cannot be totally avoided, since governments will generally privatise the SOEs that are expected to generate the highest efficiency and profitability gains (otherwise, no private investor would be willing to buy them).

Bearing these cautionary remarks in mind, the evidence is nevertheless striking. Privatisation programs in Latin America, for instance, generated extraordinary boosts in productivity and profits. La Porta and López-de-Sílanes (1999) report output increases as high as 53% in Mexico. Larraín and Lopez-Calva (2001) tell the similar story of Costa-Rican companies that, from being largely loss-making under state ownership, eventually generated between 6.2% and 12% profitability after privatisation. Employment, on the other hand, either increases or (sometimes strongly) decreases, depending on the cases.

In the UK, the privatisation of British Airways not only made the company more powerful and productive, but also generated stronger market competition, as witnessed by the price decreases adopted by their direct competitors (Eckel *et al.* 1997). Yet, as we stressed already, the picture cannot be universally rosy. Martin and Parker (1995) for instance document that, out of their sample of *eleven* privatised firms in the UK, *six* enterprises (that is: more than half of the sample) experienced a productivity *decline*. Analyzing the performance of other privatised firms, one can also observe that some of the productivity increases occur *prior* to the privatisation of the company (see e.g. Dewenter and Malatesta 2000), which suggests that governments themselves are able

to increase the productivity of their own firms. However, privatisation appears to be sometimes a necessary pre-commitment device to yield in that direction.

What about the second economic motivation to privatise, namely reducing government deficits? This effect is harder to assess. Generally, privatisations do not take place in isolation. They are part of broader changes and/or restructuring programs. Thus, one cannot fully delineate the effects of privatisation from that of these other policies. All in all, one observes a correlation between privatisations, lower government budgets, and sometimes better macroeconomic performances. When capital markets are initially undersized, privatisations also help them develop (see Chisari et al. 1997 and MN).

We thus see that there are often substantial gains to be reaped from the privatisation of some state firms. Moreover, if accompanied by an appropriate regulation framework or by the stimulation of competition, the efficiency gains that result from privatisations may well generate extra gains for the consumers, as the BA example suggests. Yet, some of these privatisation initiatives are strongly opposed politically. In other cases, they appear to be essentially politically motivated, like some of the firms privatised in the UK (in addition, these privatisations may even have generated a drop in the net present value of government income, as argues Graton-Lavoie, 2000). Therefore, to understand why privatisations take place in some cases, and do not occur in other cases, one must look at the political factors that influence them.

## **6.2. Political support for, and oppositions to, privatisation**

As we have seen, the productivity differential between state and private firms partly depends on the original motivation for bringing a given firm under state ownership. Many such motivations were political. Perhaps the most important historically had to do with the idea that “strategic” goods and services had to be controlled by the government. Such strategic goods did not only include armament; they also comprised telecommunication or transportation services, for instance. Sometimes, this strategic motive was also related to the underinvestment problem: railways for instance required a lot of heavy investment, and their development generated strong positive externalities at the national level. Interestingly, state ownership also generates an

implicit commitment to eventually develop the market in which the company operates. This commitment is simply the flipside of the economic problem of soft-budget constraints: even though the development of the company can be loss-generating, the government will more easily keep financing it if it is state-owned. Yet, strategic motivations may experience the winds of change: when the market share of automobile increases, for instance, railways naturally become “less strategic”.

Beyond this “strategic” motivation for political ownership, the government may also have equity concerns in mind. Going back to the example of railways, allowing peripheral areas or cities to access the “economic centre” of the country may well be a sound political objective to reduce inequalities. However, creating this possibility of implicit redistribution opens the room to subsequent capture by some pressure groups. One effect, as we saw, is that state ownership tends to substitute underinvestment by the private sector with politically-motivated *overinvestment*, coupled with underpricing. Equity motivation and state capture also explain why highly unprofitable communication routes remain in operation; why electricity companies provide universal service at a price that is not linked to the cost of electricity provision; why postal services ought to be priced at the same level for any pair of locations in the country; etc... Again, keeping the enterprise under state ownership may generate credibility and commitment problems in curtailing these costs.

Beyond these first two political motives, namely strategic and distributive concerns, comes a third motive that we already touched upon: *employment*. In a move to counter economic fluctuations and provide implicit employment insurance to some groups, SOEs are generally requested *not* to adapt their labour force together with economic fluctuations. A vicious effect, however, is overstaffing or labour hoarding that increases total operating costs, demotivates effort, and further reduces aggregate efficiency. Following Algan *et al.* (2002), public employment of this type may even have *adverse* macroeconomic effects on unemployment. Although their analysis does not include employment in SOEs, their conclusions directly extend to SOEs, since their “*theoretical approach predicts that the crowding out effect of public employment increases with the degree of public/private production substitutability*” (p13).

In light of these political motivations for holding some firms in public hands, as well as their consequences on aggregate (in)efficiency, it becomes rather easy to understand both why some political groups support privatisations, and why other groups oppose them. In light of the first argument, some firms are state-owned for *strategic* reasons. Whenever strategy shifts focus, the need to maintain these firms state owned disappears for the public at large. This is a reason why many of the companies that are at the forefront of nowadays' privatisation packages were the very same firms at the forefront of yesterday's waves of nationalisation. Second, the majority of the electorate may find it increasingly profitable to stop subsidizing particular fringes of the population, essentially when most redistribution schemes –even the most efficient ones– are being retrenched (see Chapters 3 and 4) and that demands for further tax cuts are mounting. Third, since it becomes increasingly popular to address unemployment issues by increasing the flexibility of the labour market, the public becomes increasingly hostile to the protected niches of less-efficient jobs that are provided by some of these SOEs. For all these reasons, the electorate and some political parties become increasingly favourable to the privatisation of many SOEs.

Obviously, this should not mean that “currently strategic” sectors should not receive public support nowadays. State ownership or other forms of public support can still yield benefits. The development of an aeronautic industry in Europe, for instance, owes a lot to the intervention of the various governments that helped create Airbus and, later, EADS. Put differently, nowadays' privatisations should focus on markets in which private and public employment (and capital) became strong substitutes. By contrast, there may still be cases in which public and private capital remain complements, in particular when the regulatory environment is weaker.

Given these benefits, why did some countries, such as Great Britain under Mrs Thatcher, privatise so much and so quickly, while other countries remained stuck with state ownerships for much longer times?

The first part of the answer, like for pension reforms, is that institutional systems are different. In Great Britain, a coalition between a majority of the electorate and the politicians in power is sufficient to pass a reform, because the system is majoritarian. Moreover, coming back to the argument by Boycko *et al.* (1993), privatisation was

also a way to shift the political balance in the country: Tories could at the time increase their support in the population through more extensive privatisations.

In many other countries, the institutional system is less majoritarian, and therefore tailored to systematically protect minorities. In that case, a reform can be blocked more easily, by a larger number of groups. Therefore, broader coalitions or an emergency situation may be necessary to pass a given reform. Given the political objectives of state ownership that we raised above, it is easy to identify which groups might oppose privatisations: first, incumbent producers. That is: 1) the management as well as the suppliers of the company, and 2) the (sometimes many) employees who fear their job or privileges could be threatened by the privatisation of the firm (See also Section 5.5.2 in the previous chapter, and Jean and Nicoletti, 2004). Next, come those consumers who benefit from oversupply and/or underpricing.

What helps a government circumvent these oppositions? In line with the above pieces of argument, market competition comes top of the list: competition reduces the rents extracted by incumbent producers, which helps reduce the intensity and effectiveness of their lobbying (see Blanchard and Giavazzi, 2003) and reinforces the demands for privatization by new entrants.<sup>45</sup> When competition is not sufficient to bring oppositions down, the government has to act gradually (see below) in such a way that the opposition of these groups can be reduced. Yet, in some cases, opposition is too expensive to buy out, and reforms cannot take place. This is another example of the status quo bias (Fernandez and Rodrik, 1991). Importantly, the more *inefficient* is the SOE, the fiercer the opposition of particular groups may become (e.g. because more jobs are at stake). Conversely, external pressures (e.g. at the European level) can sometimes be used by the local government to justify a given privatisation package.

### **6.3. How to set up a successful privatisation?**

Setting up a successful privatisation is a difficult matter, and there is certainly no unique recipe for it. To the contrary, each privatisation is different and needs to be

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<sup>45</sup> State-owned incumbents can implement easily strategies of predation and foreclosure to prevent entry and drive competitors out of potentially competitive markets (Sappington and Sidak, 2003).

tailored to the particular economic and political situation in the country, to the attributes of the firm, and to that of the market in which it operates. The main steps that should be taken in setting up such a “case-by-case” privatisation are summarised in a useful “toolkit” of the World Bank (Welch and Frémond, 1998).<sup>46</sup>

A first preliminary step to be taken is akin to sound corporate governance advice: the government must first identify what should be its *core business*. This preliminary step will help identifying which SOEs *can* and which *should not* be candidate for privatisation. The former set should be made as large and encompassing as possible, since several of the candidate firms may eventually appear too hard to privatise. The second preliminary step is to identify which, among the enterprises that could be privatised, are actually fit for privatisation. To prevent capture, however, this evaluation step, should be delegated to independent experts.

After these two preliminary steps of screening, the government will know how many enterprises should be privatised and can initiate the privatisation process itself, setting up a “battle plan” and assigning responsibilities for achieving the long-run goals of privatisation. These responsibilities should be assigned either to some central minister in the government (such as the Treasury) or to an independent privatisation agency. In this way, the privatisation process is not only made more transparent but also more resilient to lobbying pressures.

At this stage, the government also has to devise a strategy on how to build political support for the privatisation. Typically, there will be trade-offs between maximizing the proceedings of the sale, ensuring the success of the privatisation, and addressing the concerns of the groups that could oppose the privatisation. Maximizing the proceeds of the sale typically calls for unconstrained auctions. “Unconstrained” means here that the government will always benefit from increasing the number of candidate buyers in the auction (Bulow and Klemperer 1986). In particular, this requires that foreign buyers should not be discarded and that preferential treatment should not be given to particular buyers –with two exceptions. The first exception might be to give preferential treatment to the national population. Allowing them to buy shares in the

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<sup>46</sup> See also [http://rru.worldbank.org/Toolkits/concessions/detailed\\_outline.htm](http://rru.worldbank.org/Toolkits/concessions/detailed_outline.htm)

company helps reinforce popular support for the privatisation process, by distributing the benefits of the firm to a wider base (Boycko *et al.* 1993 explains why this was particularly true in Russia). The second exception is the workers of the enterprise, who may have to be offered a minority stake in the company, as an incentive to make privatisation successful.

Note also that a government who wishes to maximize total revenues from the privatisation may, depending on the size of the enterprise either call for piecemeal or one-off sale. First, because a private buyer may want to limit its exposure if the productivity of the firm is highly uncertain. In that case, the government may benefit from offering partial insurance to the buyer, through piecemeal privatisation.<sup>47</sup> Second, because financial markets must be able to “swallow” sometimes massive increases in capitalisation levels. This latter aspect was actually of primary importance in Eastern Europe (see Section 6.4).

The choice between piecemeal and one-off privatisation may also result from political concerns. Voters themselves may prefer gradual to one-off privatisation if the process is surrounded by bigger uncertainty, e.g. about the efficiency gains that will be achieved (Dewatripont and Roland, 1995). In that case, however, the two objectives of the government (revenue and political support) go hand-in-hand.<sup>48</sup>

Revenue maximisation and building political support may however conflict. For instance, one of the ways to maximising the revenues of a privatisation is to both let the firm retain market power and to make bidders pay the highest possible price for the company. Yet, this raises two problems. First, market power hurts both consumers and aggregate efficiency –see above. At the expense of lower revenues, additional regulatory constraints may thus have to be adopted to address this issue, and these

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<sup>47</sup> Piecemeal privatisation also has side-effects on the government’s commitment to pursue reforms. One effect is positive: it generates commitment to maintain the profitability of the market, not to increase corporate taxes, nor introduce regulatory hurdles immediately after the firm has been sold. The other effect is negative: in some cases, the government may change its mind and stop the privatisation process, either to retain a larger share of profits (when the privatisation is successful), or to prevent too drastic adjustments by the company (see Section 6.5).

<sup>48</sup> Actually, the analysis of Chisari *et al.* (1997) shows that, even though benefits were uneven, the privatization of most utilities benefited all layers in the population, even in a country like Argentina. Nevertheless, if privatization benefits essentially the upper class, regulation benefits mainly the lower classes of the population. Therefore, it is the joint use of privatization and of appropriate regulation that ensures all classes of the population can grasp efficiency gains.

should be passed *before* the firm is sold (Welch and Frémond, 1998). Second, the citizens who may buy shares in the company are also voters. To increase political support for the privatisation process, it may be necessary to significantly underprice the shares of the company in the initial public offering (IPO). This ensures that, by subscribing to the privatisation, voters are compensated with higher returns on their investment, which may swing political support in favour of the privatisation process (at least in the middle and upper income classes of the population).

If the employees of the firm can generate sufficiently strong opposition to the process, they will also have to be compensated. One option, already discussed above, is to offer them a minority stake in the privatised company. However, if massive lay-offs are to be feared, that move may not suffice. The government may have to undertake some steps towards the defensive restructuring of the company (offer pre-pension packages, or jobs in the public administration). This ensures that unemployment concerns are addressed by an agent (the government) who has a stake in avoiding excessive swings in employment. However, whether the government wants to undertake these defensive steps or not will often depend on the representation system in the country and on the power of the various pressure groups in the country. In any case, it is worth insisting on the fact that *strategic* decisions should be left to the new owner, since they shape the longer-run development of the new company. Evidence also tends to show that governments who try to recapitalise SOEs prior to privatisation generally lose money in the process and privatise too late (MN).

Last, if the threats of asset stripping, excessive lay-offs, and/or delocalisation are too prominent, the government may wish to set additional constraints that will also decrease the revenue of the privatisation, but calm fears and oppositions. One option is to preselect some specific buyers and negotiate the conditions of the sale only with them. Another option is to keep a golden share in the privatised company, with a policy of government interference with the management that must be limited to the abovementioned threats. If the government cannot commit to this, private investors may simply refuse to invest in the company, or do it only on excessively favourable conditions (as illustrated by the Daewoo-AvtoZAZ case study in Section 6.5).

#### **6.4. Mass Privatisations programmes: CEECs**

As we saw above, most privatisations are the result of former nationalisation policies that, instead of being efficiency enhancing as initially presumed, turned out to generate major efficiency costs. In former communist countries instead, nationalization took place because of ideological reasons alone. Basically, *all* firms were nationalised, be there an efficiency gain to be expected or not. Managing all the economy centrally eventually proved an insuperable task, and the relative productivity of all Communist countries plummeted, thereby increasing the income gap between OECD and planned economies.

Despite being unable to deliver economic development to the many, communist planning still achieved one of its goals: income inequality remained low (see for instance the data compiled by Deininger and Squire, 1996). Similarly, access to education or to health services were widespread, as witnessed by the education achievements and life expectancy of these countries that were higher than in many other countries with similar income levels (see e.g. Boeri 2000, and Roland 2000). Importantly, social safety nets were not provided by a specialised ministry, as it happens in most developed countries. Instead, employment was guaranteed by firms, which also provided many social services, such as health services, childcare, housing, access to water, etc... (See e.g. Milanovic 1995, and Brada 1996).

At the dawn of the transition to a market economy, productivity thus had to be increased, primarily so through privatisations. As a by-product, firms could be expected to curtail the provision of these social services, since these did not belong to their core business. Inequality and poverty increased substantially, and life expectancy was reduced in some countries. The major political problem faced by privatisations was thus to prevent backlashes of reform policies. Brada (1996, p67) summarises this argument as follows: *“the state’s monopoly [...] must be broken so that countervailing sources of political influence may emerge (Berger, 1992). Otherwise, the nomenklatura, managers of state-owned firms and former bureaucrats, may sabotage or block economic reforms”*. For that reason, most newly elected governments wanted to create a break with the past, and generate momentum by privatising quickly most firms in the economy, creating a new middle class, and making sure that a majority of

citizens would want to keep firms in private hands rather than to renationalise them (see Roland 2000, chp4, for more detail).

Of course, this meant that massive amounts of capital injections would be needed. In developed countries, the total value of the stock of capital is worth between 3 and 4 years of national production. Therefore, a country that saves about 20% of national income needs between 15 and 20 years of savings to re-purchase existing capital, without mentioning the need to inject fresh capital in existing firms or to create new enterprises and activities. *Selling* all existing firms to the population was therefore not an option, because of this *stock-flow* constraint (see Bolton and Roland, 1992 and Roland, 2000, chp 10); there was a strong tension between the political need to proceed quickly and the “optimal” speed of transition that resulted from this capital accumulation constraint (Castanheira and Roland, 2000).

Being faced with this trade-off, most Central and Eastern European Countries decided that generating resources for the government had to be considered as a secondary objective, while speed became the primary one. Most CEECs therefore initiated mass privatisation plans, through which the bulk of state capital would be transferred without cash compensations. There were of course exceptions, and two of them are analysed in Section 6.5.

Productive and allocative efficiency had to be improved dramatically, so as to increase national income and maintain the reform momentum. The privatisation method had to help select the appropriate buyers. Presumably, since more efficient managers should generate more value added, they should also be willing to bid higher prices. For these reasons, *auctions* are an ideal way of selling firms.<sup>49</sup> Given the stock/flow constraint, however, all firms could not be auctioned for cash. Indeed, if one wants to sell all the country's firms within a limited number of years, cash and liquidity constraints are bound to limit feasible bids; auctioning firms for money would have necessarily undervalued these firms. In addition, the asymmetric cash constraints faced by

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<sup>49</sup> Valuing these firms is also a difficult task, as they were never operated according to market rules and at market prices before. This valuation was also bound to take time. Nevertheless, auctions remain an efficient way to aggregate available information. See Megginson and Netter (2001) for summary evidence that preliminary valuation of SOEs facilitated the selling of some firms, and see Schmidt and Schnitzer (1997) for a discussion of the expected revenue raised by different types of auctions.

different potential buyers meant that the richest classes of the population (generally those formerly in power, and shadow economy/criminal entrepreneurs) would be unduly favoured. A way to circumvent these limitations is to auction firms for *non-cash bids*, which untie intrinsic valuation from liquidity constraints (Bolton and Roland, 1992): the buyer must offer a future flow of payments in exchange for the firm, instead of cashing money up-front.<sup>50</sup> However, that method was not used in practice.

The above helps explain why one or another type of auction mechanism could be used to raise ex-post microeconomic efficiency. But ex-post efficiency also requires that tensions between employers and employees be quelled. One option used in some countries (such as Russia) was then to distribute the firms' assets for free to the firm's employees. That option, which is known as "insider privatisation," of course limits the possibility to select the appropriate buyer in the first place. Yet, the hope was that, in a second stage, inside shareholders would efficiently negotiate the sale of (a fraction of) their shares to an outside investor they would select themselves. This insider privatisation method also had the advantage of being quick, in addition to being (apparently) fair: even the poorest citizen can become a shareholder.

However, there is a sharp difference between give-aways to the population at large and to the firm's workers. Giving a marginal share of the firm to its workers (as it is often done in the privatisation processes we saw above) may help align workers' incentives with shareholders'. By contrast, giving employees a majority stake in the firm poses ex-post problems: when workers become the full owners of the firm, they may develop wrong incentives and prefer to maintain employment rather than restructure the firm. This in turn implies that the labour hoarding problem cannot be addressed, and therefore that allocative efficiency would not be restored. "Giving" the firm to the initial management also meant that the privatisation process could not perform its selection function nor provide appropriate incentives to strategic restructuring. If the incumbent manager feels unable to restructure his firm, he may develop wrong incentives: it might prove more profitable for him to strip the assets of the firm rather

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<sup>50</sup> Roland (2000, chp 10) also clarifies the distinction between top-down (the government decides when to sell which firm) and bottom-up (buyers announce which firm they are interested in) privatisation methods. In addition, the problem of ex-post incentives depends on the ownership structure (see for instance Aghion and Blanchard, 1998). About non-cash bids, see Roland (2000), section 10.2.1.

than to invest in new productive equipment. Such perverted incentives actually proved of primary importance in Russia, as we discuss in the next chapter.

Giveaways to insiders thus pose a double problem: first, they do not improve matching between the management and the firm and, second, they give inappropriate or even perverted ex-post incentives to restructure. Still, they may be favoured by those insiders who fear the new, market-oriented, institutions.

Two types of risky decisions were therefore made. First, most mass privatisation programs clearly shied away from trying to raise revenue for the government. The risk associated with such a decision was already raised by Bolton and Roland (1992): by limiting the amount of resources made available to the government, the latter could subsequently face excessively tight financial constraints, which created room for macroeconomic stability problems. Second, a privatisation scheme such as insider privatisation may fail to generate the (badly needed) improvements in microeconomic efficiency that privatisations are supposed to create. The problems that Russia faced later (see Chapter 7) might be a direct consequence of these choices made early in the process of transition.

The main trade-offs were thus the following (See also Roland 2000, Chp10):<sup>51</sup>

1. *Selling or giving-away?* Selling provides resources to the government. Giving away builds more political support for privatisation. *Selling* can thus be expected to be more efficient, but may be blocked politically.
2. *To insiders or to outsiders?* Outsider-privatisations improve expected ex-post efficiency, but require more effort, and generate more risk for insiders.<sup>52</sup> In particular, selling to a foreign corporation increases the likelihood of efficiency-

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<sup>51</sup> Note that we do not cover the option of “growing out of socialism,” according to which no firm is privatised, but new private firms are allowed to be created. This road is being followed in China, but did not even seem to be an option for CEECs.

<sup>52</sup> The ex-post measurement of firms’ performance tends however to show that, in the short-run, realized productivity was not that different between insider and outsider privatized firms. Only newly created firms and SOEs privatised to foreigner performed significantly better from the start. In the longer-run, productivity increases more sharply when newly appointed managers are outsiders, and when management turnover is sufficiently high (Claessens and Djankov, 1998).

increasing strategic restructuring, since such foreign owners generally have better know-how and more extensive investment capabilities.

3. *Top-Down or Bottom-Up?* Under the former method of privatisation, the government announces which firms are to be sold, and in which sequence. Under the latter method, privatisation is initiated by the demand side. Bottom-up privatisation has the advantage of revealing the demand-side, but faces a selection bias problem. Top-down privatisation removes this selection bias, but faces the speed vs. efficiency trade-off. Which solution is most efficient depends on available resources, average initial productivity, initial efficiency, etc.

Roland (2000, chp 10) provides a careful account of the methods used in different countries, as well as a deep survey of the different theories of privatisation that are applicable to transition countries. Brada (1996) provides more detail about the amounts involved and the resulting distribution of ownership. In a nutshell, their evidence shows that only two countries primarily tried to *sell* SOEs, namely Germany and Hungary. Germany is of course a special case. The reunification implied that enormous resources could be poured into the privatisation process. As evidenced by Brada (1996), in spite of the attempt at *selling firms for cash*, the eventual flow of resources largely went from the government to the new owners. Even though the *Treuhandanstalt* (the German privatisation agency) managed to raise \$50 billion from the sale of these firms, it had to spend \$243 billion in the process. Of course, most of the other countries could not afford such costly privatisation method, which did not even yield impressive results. In Hungary as well, the bulk of privatisation occurred through sales –often to foreign investors, who accounted for about half of the total sales of assets. Privatisation to foreigners often triggers substantial opposition from nationals. In the case of Hungary, however, this strategy allowed them to maintain substantial inflows of foreign direct investment, and therefore high productivity improvements.

The approach in Poland was a mixture of direct sales and mass privatisation. In the early years of transition, the goal of policymakers was to create a functioning capital market. Hence, many firms were privatized through direct sales to (often foreign) strategic investors and stock-market floatation. Firms were selected for privatization by

the government, and restructured to make them attractive to potential buyers. The process was slow due to limited capacity of the government to restructure state enterprises, and to sustained opposition by insiders (both workers and managers). To circumvent that opposition, the benefits of privatization had to be spread more widely. To this end, a National Investment Fund program was introduced. It led to the voucher privatization of about 10% of state firms, with a complex management and ownership structure.

By contrast, the mass privatisation plan proved very successful in the Czech Republic, and these give-aways helped secure the popularity of Vaclav Klaus. As Roland (2000) points out, the reason why a similar privatisation method experienced such different fates in the two countries owes a lot to the situation inherited from the past: Poland had undergone some reforms already prior to transition, entitling workers to co-manage the firms. This in turn gave them additional veto powers in the subsequent phase of reforms, which they could block.

Because of weak institutions and strong collective inertia (see Chapter 7), the first (and main) round of mass privatisation in Russia gave firms away to insiders, preventing bottom-up privatisation except for voluntary reselling by the new owners. Given the trade-offs we presented, this seems to be the worst possible choice: enterprises are not re-matched with outsiders, and ex-post incentives become distorted either towards labour hoarding or asset stripping. The rationale behind such a choice was essentially political: in a country where labour hoarding was pervasive, profitability very low for most firms, and where property rights were poorly established, citizens preferred to maintain the rents they reaped as *workers* or *managers* rather than try and increase the income they could earn as *owners* of the assets of other firms. Their primary objective was thus to secure control in their own firm, and thereby maintain their privileges, as limited as they might be.

In all cases, however, state and privatised firms had to adjust to survive. Competition from abroad and from newly created private businesses remained inescapable for most pre-existing firms. Government budget constraints also tightened sharply, which implied that budget constraints were bound to harden relatively rapidly. One therefore observes that significant defensive restructuring also occurred in SOEs (see e.g. Bevan

*et al.* 1999). By contrast, strategic restructuring, which remained a necessary step to increase total factor productivity, only occurred after the privatisation of the firm. Accordingly, privatisation itself is seen to generate significant productivity gains in CEECs (about 5% a year, according to Claessens and Djankov, 1997).

### **6.5. Case studies: the privatisation of Škoda (Czech Republic) and AvtoZAZ (Ukraine)**

Section 6.4 above describes how the bulk of privatisations took place in most CEECs, and we focused on the best performers (Poland, the Czech Republic, and Hungary), as well as on Russia. However, not all firms were privatised according to the same technique. There were exceptions in all countries, and car producers were generally part of these. There were obvious reasons for this. First, the production of cars requires intensive know-how and relies heavily on modern technologies. Second, since this know-how requirement imposes substantial fixed costs on each car producer, only a limited number of them can survive in world markets. The recovery of national car producers therefore required that they reached the technology frontier very quickly, which called for external support and expertise. As a result, intensive negotiations with foreign car producers were initiated very early in transition. The opening of the borders offered to “established” car manufacturers new prospects for gaining market shares in Central and Eastern European markets which, contrary to Western markets, exhibited considerable growth potential.<sup>53</sup>

The automobile industry did not use to be classified as a ‘heavy industry’ by the Soviet system (and, as such, was not among the ones that benefited from the main flows of investment). Still, it enjoyed the status of a ‘strategic industry’ for all the reasons mentioned above. Moreover, the automobile industry was important for collective identity reasons. As we show below, one of the main conditions imposed by both the Czech and the Ukrainian governments in the privatization of their main car producer

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<sup>53</sup> At the outset of transition, there were only 2.5 million cars for 420 million people, that is, 80 cars per thousand inhabitants in the Central and Eastern Europe, compared to 500 in the European Union (Dörr and Kessel, 2002, p.5).

was precisely the safeguard of national models and, above all, the survival of the national brand.

Besides, both of the car producers we study here have a long history. The Czech *Škoda Automobilová A.S.* and the Ukrainian *AvtoZAZ* were among the oldest and most important producers in the region. *AvtoZAZ* was created in 1863, when the first agricultural machines were produced. *Škoda* was created in 1895. Around 1989, *Škoda* employed 21,000 workers and its annual production attained some 180,000 cars. *AvtoZAZ* had comparable production capacities, producing 150,000 cars per year and employing 18,000 workers.

On the face of it, both companies also experienced a similar process of privatization. Both companies were (partially) sold to a foreign partner.<sup>54</sup> These privatization processes were also remarkable regarding the amounts of foreign direct investment involved. Regarding *Škoda*, the offer of Volkswagen represented the highest single FDI in the Czech economy. The privatization of *AvtoZAZ*, which took place later, generated the greatest inflow of FDI Ukraine ever experienced.

Despite these apparent similarities, the privatization processes of these two large companies led to drastically different outcomes. The reasons for these differences lie in the economic and political conditions in each country; in the attitude of their governments, and in the objectives pursued by the foreign investors. In this section, we focus on the role of the government on the differences observed in the privatization outcomes of *Škoda* and *AvtoZAZ*.<sup>55</sup> By comparing the two cases, we illustrate how inappropriate political decisions by a government can lead to enormous losses in terms of economic potential, despite relatively similar economic conditions.

**Economic Conditions.** Czechoslovakia, contrary to many other transition economies in Central Europe, started its way to a market economy from virtually full state ownership: in 1989, only 2% of all registered assets belonged to the private sector

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<sup>54</sup> It should be noted that, contrary to other Central European transition economies, the privatization through sale to a foreign investor was rather atypical either for the Czech or the Ukrainian government.

<sup>55</sup> This partly explains our choice of the two firms: in the car industry, government policies towards foreign investors were quite similar across Central European countries (cf. Werner, 2004, p2-3, 11-15). Comparing a central European and an Eastern European country extends the scope of our comparative study.

(Dyba and Svejnar in Svejnar, 1995, p.29); and all industrial production was originated from SOEs. After the split of Czechoslovakia in two independent countries, the Czech economy had therefore inherited from significant distortions created by the Soviet system. The price system was highly distorted, and the labour force was primarily concentrated in the industry – it accounted for about 47% of GDP, instead of 36% in other Visegrad countries (Roland, 2000, p6). The average and median size of national enterprises were also significantly larger. More than 96% of total employment was concentrated in firms of more than 500 employees. By contrast, large enterprises only accounted for 80% of total employment in Poland and Hungary (Roland, 2000, p7). An additional inheritance of the socialist period was a strong centralization of the Czech Republic, together with its heavy dependence on the CMEA<sup>56</sup> and on extensive exports to the Soviet Union. In many respects the Czech economy was thus quite close to Ukraine and to former USSR countries.

The Czech, Ukrainian, and CIS Republics were thus particularly hit by the price liberalization and the disruption of the existing commercial and industrial links that accompanied the break-up of the CMEA. Their difficulties were worsened by the political break-ups experienced –that of Czechoslovakia and that of the Soviet Union. As widely documented, CEECs also experienced a dramatic output fall in the first years of transition, and the automobile industry was hit strongly. The reason lies precisely in the failures of these car producers to be in line with the technological developments of the global automotive industry, which rendered them uncompetitive at the international level. Their lack of competitiveness and the contraction of the internal market led to a drastic fall in the sales of many of these car makers; it increased the underutilization of production capacities, and their financial position worsened critically.

The survival of a majority of Central and Eastern Europe automotive enterprises required significant restructuring and modernization. However, the tight financial situation of these companies and the difficult economic situation observed in transition countries rendered impossible the task of generating the funds necessary for restructuring, either within the company or through the sole support of national

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<sup>56</sup> CMEA (Council for Mutual Economic Assistance)

financial markets. Therefore, to cope with this problem, external funds were indispensable.

### **6.5.1. The privatization of Škoda**

Such was the situation faced the greatest Czechoslovak car producer, Škoda, after the break-down of the central plan system. Like all automobile producers in transition economies, Škoda faced a deep demand decline. Depressed internal demand, combined with the company's technological lag led to productivity decay. In 1991, Škoda's losses amounted to nearly CZK800 million (around \$27 million). Such losses inevitably made the task of adapting the new market conditions insuperable for the company alone.

Several foreign carmakers were interested in cooperating with Škoda, but only two stayed the bidding race: the French Renault and the German Volkswagen Group. A quite interesting detail is that the Czech political leadership (including President Havel) was, mainly for political reasons, strongly in favour of the French producer (Dörr and Kessel, 2002, p10), whereas the German Volkswagen Group had the support of the Škoda workforce. Contrary to the French car maker, Volkswagen undertook direct negotiations with the management and the labour representatives of Škoda. These played a non-negligible role in the support it managed to receive eventually.<sup>57</sup> The ambivalent preferences of the Czechs, together with the uncertainties surrounding which strategy to adopt for Škoda's best sake, protracted the negotiations. In the end, the offer of Volkswagen, which proposed an investment program of over DM 9 billion<sup>58</sup> tipped the balance in its favour.

The interest of Volkswagen (VW) in the joint venture with Škoda was twofold. One of the intentions of the German car producer was to gain market shares in the Czech Republic. The second objective was to integrate Škoda into the global economy in

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<sup>57</sup> According to Dörr et Kessel, 2002 (p.11-12), "Skoda workers threatened strike and resistance if Renault were to be chosen. The overwhelming vote of Skoda employees was influenced not only by the economically more advantageous offer of VW but also by the better social benefits and pay VW generally provided."

<sup>58</sup> Renault's proposal "only" involved an investment plan of DM 5 billion (for more details, see Dörr and Kessel, 2002).

order to face international competition, and to supply not only the Czech and other transition economies markets, but also richer countries. That is, the investment of VW in Škoda allowed VW to pursue its broader strategy of expanding into “integrated peripheral markets” (see Werner, 2004, p7-10). These integrated peripheral markets offered it a comparative advantage in the production of automobiles (cheap and skilled labour force in the case of Škoda)<sup>59</sup> and provided production facilities that were close to Germany. The significant reorientation towards external and, primarily, the German market that Škoda managed to go through since the first years of the joint venture, is the best proof of this production expansion strategy on the part of VW.

The final agreement between the Czech side and the German carmaker was reached in December 1990 and finalized in the form of a joint venture on April 16, 1991. According to the agreement, VW was to gradually assume the ownership of Škoda and to increase the Czech company’s annual production capacity from 200,000 to 450,000 vehicles by 2000. To achieve this goal, VW offered DM 500 million for a 31% stake in Škoda at the creation of the joint venture.

**Control rights.** The crucial aspect of the initial agreement concerned the *management* of the joint venture: although the Czech government retained a control stake in Škoda (and thus important monitoring powers over the restructuring process), it committed to refrain from interfering in the management of the company, effectively accomplished by VW. In exchange, VW committed to manage the joint venture separately, as one of the members of its automakers Konzern (which, besides VW, includes Audi and Seat) and not as an integral part of VW.

**Temporary protection.** Strong competition among the Visegrad countries for foreign investment provided sturdy arguments and strong negotiation power to the German investor. As a result, the government offered special conditions to VW: *“Despite the government’s proclaimed principle of equal treatment for all foreigners investing in Czechoslovakia, the government did negotiate special entry conditions for foreign investors into some ventures with state-owned firms. The VW-Škoda*

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<sup>59</sup> On the quality and the role of the high skilled labour in attracting the FDI in this region, see Werner, 2004, p8, Havas 2000, p6-7. As for the labour costs, they are currently about 25 % of those in Germany and were significantly lower throughout the 90<sup>th</sup>.

*arrangement, which waived antimonopoly provisions, provided a number of trade barriers against imports of competing cars, and involved the government in business negotiations, is the most visible example of such an arrangement”* (Bohatá, 2000, p172).<sup>60</sup> One such trade barriers provisions, which clearly followed the creation of the joint venture, was the establishment of a 14% import tariff on imported vehicles. Put differently, at the same time as it invested in Škoda, VW acquired the quasi-monopoly power in the Czech market for a period of four years. The *temporary* nature of this protection deserves special attention. While such protections can generate soft-budget constraints, with their associated perverse effects, Castanheira and Roland (2000) and Castanheira (2003) highlight clearly that *temporary* protections have the power of fostering investment and accelerating restructuring. Of course, to achieve these positive effects, the government must be able to commit to its course of action. The accession to the European Union, fortunately, provided such a commitment device (Roland, 2000, chp 8).<sup>61</sup>

From the creation of the joint venture a number of important changes were carried out by the German investor, which consolidated and improved the competitiveness position of the Czech company both in internal and external markets. In particular, the administrative structure of the company was made to resemble VW's. The efficient restructuring of production and distribution procedures, together with relatively low labour costs and well-trained workers, resulted in substantial productivity growth (the labour productivity was increasing by about 7-10 % annually over that period),<sup>62</sup> and allowed the company to become competitive in European markets. The government, on its side, fulfilled its commitment by adopting a “hands-off” policy that limited its interventions to the cases where it seemed really indispensable.

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<sup>60</sup> These favourable trade provisions were completed by the Association Agreements with the EU, signed in 1991, and providing direct and indirect trade incentives to invest into the Visegrad countries (for more details, see Werner, 2004, p9-15).

<sup>61</sup> According to Dörr and Kessel, 2002, p22, “*Still today and almost more urgently than in the first years, Škoda demands greater political regulation of the [automobile] market by the Czech government. In view of the danger of monopolist pricing by Škoda and the firm's revived strength on the market, the initial market restrictions have been lifted, and so far no new restrictions have been imposed...*” This is a perfect example of the interactions between lobbies (who demand for protection) and governments (who need commitment to sustain a policy that is coherent over time) that we highlighted in Chapter 2.

<sup>62</sup> In 1994, Škoda had 15,985 employees, 1,063 fewer than in 1993 and 5,015 fewer than in 1990. Despite this reduction in employment, Škoda's production reached 220,000 vehicles in 1993. That is, 10% more than the year before.

This relative success and promising prospects regarding the future of the joint venture were saddened by the scission of Czechoslovakia in 1993 and the subsequent need to adapt to the new Czech commercial law and labour legislation. The introducing of these changes was the main reason of a particularly difficult financial situation experienced by Škoda in 1993: that year, the loss of the company amounted to CZK 4.261 billion (\$140 million). The bulk of these losses (CZK 4.157 billion) were caused by the need to adapt to new legislations.

At the same time, international markets were stagnating, which aggravated the position of VW: in 1994, VW incurred an operating loss of about DM2 billion (\$1.2 billion). VW thus had to revise its general strategy. Planned investments in Škoda were cut by more than 45% (from 9 to DM 3.5 billion), and its production plans scaled down from 450,000 to 300,000 vehicles annually. Consequently, Škoda's car production fell in 1994 from 220,000 to 174,000 cars at the same time as its losses were decreased to CZK 2.371 billion (\$70 million).

**Commitment.** During this process, the attitude of the Czech government was rather unusual. It remained adamant to the strong public pressures that demanded government intervention. The government could have tried to force VW into maintaining the initial investment and production plans. Instead, despite the uncertain success of the relationship with VW, the government realized it would be difficult to change business partner at this stage, and allowed VW to further increase its stake in Škoda. Accordingly, VW raised its stake in Škoda to 60.3% in December 1994 and, subsequently, to 70% in 1995 after another capital injection of DM 350 million. At that time, the government's residual share of 30% was intended to be sold as shares without voting rights through a coupon scheme and initial public offering. However, VW finally assumed total ownership of the company in May 2000.

The success of the Škoda privatization case is so striking that it now became an extensively studied case. Its results are remarkable: Škoda's annual production attained 460,000 vehicles in 2001; almost three times more than in 1991, when the joint venture was established. Its most recent car model is produced on one of the most advanced assembly lines in the world. Last but not least, Škoda is now one of the most efficient units in the VW group. This is a giant leap in product and service quality that allows

Škoda to export more than 80% of its production, to more than 70 countries. Alone, the company generated one seventh of all Czech exports in 2002.<sup>63</sup>

To sum up, the success of the Škoda privatization was due, first of all, to the governmental position, clearly defined at the beginning of the joint venture with VW. It committed to gradually grant VW a majority stake in Škoda, thereby creating the appropriate incentives for VW to improve the functioning of the company. The commitment of the government not to interfere in the management of the company, even when it retained its control stake, allowed VW to achieve all the (defensive and strategic) restructuring the company required. Another important aspect of the governmental implication consisted in the creation of an appropriate ‘institutional framework’. The government proved able to credibly commit to remove the short term protectionist measures it imposed when the joint venture was created so as to maintain restructuring incentives intact. Finally, VW was seeking not only to improve its strategic market position in Central and Eastern Europe, but also to expand its production activities to the “integrated peripheral markets” of the European Union. That is, the strengthening of Škoda’s competitiveness was the main objective of both the Czech government and the German VW Group. The congruence of their objectives was one of the reasons of the survival of the project, in spite of the major crises and conflicts the joint venture faced in 1993.

### **6.5.2. The privatisation of AvtoZAZ**

Ukraine is famous for its sluggish economic and political adjustments, and for being the country in transition that experienced the sharpest and longest fall in output (Roland, 2000, p20). Reforms proceeded slowly, and privatisations remained the exception. However, in this country as well, car producers were part of these exceptions, as witnessed by the case of AvtoZAZ, which was (partly) privatised to the Korean car producer Daewoo. Still, in a country where reforms were limited, and where the ambition to promote the development of a “real” market economy was questionable, this privatisation process was bound to be quite different from that of Škoda.

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<sup>63</sup> The trade surplus of the Czech Republic amounted to CZK 30 billion in that year. See also the Škoda activity report (2004, p17).

Any explanation of the differences observed in the two privatization processes would be incomplete if it did not take into account both the initial conditions of these two countries and the differences in their more recent economic and political reforms. In spite of the initial similarities between Czech and Ukrainian economies, the impact of the Soviet system on many people's view of the 'ideal' economic system was significantly stronger in Ukraine. Ukraine is geographically closer to Russia, and had experienced a longer period of Soviet dominance.

One aspect that proves to play a significant role in the progress of reforms in CEECs is the proximity of the country to the European Union (see Roland and Verdier 1999, and Roland 2000, chp8). This effect goes in two directions. First, being "close to Brussels" increases the attractiveness of the country for international investors. Second, the prospect of European Union membership improves the ability of these governments to commit to a given course of action, including their ability to establish high standards of democracy (and therefore of representation) within extremely limited periods. Accession prospects therefore reduced uncertainty for investors, and led to significant transfers from the EU. Potential accession to the EU served as an "outside anchor" to the reform process in these countries.

By contrast, a country such as Ukraine could not reap the benefits of this outside anchor. While the Czech Republic had already privatized 70% of its assets by 1995, only 50% had been privatized in Ukraine (like in Russia). Though relatively limited, this privatization process had stirred substantial resistance. The privatization of AvtoZAZ was nevertheless initiated in 1997, amidst this political context. The attractiveness of AvtoZAZ to international investors was limited. They had had ample time to realize that the economic and political evolution of Ukraine was quite different from that of Central and Eastern European accession countries. Moreover, many potential investors were scared away by insiders (industrial lobbies), which were reluctant to the full privatization of AvtoZAZ.

Finally, contrary to the Czech Republic, the government of Ukraine was not representative of the majority of the people in Ukraine. Representation was weak, because voters' power also was. One important implication of this fact was that the

motivations for the privatisation of AvtoZAZ were quite far from efficiency improvement or the development of effective competitiveness on international markets. The government essentially wanted to attract capital from abroad to prevent the outright bankruptcy of the company. The poor management of the company, together with the continued fall in GDP had indeed led to a gradual decline of production: from about 156,500 cars in 1992, it had fallen to only 94,000 cars in 1994. These critical conditions forced the government to look for a foreign investor already in 1995, when the production level had further fallen to 58,984 cars.<sup>64</sup>

**Control rights.** The main companies that revealed their interest were General Motors, Fiat and Daewoo. Few details are known, however, about the negotiation process between these companies and the Ukrainian government since it took place in a completely non-transparent manner. It was quite clear from the start, however, that the Ukrainian government wanted to preserve direct control over the “strategic” decisions that AvtoZAZ would have to make. One such “strategic” decision was that the production of the only national model, the “Tavria” had to be maintained.<sup>65</sup> Another one was that employment would have to be maintained, at all costs. Clearly, such constraints limited the freedom of the management to enhance the productivity of the firm, improve the production of the Tavria, and introduce newer models. Obviously, since the goals of the Ukrainian government were so different from that of the Czech government at the time of Škoda’s privatisation, the selection of an international partner also followed different objectives, and led to different outcomes.

The most attractive proposition for the Ukrainian side emanated from the South Korean car producer Daewoo. Officially, the selection of Daewoo was justified by its investment plan, which was by and large superior to the other bids. Daewoo proposed \$1.3 billion of direct investment (the highest foreign direct investment the country

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<sup>64</sup> Some attempts were made to find national financing. However, national investors (such as “Prominvestbank”) seemed to be rather sceptic as to the benefits of such an investment without any restructuring and efforts to increase the competitiveness of the company (Piskovi 1999, whose article was precisely titled: *AvtoZAZ+Daewoo=the results that could be expected*). Moreover, the managers of the company clearly preferred a foreign investor (bringing not only the funds but also frontier technologies) to a national investor, having more demands for fewer contributions.

<sup>65</sup> The Tavria model was put into production in 1987 in order to replace the old model, the Zaporozhets. By 1997, this model was suffering of a poor image: it was clearly outdated, of poor comfort and had mediocre performances.

would have ever received), promising to maintain employment unchanged (18,000 workers), and to increase the annual production up to 255,000 cars within four years. In comparison, General Motors initially proposed to invest \$23 million, to produce 25,000 Opel Vectra per year. Later, in April 1997, it increased its bid to an investment of \$60 million, and a production of 60,000 cars per year. As for the employees, only 1,000 workers were considered to be necessary for such production volumes.

The “non-negligible” question of whether the “generous” offer of Daewoo was any realistic was of course of secondary importance for the ex-Soviet Republic leaders. Actually, some specialists and people in Ukraine still believe that this attractiveness was not unrelated to personal favours offered to some of these Ukrainian officials.

**Why casting doubt on this investment plan?** First, because the production of AvtoZAZ only accounted for 6,881 cars in 1996. Second, because the estimated volume of car sales on the Ukrainian market was of 200,000 cars, and that the constraints imposed on the management AvtoZAZ would not enable it to develop a strong export capability (Besides, the global sales of Daewoo in the whole European Union only attained 200,000 cars in 2000). Consequently, a sale target of 255,000 cars per year, that is: 127% of the national market, appears clearly unrealistic. Third, because Daewoo was already facing obvious financial troubles before it assumed joint ownership of AvtoZAZ, and had substantial problems of excess capacity worldwide.<sup>66</sup> Hence, there was little doubt that Daewoo was interested above all in obtaining substantial protections to achieve a monopoly position onto the Ukrainian market. As we will see, the organizational form chosen for the new Company *AvtoZAZ-Daewoo* was particularly appropriate for these purposes. Among other things, the central role assumed by the government in the management of the company, with its clear objective of maintaining employment before profitability, was perfect to guarantee that soft-budget constraints could be sustained for long periods of time.

Despite high debts and the questionable financial position of Daewoo Corporation, the negotiation process resulted in an agreement, signed in September 1997, creating a

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<sup>66</sup> These problems were common to many Korean firms and were one of the reasons why the “Asian Crisis” occurred a few months later.

joint-stock company “AvtoZAZ-Daewoo”.<sup>67</sup> The statutory fund of the joint venture was brought by both parties in equal shares, where Daewoo’s contribution amounted to \$150 million in cash. To repeat, the fact that 50% of the newly created joint venture would belong to the state is explained by the will of the government to retain control of the new firm. Moreover, it was an additional guarantee to insiders and to Daewoo (ensuring the existence of soft-budget constraints and preferential conditions). These employment and management constraints rendered difficult committing either to defensive or strategic restructuring of the company.

**Temporary (?) protection.** Like with the privatisation of Škoda, generous protections and preferential treatment were offered to Daewoo. Among these conditions, the most important ones were (1) the adoption of a law promoting automobile production in Ukraine and (2) the introduction of import restrictions on used cars.<sup>68</sup> The former, adopted by the Parliament on September 19, 1997 consisted in offering substantial tax privileges to investors in the automobile industry and in granting exemptions from import duties and other foreign trade regulations under (rather “precise”) conditions.<sup>69</sup> These measures were to be applied until August 2008 (that is, for more than 10 years). Although there was no mention about the South Korea investor in that law, it is evident that it was tailored especially for Daewoo: the AvtoZAZ-Daewoo joint venture was the only investment project that could meet all the criteria for the preferential tax and foreign trade regime. Another “welcoming present” consisted in the debt write-offs to AvtoZAZ (which took place already during the latest negotiations stages, in the fall of 1997), and the restriction that public organizations could only purchase cars produced in Ukraine. All the objections raised from other investors in the Ukrainian car industry were thoroughly ignored.

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<sup>67</sup> The corporate structure then became the following one: the government would remain the unique owner of AvtoZAZ (probably to avoid using the politically sensitive word of “privatisation”). However, AvtoZAZ was hollowed of its labour force and productive equipment, which were entirely transferred to the joint venture. That transfer represented the 50% contribution of the Ukrainian side to the joint venture.

<sup>68</sup> The new law stipulated that import of cars more than 5-year old and/or worth less than \$5000 would be forbidden.

<sup>69</sup> These criteria were : 1) Minimum \$150 mln cash investment into the automobile producing venture registered by an authorized Ukrainian authority (just as much as Daewoo proposed to invest) and 2) Localization, i.e. establishment of a domestic production of car parts, which must employ local workers at not less than 90% of the total workforce.

Even though some may argue that such measures (the law on promoting automobile production and import restrictions) can be necessary to protect an infant industry, there is no doubt in the present case that it has strong negative implications in terms of competitiveness and of potential catching up. Some authors even contended that these protectionist measures were responsible for the almost complete destruction of the Ukrainian car industry.<sup>70</sup> Moreover, tax reductions and tariffs, contrary to the Czech case, were planned to hold for ten years, and the lack of an outside anchor weakened the commitment capacity of the government not to prolong these measures. The concomitant soft-budget constraints clearly limited incentives to enhance efficiency (Kornai, 1998).

**The players.** What led to these choices? Lobbies played a crucial role in the negotiation process. First, some non-official voices argue that Daewoo managed to attract strong support among the political elites of the country. Second, there was a significant lobbying in favour of Daewoo by some of the main groups of actors concerned by this process, in particular by the incumbent managers of the company.<sup>71</sup> The employees of AvtoZAZ also backed the proposal of Daewoo unanimously, hence rejecting the offer of General Motors, which was proposing to lay off 95% of the staff. It should also be noted that the time constraint was getting very tight for the Ukrainian side, (with 18,000 employees, AvtoZAZ only produced 6,881 cars in 1996, and this had further decreased to 1,000 cars in 1997).

This lobbying process fed directly the objective of the Ukrainian government to maintain employment at its Soviet times level. In light of the successes observed abroad (cfr. Škoda), the Ukrainian government apparently believed it would be possible to achieve this objective through cash contributions and the technological improvements that Daewoo would bring in. Regarding the South Korean car producer, its target consisted mainly in establishing its activities and its market share in Ukraine. Therefore, the competitiveness of the main Ukrainian car maker was not of primary

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<sup>70</sup> "...For example, countries that decided to protect their car industry (Ukraine) have practically destroyed this industry and several other related activities, while countries that made allowance for foreign competition (the Czech Republic) have seen a fast development of this industry." Szyrmer "Post-Soviet Transition: Problems; Lessons; and Solutions", p. 16 in Szyrmer and Snelbecker, 2000.

<sup>71</sup> According to "The Day" (nov. 2000), the Reforms and Order Party, its leader, Viktor Pynzenyk, and Reforms and Order Zaporizhzhia oblast branch chairman cum AvtoZAZ director, Oleksandr Sotnikov, were accused of lobbying in favour of the AvtoZAZ-Daewoo project.

importance for any of the parties. A good illustration of their objectives is to be found in the last stages of negotiation. The Ukrainian side insisted on including in the joint venture *all* production sites of AvtoZAZ, even the least profitable ones. Daewoo agreed on this only after having obtained the promise from the government to impose drastic limits on the import of used cars.

These decisions demonstrate how the interests of the employers and employees of the firm were given outright preference to that of voters, consumers, and aggregate welfare: through taxes privileges and duties exemptions, the government sacrificed huge amounts of potential gains in efficiency. By investing in AvtoZAZ and negotiating these protectionist measures, Daewoo purchased the right to dominate the Ukrainian car market and, as a consequence, to increase aggregate prices.

Admittedly, Daewoo did not obtain such favourable conditions without having itself to offer an (unrealistically?) ambitious development plan for the company. In return for all the protectionist measures it obtained, the South Korean carmaker agreed to issue a \$1.1bn loan to AvtoZAZ, with no guarantees from the government's side, to modernize the existing production facilities. That loan would be used to restructure production plants in accordance with Daewoo's production technologies, and to finance improvements and the production of the Ukrainian Tavia model. Furthermore, the AvtoZAZ-Daewoo company promised to reinvest the profits in order to develop the Ukrainian car industry and therefore provide employment to all 18,000 workers. Initially planned production levels were however revisited downwards several times.

**The outcome.** Since the first year of operations, the company's production was far below its minimum targeted level of 100,000 vehicles: only 24,000 cars were produced and, out of these, only 11,700 could actually be sold. The managers of AvtoZAZ-Daewoo justified this on the ground that national demand had decreased and that the introduction of a new car model can take some time.

External experts instead think that the main reason lies in the poor performance of the joint venture. The new Korean models were quite unpopular in the Ukrainian car market, and AvtoZAZ-Daewoo failed to improve the quality of the pre-existing Tavia model. The effort of the management indeed focused on improving the appearance of

that model, instead of its reliability. This led to a change in the image of the Tavria model: instead of being perceived as a “low-quality and low price” car, it became a “low-quality but quite expensive” one. Finally, some of the protectionist measures put in place to protect the car maker did not significantly affect imports.<sup>72</sup>

**Lack of commitment.** The main explanation may however be found in the lack of commitment on both sides of the deal. The financial situation of Daewoo rapidly became alarming. Since the government had not devised any way to constrain Daewoo to stick to its promises, none of the latter were fulfilled. There is no proof that the loan ever materialized and, concomitantly, the plants were not restructured. Going from bad to worse, instead of trying to produce cars entirely in Ukraine, Daewoo used its international excess capacity (estimated at some 2 million units in 1998) together with the Ukrainian protectionist measures to ship already built cars to a factory in Odessa and, after a minimal addition of value by Ukrainian labour, sell them as domestic cars: “*‘They’ll (the Daewoo Nexias) have their wheels taken off in Varna, Bulgaria,’ said Vladimir Ushakov, an Odessa shipping professional. ‘Then the Koreans will bring the wheels in separately and put them on. Voila!’ says Ushakov, ‘A Korean car made in Ukraine!’*” (Korshak, RFE, 1998).

Despite the coming financial crisis, the government was strongly “advised” to postpone the full privatization of AvtoZAZ, in order to sell the other part of the Company’s shares in a “*more favourable*” moment. The pressure from the insiders’ lobbies went in the same direction: “*As long as the joint venture [AvtoZAZ-Daewoo] is at stage of gaining strength, it would be better for the government to remain the chief property holder, to manage us and to help us*” (AvtoZAZ Deputy Director, M. Lastovetsky, quoted in Korshak, RFE 1998 – Italics added).

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<sup>72</sup> The effects of the decision on quantitative restrictions on imports of used cars can illustrate this claim. Although the introduction of the age limits of used car led to an increase of their price of about 40% immediately after the moment of announcement, prices and imported quantities returned to their previous levels a year after the decision came into force, i.e. in the beginning of 1999. The reason is that a loophole in the legislation could be spotted. The law could indeed be circumvented in the following way: all the cars, concerned by the restrictions were declared as temporary imports. Indeed, any car could be imported temporary, i.e. for at most 3 years. And at the end of the 3d year of use, one could re-register this car –e.g. by declaring another member of the family as the new owner. The government then added new constraints that limit temporary imports.

On the 1<sup>st</sup> January 1999, 13,000 unsold cars were stocked in the AvtoZAZ plant. Sceptics were thus wondering why the plants should operate at all in 1999. Already two years after the creation of the joint venture, the privatization of AvtoZAZ to the South Korean car maker had apparently resulted in blatant failure: despite the efforts of AvtoZAZ-Daewoo and the protectionist measures of the government, the company had not managed to conquer the Ukrainian market. In light of the theories of privatisation we outlined above, this does not come as real surprise, though. Cynically, however, even the Ukrainian and the Korean sides seemed to be aware of this possibility already at the time of signing the initial agreement.

Despite (or perhaps because of) these evolutions, the government set up a program for selling the shares still in its possession and to delegate the entire management of the joint venture. To spare the interests of the insiders and to create the support for this additional step of privatization, the program nevertheless maintained some of the initial conditions that had already undermined the first phase of privatisation. Namely, potential buyers would have to run the firm “efficiently”. The meaning of the word “efficient” however still meant that all workers had to remain employed. Another measure aiming at the creation of support was a *gradual* privatization process. Only 32% of AvtoZAZ shares were to be sold in a first stage (in September 2000), and the rest was to be sold by 2004.<sup>73</sup>

Unsurprisingly, this attempt failed for a lack of bids. The Daewoo Corporation was already bankrupt, and rare were the other firms interested in AvtoZAZ, which was producing at less than 10% of its capacity and unable to sell its own production. In addition, the company had enormous debts. Its losses had amounted to more than \$5 million for the first half of 2000. This tight financial situation was not due to transitory restructuring costs but, on the contrary, to the absence of any kind of restructuring. September 2000 was apparently still not a “favourable moment”...

**External constraints, external players, and light at the end of the tunnel.** As observed before, critical conditions are sometimes necessary to force governments into undertaking necessary reforms. The huge losses of AvtoZAZ, together with the ever

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<sup>73</sup> Given the corporate structure of the joint venture, these 32% of AvtoZAZ only represented 16% of AvtoZAZ-Daewoo but would enable the buyer to effectively control the latter.

increasing deficit of the Ukrainian government and with external pressures probably explain how AvtoZAZ may eventually get out of the vicious circle we described.

By 1998, the overall economic situation in Ukraine had followed the same road as that of AvtoZAZ. Already in January, the Ukrainian government was in a position to anticipate the default of Russia on its public debt. The financial needs of the Ukrainian government had been increasing as well: in 1997, the public deficit was reaching 7% of GDP (the limiting measure imposed by IMF for continuation of financial cooperation was 2.5%). The government kept relying on foreign borrowing, but difficulties in its relations with the IMF, the World Bank, and other international financial institutions, made further loans increasingly difficult to obtain. The deficit thus *had to* be reduced. When these external constraints had finally shifted the balance of powers away from industrial lobbies, the government ambioned to raise \$1 billion in revenues through the privatisation of key SOEs. This privatization wave included some firms such as Zaporozhstal (the biggest steel producer), Tsentrenergo (power generator), Ukrainian International Airlines (already partly owned by Swissair) and, of course, AvtoZAZ.

Another external constraint forced the Ukrainian government to lift some of its protective measures as well. The Ukrainian protectionist measures had induced the European Union to intervene and oppose them. They were declared to violate existent agreements between the EU and Ukraine.<sup>74</sup> Therefore, the Ukrainian side was “invited” to change its legislation and to make it consistent with its international commitments. The Ukrainian government followed the invitation and, after several years of reflection, presented a project of law about “Conception of Car Market Regulation and Development of Automobile Production in Ukraine until 2005”. The quantitative restrictions of the imports of used cars into Ukraine had to be waived partially –the car’s age limit was increased to 8 years, and the price criterion was suppressed in spring 2000.<sup>75</sup>

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<sup>74</sup> More precisely, it was violating Arts. 5 and 7 of the Interim Agreement between Ukraine and the European Union already in force since 1996, which are identical with WTO (World Trade Organization) rules.

<sup>75</sup> In reaction to these amendments, the General Director of AvtoZAZ-Daewoo, Wang Yang Nam, declared that they represented a direct and unambiguous violation of the guarantees set forth by Section 2 of the law of Ukraine “On the Regime of Foreign Investment” and that the Korean side would take some measures and make Ukraine pay moral damages according to Article 10 of the abovementioned

These external constraints nevertheless ended up forcing the government to sell much more than a 32% share of AvtoZAZ to private investors. Eventually, a majority stake of 82% was put on offer, at the beginning of 2001. After several unsuccessful attempts to sell this stake to a foreign company, AvtoZAZ was privatised to a national car distributor, “Ukravto,” for a half of their initial price. As to the Daewoo’s shares in the AvtoZAZ-Daewoo joint venture, the bankruptcy of the latter partner forced it to sell its 50% share to “Hirsch&Co,” which acted on behalf of an undisclosed actor. The latter, however, announced officially that it would not interfere with the management of the joint venture. Ukravto therefore became the *de facto* manager of the company. However, Ukravto being a national car *distributor*, and not a car producer, its main efforts focused on defensive restructuring and on improving the distribution of cars in Ukraine. Together with this defensive strategy, it signed several agreements with foreign car makers (such as Daimler-Chrysler and Opel, which ironically is part of the initially rebuffed GM group) for the knocked-down production of their models by AvtoZAZ, and their distribution on the Ukrainian market. This conservative strategy led to clearly positive results. Production and sales significantly increased and, in 2002 and 2003, the demand was so high that it was impossible to satisfy demand with the production capacities of the AvtoZAZ plant. The prospects of the company are now widely improved, and it plans to produce 120,000 cars this year, although it has to keep employing 20,000 workers.

There is thus light at the end of the tunnel, even though the long-term survival of the company cannot be ensured without deeper restructuring. This restructuring will have to be carefully meditated. A long-term strategy must be devised, to make the company able to confront international market challenges. Focussing on the national market will not suffice, since it will rapidly become saturated. Poget *et al.* (2001) describe that only four options exist for the long-run. First, the status quo, which will inevitably lead to the bankruptcy of AvtoZAZ. Second, focusing on Eastern European markets, with a particular focus on Russia. Third, adopting a strategy similar to VW with Škoda, one of “integrated peripheral markets”. Fourth, waiting for a white knight to take over and

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law. Hence, “Cabinet members are now racking their brains over the issue of how to kill two birds with one stone, satisfy the EU and to comfort the investor” (Mr. Papashev, Chairman of the AvtoZAZ-Daewoo Joint venture, in Brovkin, 2000).

restructure the company. However, they argue that such a knight will never come before the company falls into dusk...

## Chapter 7

# The tale of failed corporate governance reforms in Russia

### 7.1. Introduction

On Monday August 17, 1998, the Russian authorities unilaterally declared a moratorium on all rouble-denominated public debt, and suspended all private foreign obligations. This amounted to a de facto default by the government and the banking system. The rouble rapidly lost two-thirds of its value vis-à-vis the dollar, followed by a liquidity crisis and runs on many banks. The shock created by these measures developed into a full-scale international crisis of confidence, with credit spreads widening sharply in all markets and briefly raising doubt on global financial stability.

There were visible macroeconomic causes to the Russian collapse: ultimately, the Russian crisis followed an unsustainable overvaluation of the rouble and a fiscal crisis (Popov, 2000). The rouble became overvalued under a fixed exchange supported externally, while undermined internally by capital flight.

Yet the rouble was perceived to be overvalued precisely because of the poor credibility of the reform process, and in particular of its governance. Russia had a massive trade surplus. So, in a conventional setting, it would have been conceivable that investors could have continued to fund its budget deficit. But capital flight resulted precisely from the recognition by insiders that the reforms lacked a solid foundation, because of design flaws favouring a small connected clique. The associated lack of legitimacy reinforced the incentive to bring ill-gotten gains abroad to secure them from an unavoidable political reversal, which started after the crisis. Even among those macroeconomists who were involved in advising Russia, a general consensus has emerged that the failure at microeconomic reforms undermined stabilization policy and restructuring (Fischer and Sahay, 2000). Such reforms include *“establishing property rights, hardening budget constraints, building a healthy banking system, and ensuring true domestic competition”* (Wyplosz, 1999). Yet there was no lack of formal legislative change under Yeltsin, prodded by the IMF’s conditionality lending, which

often came in unprecedented degree of details. While important aspects of legislation were delayed or left incomplete, Russia *on paper* adopted most of the suggested regulatory framework. The key ingredient which failed to materialize was reliable enforcement. In practice, powerful interests could ignore most rules or comply only in a perfunctory fashion. This undermined their credibility among the population, which responded with collective inertia and cynicism. In other words, reforms failed because Russians did not believe in them.

### **Was state capture inevitable?**

Was there a choice that was missed at the beginning of transition? Why did the Yeltsin regime fail to resist the powerful interests that captured the reform process? Perhaps after seventy five years of Soviet rule, there were no institutions left which could ensure proper arrangements in the power vacuum created by the collapse of a regime based on fear.

The critical institution which in a power vacuum could have supported necessary, but painful, reforms was popular support. Legitimacy helps disciplining abuses by the executive because it coordinates a public response, and thus empowers reformers in good faith. Countries in Central Europe could rely on a diffused perception of a Western national identity and the outside anchor provided by the promise of joining the European Union. By contrast, like Ukraine (See section 6.5), Russia as created by Yeltsin had no such perspective.<sup>76</sup> The painful reforms that the Yeltsin government initiated could thus not count on a sufficient popular legitimacy, as they missed a powerful disciplinary mechanism on policy implementation. Much of the initial support for painful adjustment dissipated rapidly as it became clear that politically connected interests could go about unchallenged, while costs were socialized.

Thus, we explain the lack of credibility of the new reforms under Yeltsin by a combination of concentrated power by a few veto players, which puts them above enforcement, matched by, or rather leading to, lack of legitimacy for the reforming institutions. The effect of this poor credibility among the population led to a massive

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<sup>76</sup> The relatively good performance of the Baltic countries appears to be a confirming indicator that even countries which were formally incorporated in 1945 in the Soviet Union maintained some social institutions which enables them to revert to a distorted, yet ultimately reasonable system based on legal rule rather than sheer abuse of power.

non-compliant response to new laws and reforms by individuals and firms, which fatally undermined the process. The realization of the vulnerability of the reform process by itself hastened the process of opportunistic stripping, and gave powerful incentives for rapid capital flight.

Was there an alternative to this scenario? Russia had some distinctive disadvantages in terms of the ease and credibility of the reform process. Russia faced higher adjustment costs relative to Central European economies. It did not have a credible external anchor in the chance to join the EU, which created serious constraints on executive decisions as well as on providing political consensus in favour of reforms. This combination produced critical discipline for behaviour both at the level of the political executive and a focal point for individual behaviour. These objective difficulties reinforced scepticism about the viability and attractiveness of rapid reforms. Yet, arguably, the critical factor in creating the diffuse cynicism which led to a self-reinforcing expectation of failure via massive non-compliance was the blatantly visible capture of the decision making process by few, well-connected, interests.

What are the responsibilities of the West? Most Western economists who assisted the early stage of transition in the FSU were macroeconomists, responding to the visible monetary and fiscal imbalances. At the same time, the declining economic performance of transition economies had required that social peace be bought by (hard to sustain) social promises. As a result, practically all countries exhibited a large monetary overhang and considerable fiscal deficit. The fear at that time was that Russia and the other FSU states would not manage to stabilize their economies. Yet, the main political goal for the West was probably privatization, as it was supposed to break down a militaristic command structure and create a strong constituency for a market economy (see Brada 1996 and section 5.4).

The absolute priority given to these goals gave convincing results: by 1996-1997 Russia had achieved both stabilization and privatization, and not just on paper. The West pushed these goals with a large financial support. Yet, in order to overcome the veto power of older established interests in ministries and enterprises, the West condoned a massive appropriation of state property by enterprise managers and powerful interests. This granted such wealth and power to a few oligarchs to allow

them to dictate terms to the government, which relies on their financial and media support to overcome its weak legitimacy.

**State capture leads to poor compliance** In a systemic adjustment, enforcement depends critically on a sufficient adjustment response; as a result, expectations are critical in determining the aggregate outcome. Cynical expectations regarding the response by other agents and the credibility of enforcement may thus produce a critical mass of non-compliance with legal and financial obligations, which creates an insurmountable barrier for enforcement.

State capture seriously weakens the credibility of enforcement. While corruption accompanied transition in all countries, its extent in the FSU (Former Soviet Union) led many authors to describe it as *state capture*, where corrupting agents hold more power than the corrupted officials (Hellman et al, 2000).<sup>77</sup> A weak political regime under Yeltsin needed the support of special interests to remain in power, and allowed them a free reign in plundering state assets and escaping obligations. Such a poor example from the top affected individual attitudes and expectations among the population on the reliability of legal enforcement, and further weakened compliance.

Major structural reforms can thus fail when their design leads to regulatory or (in the extreme cases) to state capture. Good examples are large privatization programs in Chile in the late 1970s, in Mexico in the 1980s and in Russia in the mid 1990s. In some early Latin American privatization programs, large private investors were grossly favoured on the privatization of the large state banks. This enabled these investors to fund the acquisition of control over a number of privatized firms. In all these cases, the abuse of bank resources for private purposes led to brutal financial crises, which forced renationalisation of most of these groups.

Consider the case of the fiscal deficit. Special interests were able to capture the political decision process so as to ensure either *de jure* or *de facto* vast scope for tax exemptions or tax evasion. This impunity contributed to reinforce a cynical attitude leading to diffused tax avoidance, and more generally, collective non-compliance with

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<sup>77</sup> There is evidence that while connected firms benefit, on average, firms grow less than in less captured economies (Hellman, Jones and Kaufmann, 2000).

any contractual and financial obligations. The consequences were that financial imbalances of all types steadily accumulated throughout the system.

Consider next the case of the banking sector. Many observers recognized that the main activity of Russian banks was never to intermediate funds to the real sector.<sup>78</sup> Most Russian banks were kept as empty boxes in which liabilities accumulated, while cash was sent abroad. Firm managers converted corporate assets into cash to appropriate it (asset-stripping), even at large losses. So asset-stripping and capital flight were rational, if perverse and corrupt, responses to the institutional failure of the post-Soviet reforms, and were the direct counterparts of the non-payment problem. Consistent with this view, capital flight was not concentrated before the collapse, unlike traditional crises, but continued at a steady, massive rate throughout the 1990s. It was particularly high during the 1995-1997 stabilization period, a time of large trade surpluses and high domestic real rates (Loungani and Mauro, 2000).<sup>79</sup> This is *prima facie* evidence that the financial crisis and devaluation were the final consequence of steady structural outflows, not of a progressive fiscal deterioration.<sup>80</sup>

A challenge to our argument is that other transition and developing countries faced the same institutional problems as Russia<sup>81</sup>. Similar arguments, based on opportunism and crony capitalism, were put forward for the Asian crisis as well. Why was the financial crisis in Russia so sharp? In what way was Russia different from, say, Ukraine or Bulgaria, which endured a more steady decline, or even Indonesia?

Russia's fall was spectacular because it had been artificially delayed. Nominal reforms without real enforcement (what we term soft legal constraints)<sup>82</sup> were tolerated for too long by international institutions keen to see a pro-Western stand survive in Moscow.

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<sup>78</sup> While bank deposits became an accepted form of savings in Central Europe, in Russia (and the FSU) the amount of cash in circulation rose throughout the 1990s from a fraction to over four times total deposits, far above Central European values (Tang et al, 2000).

<sup>79</sup> In Loungani and Mauro's estimate, capital flight per capita are higher in 1996 and 1997 than 1998; the rate of ruble outflow in real terms is comparable in earlier years.

<sup>80</sup> Loungani and Mauro (2000) show that after controlling for fiscal and monetary conditions, poor implementation of structural reform is associated in transition countries with higher capital flight.

<sup>81</sup> There, the macroeconomic picture looked quite different, with large trade deficits, good fiscal balances, large domestic savings, high investment and growth rates. Yet, the degree of financial misallocation, supported by moral hazard (Corsetti, et al. 1998 and 1999), appears quite similar.

<sup>82</sup> Gelfer, Pistor and Raiser (2000) show that it was not lack of legal text, but of capacity or willingness to enforce which determined the unreliability of financial transactions in Russia.

Western government loans and the 1996 and 1998 International Monetary Fund (IMF) loan programs were clear examples of concessionary support, and sent powerful signals to investors. Most countries are not allowed such a long run, and their failures are thus less spectacular. In addition, in few countries were the incentives to strip cash at all cost as strong, and the risk of punishment as feeble, as in Russia.

The next section offers a brief chronology of the main trends in the Russian economy during the period of post-communist reforms. Section 7.3 presents illustrative applications of the state capture model to various segments of the Russian economy and briefly discusses the post-crisis condition.

## **7.2. Main trends of the Russian economy, 1992-2001** <sup>83</sup>

After a period of partial and inconsistent reforms under Gorbachev, the demise of the Soviet Union in the fall of 1991 opened the way for an ambitious “shock-therapy” program, launched along lines comparable to the 1990 Polish plan (Lipton and Sachs, 1992). The Gaidar government tightened credit in January 1992 to encourage microeconomic restructuring, following price liberalization. The critical phase of this policy required resisting pressures for reflation and compensatory bailouts and ultimately forcing real adjustment. In Russia, the adjustment response was very limited, and most trade bills went unpaid. The policy collapsed by summer, when trade arrears rose to three times total bank credit, with a massive bailout funded by money printing by the CBR (Central Bank of Russia). The bailout validated collective inertia and led to new cycles of accumulation and bailing out of arrears (see Figure 7.1). High inflation in 1992-94, with a monthly inflation rate between 5 and 25%, wiped out domestic savings.

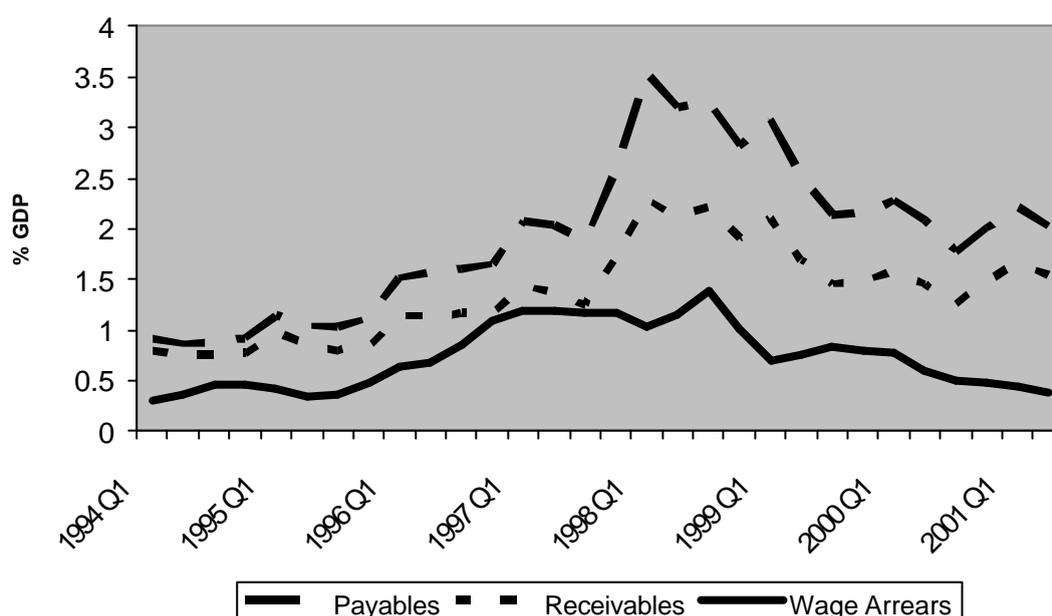
At the same time, under an extremely laissez-faire policy of minimal bank capital requirements, the number of banks went rapidly from fewer than 10 to over 2500. Many such “banks” performed cash management, capital flight and whitewashing services for enterprises or shadowy organizations, and were at first mostly speculating

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<sup>83</sup> We have drawn from the chronology of events in Perotti-Sgard (2000).

against the rouble. Well-connected banks thrived from managing the balances of federal or local authorities. Banks also held on to transfer payments for clients as a form of costless funding, indirectly collecting a large inflation tax. Bank supervision performed perfunctorily, monitoring compliance with the formalities of regulations rather than with their content. Pure Ponzi schemes became common, such as the large MMM collapse in 1994.

**Figure 7.1. Dynamics of Payables, Receivables and Wage Arrears** (Source: RSA)

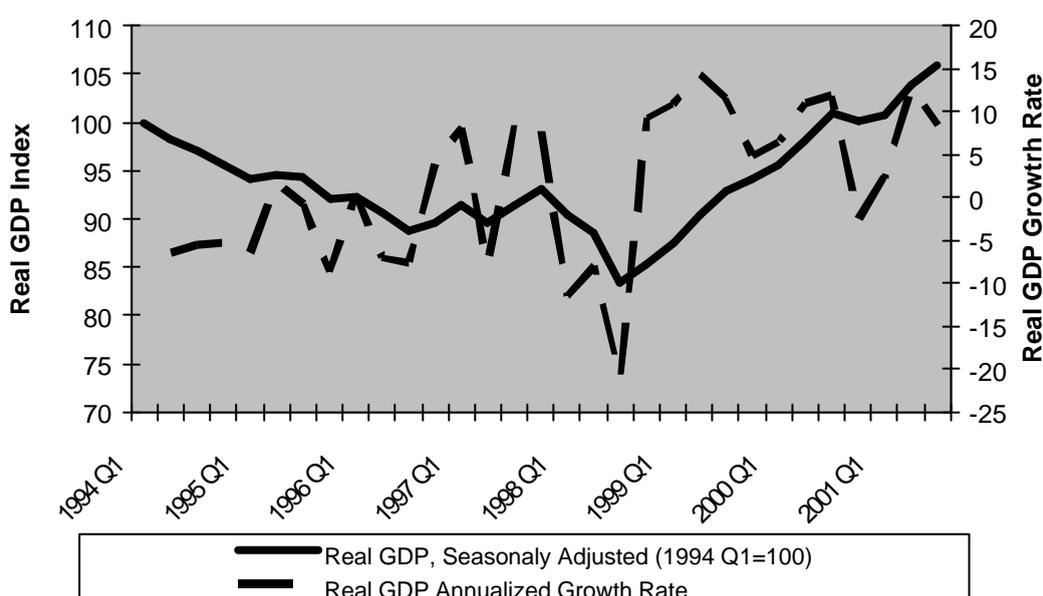


When stabilization policy from 1995 onward froze the printing presses, there was a last chance to tighten financial discipline. Yet, the government had lost further support, and was by then at the mercy of special interests. It thus shifted to a different form of ex post laxity, substituting loose enforcement for loose money, condoning non-payment and asset-stripping while stoking trouble for later. The CBR kept administering merely cosmetic supervisory controls, so that banks were allowed to operate on the edge of insolvency. While stabilization policy stopped the destruction of financial obligations via inflation, enterprises moved to accumulating arrears.

Nominal stabilization was maintained by shifting from inflationary financing to issuing rouble-denominated public bonds at extremely high yields. Rouble assets, for the first

time, offered better returns than mattress dollars. As the risk of a communist victory at the 1996 presidential elections disappeared, a number of private banks competed for deposits with Sberbank, the former Soviet retail monopoly and sole retail bank enjoying deposit insurance. In 1997, there were signs of growth in intermediation to enterprises<sup>84</sup>. The stock market boomed, as foreign brokers interpreted the low price-to-earning ratio of Russian stocks as an opportunity, rather than a reflection of non-existent minority rights. Thanks to falling interest rates and strong inflows, the growth rate became marginally positive in 1997 (see Figure 7.2).

**Figure 7.2: Real GDP Growth** (Source: RSA)



This window of opportunity faded rapidly. A stronger political leadership could have controlled capital flight, but it would have had to challenge powerful interests as well as the disapproval of the West. In practice, the government was unable to enforce even tax collection. The pressure of increasing budget deficits resulted in a rapid accumulation of government debt. The government bond market paid very high rates in real terms, which further encouraged cash stripping and tax arrears. Banks took advantage of stabilization and the progressive overvaluation of the rouble, borrowing

<sup>84</sup> Ex post, much lending appeared to having been granted either within bank-controlled groups or to personal relationships (Laeven, 2001).

massively abroad. While some of these inflows were invested in the GKO market (Russian government bonds), most simply returned to the West as capital flight.<sup>85</sup>

The withdrawal of the CBR from offering currency forward contracts in 1997 led commercial banks to insure foreign investors eager to hedge their rouble risk on a massive scale. While the exchange rate held, this offered massive profits with no real downside, since the banks had no assets to back up these claims after devaluation. In essence, they were offering insurance they had no plan to honour.

The difficulty in refinancing the booming stock of short-term public debt was compounded by the Asian crisis and falling oil prices. A new government was brought in March 1998, on a mandate to restore fiscal responsibility. Because of its political weakness, its few reforms went unimplemented, tax collection did not improve, and capital kept flowing abroad.<sup>86</sup> Several large private banks became visibly insolvent. Only the arrival of a first tranche of an IMF loan delayed the final meltdown.<sup>87</sup> However, this IMF loan fled the country at extraordinary speed, leaving no choice to the government but to announce a devaluation and a moratorium on the debt, a de facto default. Under heavy pressure from bankers, the government extended the moratorium to private bank debt, a final confirmation of the soft legal constraints under which the financial system had been operating.

After the rouble fell, a liquidity and payment crisis broke out; many private banks experienced runs. But banks were able to refuse or delay withdrawals, while shifting the last assets abroad or to affiliates.<sup>88</sup> The Central Bank suspended withdrawals in the major banks and shifted private deposits to Sberbank. As a result, the share of Sberbank reached almost 90% of the rouble savings market (see Figure 7.3). Insolvent banks were not declared bankrupt, nor were their owners ever called to respond to the

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<sup>85</sup> In addition to their ability to lobby and bribe, Russian banks also enjoyed de facto immunity thanks to their link to criminal elements. In the language of the FBI Director Louis French: "Organized crime shaped the post-communist Russian banking industry and now manages it."

<sup>86</sup> A rare glimpse into asset-stripping emerged when officers at Bank of New York were found guilty of aiding the stealing and exporting of several billion dollar from InkomBank.

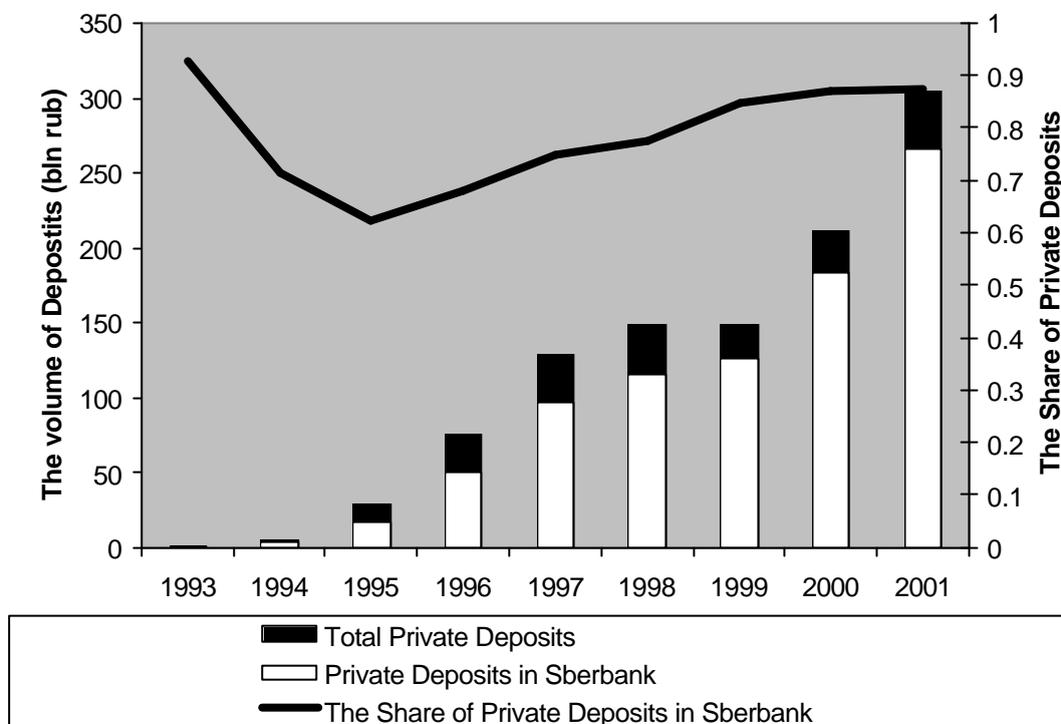
<sup>87</sup> Yet even the average Russian investor turned out to be a bit naïve; Perotti and Sgard (2000) argued that Russian bond markets had envisioned a devaluation, not a complete default. A few influential Russian bankers managed to capture the last rounds of dollar reserves from the Central Banks just before the collapse.

<sup>88</sup> For a description of the asset-stripping by banks, see Schoors, 1999.

asset-stripping. After frustrating attempts to have their claims enforced, foreign investors accepted settlements of a few cents on the dollar.

**Figure 7.3. The Structure of Private Deposits**

(Source: CBR, Sberbank of Russia)



Interestingly, the crisis in Russia did not have the same impact on real activity as in Mexico in 1995 and in Asia in 1997. Financial crises usually cause severe recessions. In Russia, the ability of firms and banks to renege on their obligations to depositors or workers, the decline in attractiveness of cash payments and the extent of barter trade all contribute to explaining why the crisis did not feed through into the real economy.

### **7.3. Regulatory and governance capture under Yeltsin**

This section discusses the special cases of regulatory and governance capture across the Russian economy and society under Yeltsin. We start, however, by discussing the broader consequences of such capture on the behaviour of ordinary Russian citizens.

We argue here that the failure of economic reforms in Russia were due to a deliberately poor design, compounded by a diffuse cynical response by the population,

which rationally saw the emptiness of the new legal institutions and chose for a collective inertial response of non-compliance with the new rules. State capture reduces the credibility of authorities, as they are expected to bend rules themselves to accommodate special interests. Coupled with the high average adjustment costs faced by the militarized and monopolized Soviet economy, this created an expectation of a critical mass of non-compliance which overwhelmed even proper intentions and enforcement, thus reinforcing resistance to adjustment.

In contrast, governments in Central and Eastern Europe had greater credibility, which ensured greater compliance and the ability to ensure some degree of legal control. Objectively, the adjustment cost for these societies was much lower than for a society traumatized for many generations under Soviet rule.

We apply the logic of this inertial response to several aspects of policy in Russia. If tight credit policy results in massive non-payment, monetary authorities come under pressure for financial relief; in the face of massive tax evasion, fiscal authorities are forced to tolerate arrears, thus validating non-payment. Similarly, regulatory and legal reform cannot be enforced, and diffuse criminality is not policed.<sup>89</sup> Next, we describe how inertial response may explain massive non-compliance in Russia with financial and fiscal obligations, as well as with new laws or prudential rules in the banking sector. In the concluding section, we discuss how this failure at enforcing compliance may be a determinant for the great economic divide that has opened between the reforming Central European economies and the FSU states.

### **7.3.1. Stabilization policy**

To start applying our reasoning about non-compliance in Russia, we describe the collapse of the early attempts at stabilization policy in 1992. Consider the choice faced by an enterprise having to take a tough restructuring decision under tight credit conditions. In deciding whether to adjust, each manager would compare the adjustment

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<sup>89</sup> This effect, termed by Janet Mitchell (1998) the "too-many-to-fail effect", has been modelled by Perotti (1998) in the context of monetary stabilization, by Roland and Verdier (1994) for privatization, and by Mitchell (1993) for bankruptcy reform.

costs against the chance of a general bailout. As a critical mass of insolvent firms creates an insurmountable political pressure for relief, the probability of a bailout depends critically on the expected aggregate response (Perotti, 1998). The individual decision depends on the perceived decision by others, as well as on government credibility and on adjustment costs; in Russia, these factors were considerably worse than in Central Europe. In 1992, the adjustment response in Russia to tight monetary policy was very modest. Firms stopped paying their bills, apparently assuming that most other firms would find it impossible or unattractive to adjust, and thus that the risk of strict enforcement was minimal. In the end, the Central Bank was indeed forced to monetize the arrears, creating the expectation of further bailouts and undermining the credibility of the stabilization program for years.

In general, any systemic policy shift where all agents have to adjust at once creates an externality in individual adjustment responses (Roland and Verdier, 1994; Perotti, 1998). Russian firms' expectations in 1992 about the behaviour of other units (in part a function of historical experience)<sup>90</sup> appeared to reflect a rational lack of confidence in the capacity to maintain a tight credit policy in the face of massive defaults, an experience shared by other stabilization programs in transition countries.<sup>91</sup>

### 7.3.2 Enterprises

In a grand political bargain to buy out opposition to privatization, ownership of most enterprises became controlled by managers (Shleifer and Treisman, 1999). Perhaps there was no other way to securely establish private property in Russia than to "buy in" the potential opposition. Yet, it appears that the extent of control transfer to the managers seriously weakened the ability of the state to control the reform process.<sup>92</sup>

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<sup>90</sup> Passive resistance was already developed under central planning, when unrealistic diktats could be resisted by collective sluggishness.

<sup>91</sup> For direct survey evidence linked to the related episode of bailouts of enterprise arrears in Romania, see Kotzeva and Perotti, 1996.

<sup>92</sup> Many structural reforms, such as bank legislation, the sale of the most valuable resource companies, the public debt market, and the provision of currency hedges were implemented in a compromise with powerful interests.

Under poor legal enforcement, control rights are very valuable (Modigliani and Perotti, 1998; Bebchuk, 1999). Control generates access to cash-appropriating activities. Privatization thus granted insiders great discretion to capture resources from the state and investors, without exposing them to binding “rules of conduct”<sup>93</sup> (Filatotchev, Bleaney, and Wright, 1999).

The overwhelming empirical evidence suggests that privatization failed to improve performance (Earle and Estrin, 1998). The incentive for managers to restructure, retain cash flow and reinvest it internally did not exist in Russia.

**Why did partial ownership fail to motivate management?** Restructuring offered low returns and high risk, due to rouble overvaluation, increasing competition and the difficulty of switching to Western markets. Corporate profits were exposed to taxation and external predation, by bureaucrats and racketeers, and even by political reversals by the Communists in the Duma. In this environment, manager-owners protected their own interests by stripping assets and transforming them into cash (cash-stripping). Cash is anonymous, easy to transfer, and difficult to track.<sup>94</sup> Stripping assets destroyed long term value, but cash was more appropriable than what managers could gain as value-optimizing shareholders. The progressive overvaluation of the rouble also discouraged productive activities and encouraged capital flight.

Insider privatization, while problematic everywhere (see Chapter 6), performed relatively better in other countries such as the Czech Republic, perhaps because of greater political stability and greater control from the state over the process. While there was even extensive “tunnelling” of resources (for a description of tunnelling, see Johnson et al., 2000), the extent of asset-stripping in the Russian case suggests a loss of regulatory control to special interests. A spectacular example of policy capture was the debt-for-shares deal negotiated on the eve of the 1996 presidential elections. Via a highly dubious secured loan, control of the best natural resource companies was captured by a few influential banks, creating a number of Financial Industrial Groups (FIGs). Cash-generating companies in these groups were actively milked by

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<sup>93</sup> This outcome compares unfavorably with the Chinese experience of central control over major resources while allowing liberalization on new ventures (Roland, 2001).

<sup>94</sup> This problem was made more acute by a legal framework in which someone who acquires illegally obtained property in a formally correct procedure is recognized as the owner.

controlling shareholders, leading to major conflicts with investors, and more recently, with the new Russian government.<sup>95</sup> The high opportunity cost of cash payments (because of the high appropriability of cash for managers) also fed a massive demonetization of transactions and a shift to barter.<sup>96</sup>

The ability to ignore payments to suppliers depends on the counterparts' comparative importance. Clearly, Russian firms needed to maintain good relations with suppliers to secure inputs. Yet, such was the value of cash that they switched en masse to barter, leading to an unprecedented degree of demonetization.

A simple way to illustrate this failure is to describe the role of cash in an economy with no enforcement. Converting enterprise assets in cash allows enterprise managers to appropriate and easily transfer value. As a result, firms avoid cash payment and often fail to pay altogether. Massive non-payment minimized the risk of prosecution. Settlements of payment obligations became a matter of bargaining. In Russia, a *de facto* seniority of claims emerged with little connection to contractual priority.

Creditors with the highest priority were those who could impose concrete sanctions. Under Yeltsin's weak leadership, criminals had more power than authorities, as did local governments relative to federal authorities. Next in seniority came those who had power derived from reciprocal dependence, such as critical suppliers and political partners. Foreign investors belong to this category only if they were critical for technology transfers or future funding.

The lowest priority creditors were dispersed or socially disorganized agents, such as workers, depositors and minority shareholders. In Russia, such agents are perhaps more resigned to abuse: unlike, say, in Latin America, it was possible for both government and enterprises to delay payments to workers, savers, and pensioners

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<sup>95</sup> Large industrial-financial groups, common in underdeveloped financial systems, certainly owe their influence to political support, yet may provide governance and an internal capital market to alleviate credit constraints. Empirical research on Russian FIGs (Perotti and Gelfer, 2001) has shown that while group firms were better managed, cash flow from cash rich group firms was reallocated on a massive scale, and may have been shifted outside the group.

<sup>96</sup> Evidence that cash-stripping took precedence over productive activity is that barter rose with real interest rates, and with ruble overvaluation. Ivanova and Wyplosz (1999) find that both higher monetary growth and higher interest rates are correlated with higher barter.

without serious social unrest. In no other industrialized country have workers suffered such non-payment with such resignation (Earle, 1998).<sup>97</sup>

A related view is that barter is a form of collateralized trade credit, which emerges when there is no credible liquidation threat. Marin and Schnitzer (1999, 2000) argue that barter supported trade between firms with tightly integrated production. Thanks to mutual bargaining power, trading via barter provides a form of collateral. Barter then offers the sole transacting solution when managers have incentives to strip cash.

**Taxation**            The de facto seniority of tax liabilities in Russia (i.e., the willingness to pay taxes relative to other liabilities) was always contingent on the perceived political strength of the federal government.<sup>98</sup> Consider a Russian firm facing a tax obligation. The risk of punishment for non-payment diminishes as more firms fall into arrears, and as tax authorities face a greater task of collection.<sup>99</sup> At the same time, the incentive to delaying payment increases with the opportunity cost of cash, measured by the expected devaluation or the GKO yield. Fiscal weakness thus further reinforces the benefits of tax resistance: the lower the tax revenues, the stronger the need to issue bonds, and the higher the GKO yield. Thus the costs of tax arrears fall and its rewards rise in the perceived number of firms in arrears.

Indeed, tax revenues remained weak throughout the reform period, and tended to respond to signs of weakness in the federal government. The last days of the Chernomyrdin administration in 1997 were marked by a massive expansion in tax surrogates (i.e. payment in kind, or cancelling federal taxes against payment obligations by local government) and coincided with sharply rising GKO rates. Even as the government of Kirienko tightened rules immediately after, and closed the loopholes of tax offsets, tax payments did not improve significantly, reflecting the perceived impotence of the government (Ivanova and Wyplosz, 1999). In part as a result, the government persistently failed to comply with its own payment obligations.

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<sup>97</sup> We argue later that the capacity to run up wage arrears is crucial to understanding how Russia could maintain such a tight monetary policy after the devaluation.

<sup>98</sup> Tax obligations to local government may have been more binding, since local support allowed firms to resist federal taxes.

<sup>99</sup> While there are penalties for late tax payment, settlement in Russia is always a matter of bargaining.

The incentives for tax evasion changed markedly since the crisis. The disappearance of the overvaluation and the collapse of the GKO market after the default reduced the return to tax arrears. Strong political leadership restored a measure of enforcement credibility under the Putin administration, affecting compliance directly and indirectly via a shift in the perceived degree of overall compliance. Even the federal government has given a positive example by significantly improving its payment record, a step which shifted the focal point of expectations on payment discipline.

The steady fall in barter since the crisis reflects the reduced opportunity cost of cash due to the devaluation and the disappearance of the GKO market. In addition, the devaluation restored incentives for productive activities, and thus induced payments in cash to ensure a timely delivery of inputs.

**Banks and Banking Supervision**            The choice Russia made early on (under heavy lobbying by bankers) for the “universal bank” format granted maximum discretion in investment choices and contributed to the failure of prudential supervision. The large number of licensed banks overwhelmed the CBR’s supervisory capacity, thus reducing compliance; it also spread financial skills thinly across banks and reduced lending margins. In such a situation, speculation was more attractive than proper bank lending.<sup>100</sup>

Many observers recognized that, prior to the crisis, banking supervision at the CBR was largely perfunctory,<sup>101</sup> leaving much leeway to Russian banks to claim compliance with prudential regulations and capital requirements (Laeven, 2000). Connected lending (loans to insiders and friends) often amounted to outright transfers; cash would be lent to an empty box firm which would pass it on and vanish, leaving no trace. Cash also left the banks via purchases at face value of worthless securities from obscure

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<sup>100</sup> Paradoxically, the crisis did not produce improvements in prudential enforcement. Bank closures fell, just as bank insolvency became obvious. The CBR officers who tried to force bank closures were countermanded and had to resign. Failed bankers were allowed to escape repayment with no legal consequences, and had enough time to transfer the last assets elsewhere. Incredibly, some bankrupt banks whose licenses had been withdrawn managed to have them returned on legal technicalities. The sole steps taken after the crisis were to transfer deposits in failed private banks to frozen accounts in Sberbank, which have since been withdrawn at considerable loss.

<sup>101</sup> The Central Bank mostly sought control by requiring very high obligatory reserves without remuneration. Schoors (2001) shows that Russian banks, notwithstanding this confiscatory policy, preferred to hold liquidity and gamble rather than to lend.

companies, often located abroad. State capture appears the main explanation for such lax controls. Bankers enjoyed tremendous political clout, either via lobbying or by virtue of their control over the media.

One example of their political power is reflected in the incredible story of Russian bankruptcy law, a classic example of soft legal constraints. The first general bankruptcy law in 1990 was extremely pro-debtor and thus toothless. Even after later amendments, removing insiders from control after default turned out to be impossible. Furthermore, as a result of intense lobbying, the new legislation explicitly stated that it would not be applicable to banks. Yet no law on bank bankruptcy was passed until the crisis. The most indebted and vulnerable sector in the Russian economy could thrive without any threat of exit. *De jure*, Russian banks could not go bankrupt.<sup>102</sup>

As the crisis approached, banks maximized their leverage and dollar exposure. Any cash or valuable asset was transferred abroad via dubious transactions, while contingent liabilities piled up. Two major and generally well-regarded private banks, Tokobank and SBS-Agro, collapsed even before the crisis, foreshadowing the extreme precariousness of the banking system.

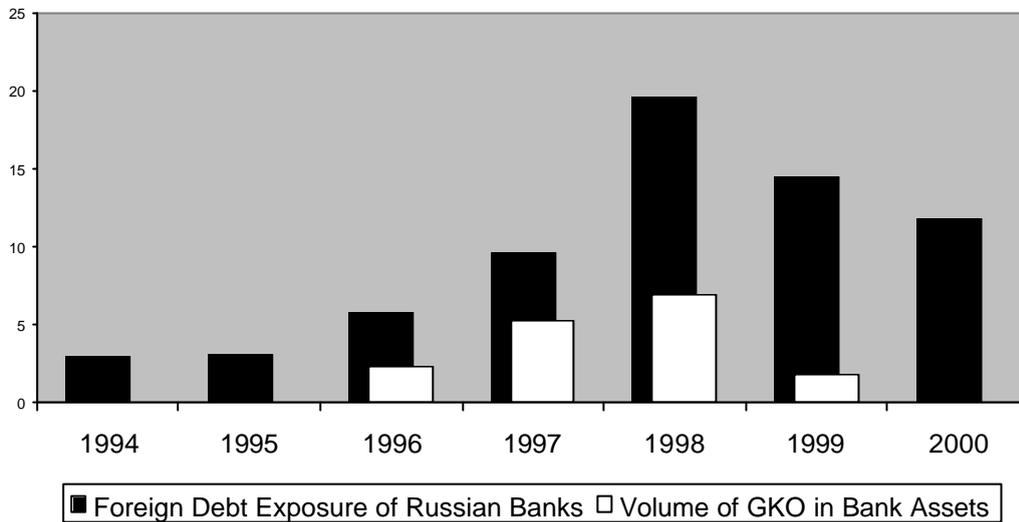
Direct evidence of the main causes of the insolvent status of the banking system comes from a Western bank audit performed in the fall of 1998 in 18 large Russian banks. Poor lending, often in favour of connected parties, accounted for over a third of capital losses. The rouble fall accounted for another 25% of capital losses, largely via huge forward positions. In comparison, losses due to the GKO default accounted for just 13% of losses. Yet as late as 1997, balance sheet data of Russian banks indicated large holdings of GKO debt and a low net dollar exposure (see Figure 7.4). In early 1998, Russian banks were reporting capitalization rates (i.e. ratios of book equity to assets) above 10%, a modern equivalent of the façades in front of empty houses in a Potemkin village. The banks' exposure to the dollar was in reality higher and more leveraged than reported, thanks to massive sales of forward dollar hedges to foreigners, and it

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<sup>102</sup> Even the rights of the CBR to withdraw a bank license were unclear and some attempts were thrown out in court. Tighter legislation was passed in 1999 under IMF pressure, but few significant banks have been closed since.

rose as banks liquidated their GKO in 1998. These gaping holes in the balance sheets were kept well hidden.

**Figure 7.4. Foreign Debt Exposure and GKO holdings of Russian Banks (Source: CBR)**



**Figure 7.5. Russian Banks with the Largest Forward Positions (Source: RSA)**

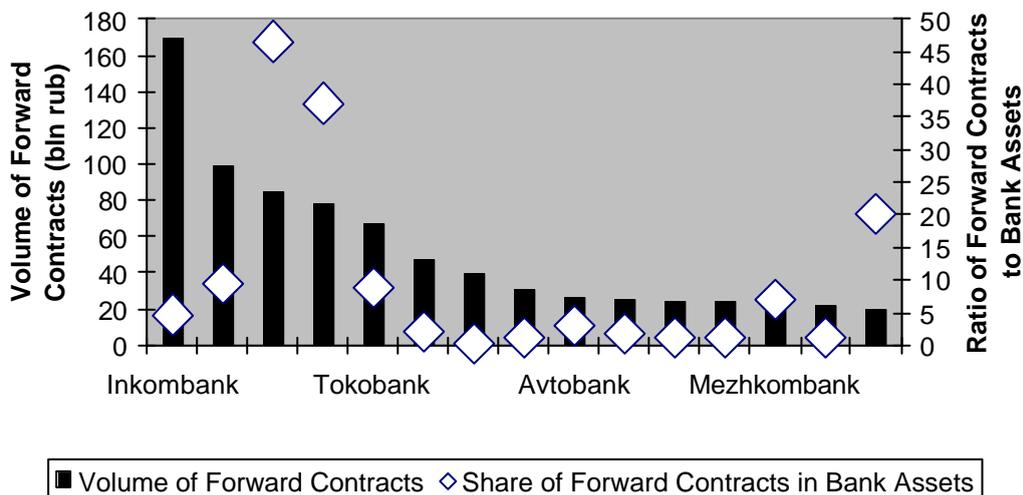


Figure 7.5 illustrates the vast dollar exposure that the largest Russian banks had built by 1998, relative to their own (largely imaginary) equity capital. Such contingent liabilities allowed them to capture the large interest rate differential without committing any capital to back up the promised claims. The Central Bank provided no

prudential oversight: when pressed, banks claimed to have "cross-hedged" their exposure with (grossly undercapitalized) small regional banks. There was in the end no difference between net and gross exposure.

**Lessons since the crisis** Three important elements have changed in Russia since the crisis. The main change is certainly political: a major recentralization of power, supported by a population exhausted by pervasive abuse and appalled by the implosion of the state. As a result of political consolidation under President Putin, state capture has ended and fiscal authority has been restored. In addition, the devaluation has revived domestic production. Thus the trade-off faced by managers between cash-stripping and productive activity has shifted; as a result, firms started using cash payments in place of barter, stripping was reduced and capital flight has slowed (see Figure 7.6). The high oil price was certainly also a boon, and coupled with tighter spending discipline it has ensured a fiscal surplus, granting Russia a modest financial buffer. Even the government has taken to paying its bills.

The slowdown of capital flight presumably reflects a reduced incentive to escape the rouble since the devaluation; moreover the new political leadership has been assertive in forcing greater fiscal and payment discipline. But capital flight persists at high levels, and the vulnerability to external shocks remains extreme.

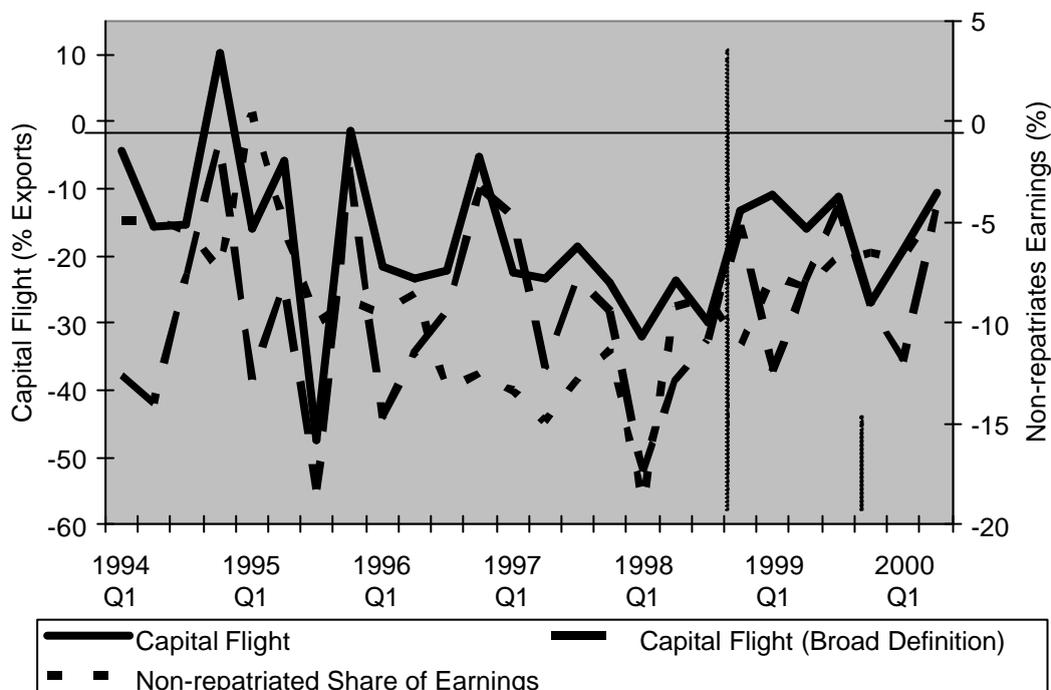
Russia probably needs simple regulatory solutions enough to be easily implemented and monitored: its simplified fiscal code has been quite successful. More importantly, these reforms must be robust with respect to the nature of opportunistic behaviour we described.<sup>103</sup> On the other hand, such uncontrolled abuse is unlikely under Putin, who has ensured that no oligarch could present a challenge. Yet although Putin has ensured political stability and some restraints on uncontrolled plunder and pillage, the cost has been high in terms of independent institutions outside the political centre. Russia is thus regressing towards a society based on fear, just as it needs to develop a more open and democratic process. Alternatively, Russia will continue to alternate between phases of increasing abuse of unchecked central power and phases when small groups

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<sup>103</sup> Glaeser and Shleifer (2001) show that when regulatory enforcement is difficult, quantity restrictions, while less efficient, may be preferred to other restrictions which are easier to circumvent.

capture critical governance and regulatory functions, undermining the credibility of a decentralized market economy and open society.

**Figure 7.7. Capital Flight** (source: OECD)



#### **7.4. Conclusion**

This chapter described the dynamics of the Russian crisis as the outcome of the failure to move from central planning to a reliable system of decentralized obligations. We argued that this failure was due, next to high adjustment costs, to poor policy credibility, undermined by state capture and sustained rouble overvaluation. Russian enterprises and banks effectively moved from a Soviet-period soft budget constraint to soft legal constraints. Asset-stripping at the top was matched by systemic non-payment, illegality and passive resistance to reforms at all levels of society.

How can we explain the difference with other transition countries in Central Europe where stabilization succeeded? Clearly, state capture mattered. While success for Central European businessmen reflected their capacity to succeed in open competition, in Russia it resulted from the capture of state resources or protected rents (Black, Kraakman and Tarassova, 2000, Johnson, Macmillan and Woodruff, 1998).

But why was the new Russian state so easily captured? Was Yeltsin's rule inept, or seen as not fully legitimate? Perhaps part of the answer is that the ability to enforce rules is endogenous. Only when a critical mass chooses to obey the law, does it become possible to enforce it on the few who do not comply. In that sense, a rapid reform process was not credible in Russia, both because of adjustment costs and of diffuse expectations of non compliance. Besides, the greater distance from Brussels and the poorer infrastructure of the FSU countries implied higher costs to access new markets, but also made quick adjustment less credible and thus undermined the implementation of rapid reforms.

Yet it is impossible not to conclude that the extent of state capture in the Yeltsin years diminished the credibility of the authorities, since it signalled to everyone the inability of a corrupt political system to commit to the enforcement of the rule of law. Inevitably, this in turn created the expectation of massive non-compliance, and undermined the enforcement of reforms.

Russia missed a major factor which reinforced support for reforms in Central Europe, namely the realization that there were necessary steps to join the European Union. Unfortunately, this option was not open to Russia for political and military reasons (Roland and Verdier, 2000). While much can be learned from the Russian crisis, a major lesson is that no special methodology is required to understand it; in other words, the Russian crisis is extraordinary because of its size, not because of its nature. Russia is indeed a special country, because of its size, complexity, and history; and yet Russia is not unique, nor do its citizens have a different system of economic aspirations. Quite simply, the Russian crisis is the systemic consequence of a structure of perverse individual incentives built on an extremely weak legal environment. While lack of experience and external factors (e.g., the oil price drop and the Asian crisis)

played a role, the collapse was the result of poor incentives, arising from (and contributing to) the failure to establish financial discipline.

Russia is different in one respect: because of its political and military importance, it enjoyed a high level of support by international institutions despite its unsustainable course of policy; one which encouraged capital flight and theft on a unique scale. In such a context, the focus of Western assistance on monetary stabilization, funded by foreign aid and loans, was misplaced, as it just fed the capital outflow without correcting the roots of the problem. A more appropriate policy would have pressed for stricter discipline in state and private institutions.<sup>104</sup>

In contrast, the Chinese experience, where the state has retained control over privatization and deregulation, has limited private capture of the reform. While its success has been attributed to its gradualism, its main critical element may have been privatization by favouring entry, rather than rapid transfer of control. Arguably, the Chinese economy had ample underutilized resources and its industrialization had barely began, so there were many free resources to deploy, while in the FSU reforms required massive reallocation of resources frozen in inefficient production. Moreover, considerable uncertainty remains over the future path of further retreat.

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<sup>104</sup> To be fair, the IMF and the World Bank came under intense political pressure to support Russia at any cost and were forced to gamble, in the hope that the rouble rate could be defended until a stable economic foundation was built. Instead, the massive support given to prop up the rouble actually reinforced the short-term incentives to expropriate and export capital.

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