Abstract

We examine the political economy of economic policy reforms. Anecdotal evidence suggests that major economic reforms are undertaken primarily after a sustained period of deteriorating economic performance; examples include the reforms in Britain under Thatcher in the 1980s, the Swedish reforms in the 1990s, and labor market reforms in Germany under Schroeder in the early 2000s. To understand these patterns, we consider the decision problem of an incumbent politician who derives rents from remaining in office. The quality of the politician is not directly observable, but the electorate updates beliefs about quality based on the performance of the economy. When beliefs about the quality of the politician fall below a threshold value, the politician is replaced. The politician can undertake economic reforms that, in expectation, increase the growth rate of the economy. The nature of the reforms may not be perfectly observable either. We derive conditions under which this setup leads to reform cycles, i.e., reforms are undertaken only when the state of the economy is sufficiently bad. We confront our theory with data on labor market reforms in OECD countries, and show that low GDP growth and high unemployment over a multi-year period predict economic reform.