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Abstract

Despite a substantial literature devoted to the nature and mechanics of microeconomic reform in Australia, surprising little effort has been directed to the question of the timing of microeconomic reform. This short note adapts the seminal arguments of Rodrik (1986; 1994; 1995; 1996) and Fernandez and Rodrik (1991) to the Australian milieu, augmented by Wallis' (1997) policy conspiracy theory of policy change. It is argued that Rodrik-style models can explain the infrequency of comprehensive microeconomic reform programs and the phenomenon of "policy fatigue". Moreover, by adding the Wallis model it is possible to show why a majority of citizens could be persuaded to accept reform notwithstanding the uncertainty of ex post distributional outcomes.

Key Words: microeconomic reform, policy fatigue

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1. Introduction

Since at least the early 1980s, Australians have elected a succession of reformist Commonwealth governments that have sought to improve the growth performance of the Australian economy by increasing its degree of flexibility and removing structural constraints on the efficient use of scarce resources. This process, typically referred to as microeconomic reform, has now become a central plank of economic policymaking and its ubiquitous effects have pervaded virtually all areas of contemporary Australian life. Perhaps the most useful definition of microeconomic reform has been provided by Forsyth (1992, p.5):

> "Microeconomic reform can be understood to include those measures taken at the microeconomic level to make the economy perform better in terms of creating real income from the available inputs. It is about raising standards of living by raising real incomes available for consumption. It includes measures to make individual firms produce their outputs more effectively, better to provide the goods and services that consumers want, and measures to make market more effective conduits between consumers and producers. Higher real incomes can mean more goods and services in total, better quality goods and services, or production of goods and services that more effectively fulfil customers' wants. In short it is primarily concerned with efficiency of production and allocation of goods and services.

Defined broadly in this manner, microeconomic reform includes all "… changes in government policies and institutional arrangements that affect the economic behaviour of particular firms, industries, individuals and households (Productivity Commission, 1999, p.15). Accordingly, it applies to privatisation and contracting out as well as deregulation.

A large and growing literature has been devoted to the mechanics of microeconomic reform, its purported benefits and costs, and various critiques of whether or not it can achieve its intended aims (Forsyth, 1992; Jones, 1994; Quiggin, 1996; and Bell, 1997). Despite this extensive and prolonged discussion of the nature of the microeconomic reform process in Australia, surprisingly little attention has been directed at a puzzling aspect of the reform process: why did microeconomic reform gather momentum in Australia during the 1980s rather than earlier or later in the nation's economic history? Put differently, the question arises as to why public opinion in Australia and elsewhere has consistently been sceptical of the claims made by exponents of microeconomic reform despite evidence to the contrary. Rodrik (1996, p.10) has put this conundrum thus:

> "…[G]ood economic policy should produce favourable outcomes and therefore should prove also to be good politics… Good economics does often turn out to be good politics, but only eventually. Policies that work do become popular, but the time lag can be long enough for the relationship not to be exploitable by would-be reformers… Conversely, bad economics can be popular, if only temporarily… The puzzle is why we observe such instances of collective irrationality… Most fundamental of all, why are so many governments reforming now, after decades of adherence to policies of an opposite kind."

Whilst a voluminous international literature has sought to provide answers to these kinds of questions, with somewhat indifferent results (see, for instance, Krueger (1993); Bates and Krueger, (1993); and Haggard and Webb, (1994)), only a nascent literature exists with a specific Australian focus. The limited purpose of the present short note is to add to existing Australian material on this enigmatic issue. The note itself is divided into three sections. The second section provides a brief synopsis of existing Australian literature in the area. Section 3 sets out in outline an alternative explanation of the microeconomic reform process in Australia. The note ends with some brief concluding comments in Section 4.

2. Explanations for Microeconomic Reform in Australia

It is possible to identify at least four arguments which have been advanced to account for the historical fact that major microeconomic reform was launched in Australia in the 1980s rather than at some other time. Whilst these arguments are neither completely plausible nor necessarily mutually exclusive, they do shed some light on the problem.

Firstly, in response to the question "why has the particular agenda for microeconomic reform arisen now?", Gerritsen (1992, p.25) proposed a "preliminary model" with three main ingredients: a "public interest" deriving from "the policy community and the 'public' interest", a "private interest" drawn from "partisan coalitions and interest group[s]", and the "politics of agenda-setting and agenda management". Gerritsen (1992) argued that microeconomic reform occurred when it did due to three factors. In the first place, the emergence of continuing current account deficits and Paul Keating's concomitant "banana republic" speech in 1986, which set the national stage for microeconomic reform. Gerritsen (1992, p.29) contents that shortly thereafter, "private interests likely to be disadvantaged by any changes lost hope that the *status quo* would in any case preserve their interests", and this lowered interest group resistance to change. Finally, Gerritsen (1992, p.30) argues that the "policy community" became convinced that microeconomic reform was "inevitable and necessary".

Another argument to account for the timing of microeconomic reform in Australia centres on the heated debate engendered by the publication of Pusey's (1991) *Economic Rationalism in Canberra* with its claim that the growing influence of neoclassically-inspired economists in the Australian Public Service on federal politicians led to a proliferation of reformist microeconomic policies. This explanation is clearly narrower in focus than Gerritsen (1992), and places tremendous weight on the ostensible dominance of policy elites by neoclassical economists. Pusey's (1991) methodology and his conclusions have also been severely criticized (Argy, 1992; Gregory, 1992, Valentine, 1992 and Dollery and Hamberger, 1996).

Gregory (1992) has argued that the political imperative for microeconomic reform has grown in direct proportion to the decline in the performance of the Australian economy. During the 1970s and 1980s this decline was evident in declining manufacturing employment, slow aggregate employment growth, and sluggish real wage growth in the Australian economy. According to Gregory (1992, p.310), the net result of the fall in living standards has been a different political milieu:

> "The taxpayer faced with lower real wage growth and now higher taxes, has demanded government economies. As a result a considerable amount of micro-reform is occurring within the government sector, especially among government business enterprises which have been attempting to increase profitability and decrease employment levels."

Despite the plausibility of Gregory's (1992) argument, it has met with some criticism. For example, noting the uneven spread of microeconomic reform initiatives in the Australian economy, Dollery (1994, p.87) has observed that "… if we wish to explain why microeconomic reform took place when it did, aggregative or macroeconomic arguments along the lines of Gregory's (1992) observations about the decline of economic performance in Australia cannot provide the full picture. What is required is a conceptual framework which can account for why reform occurred in some sectors and not others."

Finally, Dollery (1994) has drawn on the economic theory of regulation, and especially Peltzman (1989) and Levine (1981), in an effort to explain why microeconomic reform would occur in specific industries at particular times. In essence, Dollery (1994, p.89) sought to demonstrate that if the net reform to producers and the providers of regulation fell sufficiently, then deregulation would result. Dollery (1994) argued that with no change in the costs of maintaining regulation *in a specific industry*, the demand for continuing regulation will fall. Eventually deregulation will occur with its attendant large gains in consumer surplus for consumers which should translate into votes for deregulatory politicians.

Dollery's (1994) argument has been attacked by Quiggin (1995; 1996), who argued that since the ratios of final to initial gross rents, deadweight losses, and consumer surplus remain unchanged in the fact of increasing costs, and if the cost of obtaining regulation is "fixed and independent of the gains and losses involved", then "… the level of regulation should be higher in large industries than in small ones and in large jurisdictions than in small ones…" (Quiggin, 1995, p.95). However, Dollery (1996, p.96) has countered by noting that it was only necessary for the costs of maintaining regulation *in the industry in question* to remain the same for the mechanism to work. More generally, Dollery (1996) noted that this was in accord with the symmetry argument advanced by Peltzman (1989, p.48).

3. An Alternative Perspective

An alternative explanation for both the timing of microeconomic reform in Australia and its apparently growing unpopularity can be developed from the pathbreaking work of Rodrik (1986; 1994; 1995; 1996) and Fernandez and Rodrik (1991). Rodrik (1996, p.11) emphasises the analytical importance of the dichotomy between macroeconomics and microeconomics in the evaluation of real-world reform processes:

> "One of these concerns the distinction between (a) macroeconomic policies aimed at economic stability, such as fiscal, monetary, and exchange rate policies, and (b) liberalization policies aimed at structural reform and growth, such as the removal of

> relative price distortions and the reduction of state intervention. It has become commonplace to conflate these two groups of policies, but for analytical purposes they are best kept apart."

Whereas prudent monetary and fiscal policies are essential for sustained economic growth and stability, the same cannot be said for microeconomic reform policies. By themselves even successful microeconomic reform initiatives cannot remove underlying macroeconomic imbalances, like ongoing balance of payments difficulties, or accommodate external shocks, such as rapid deteriorations in the terms of trade. This point is well-recognised in Australian policy debates. For instance, Forsyth (1990, p.232) has noted that "policies directed towards securing the main gains from microeconomic reform, by removing the most costly distortions, will not have any substantial impact, directly or indirectly, on the current account or on the foreign debt".

A Rodrik-style model for explaining why microeconomic reform has occurred in Australia and why these reforms may subsequently prove unpopular, so-called "reform fatigue", contains two main elements. In the first place, it is assumed that reform processes are characterised by "non-neutrality". Relative to conventional interest group models use of non-neutrality, which focus on the unequal diffusion of the benefits and costs of reform across society, free-rider problems, and the differential abilities of interest groups to secure their desired outcomes, non-neutrality in this context carries an entirely different meaning. Non-neutrality refers to the *ex ante* uncertainty amongst individual members of society as to the potential distribution of the benefits and costs. This uncertainty does not have to be universal. It is only necessary for some (median voter) individuals, who are risk-neutral, to feel uncertain as to whether they will be winners or losers in an *ex ante* sense. One implication of the employment of this form of non-neutrality is a bias in favour of the *status quo*, even when a majority of citizens stand to gain if microeconomic reform processes are set in motion.

Secondly, it is assumed that the greater the number of individuals in favour of some proposed microeconomic reform policy, the greater will be the probability that the reform package will be implemented. For simplicity, Fernandez and Rodrik (1991, p.1147) observe that "… it is convenient to use the language of majority voting (although our argument will also hold for some other social choice mechanisms)".

This assumption stands in marked contrast to conventional views on the nature of economic reform processes. In the context of developing countries, it is commonly believed that decisive authoritarian top-down decision-making is the best method of initiating reform (Taylor, 1993). Similar arguments adjusted *mutatis mutandis* have also been applied to reform processes in advanced democracies. For example, in his analysis of economic restructuring in New Zealand, Wallis (1997) has characterised the reform process as a "policy conspiracy" in which "a network of technocrats, technopols and change agents" played a pivotal role in forcing through a drastic reform program despite unpopular opposition amongst citizens.

The actual mechanism invoked in the model is perhaps best described by means of simple examples. Suppose in a democratic economy with 100 voters, a specific reform will increase the incomes of 51 voters by $10 each and decrease the incomes of the remaining 49 voters by $5 each. In terms of national income, this reform will result in a net social gain of $265, after the adjusted incomes of winners (+$510) and losers (-$245) are compared. Suppose further that some uncertainty exists amongst voters about whether they will in fact be winners or losers. Let 49 voters know for certain that they will be amongst the winning 51 voters, but let the remaining

51 voters be unsure as to their *ex post* position. For this remaining group, net expected per capita benefits of reform would be negative. Since only 2 out of the remaining 51 voters can join the winning group, net expected per capita benefits of reform will be negative $20 (2 x $10) - $245 (49 x $5)/51 = -$4.41. Accordingly, despite the known net social surplus of $265 contingent upon the reform taking place, distributional uncertainty concerning *ex post* outcomes will prevent its introduction. However, if this reform was forced through somehow by a policy elite against the popular will, it would clearly be retained in an *ex post* vote when 51 citizens found themselves to be winners.

Counter examples can be constructed to explain how microeconomic reform had majority support *ex ante* but would not be retained *ex post* if it were possible to reverse reforms. For instance, suppose a proposed reform is believed to raise the incomes of 60 voters (who assume they will be winners) by $10, and lower the incomes of the residual 40 voters (who assume they will be losers) by $5. A net social gain of $400 is projected and 60 citizens vote for the reform which is enacted. But only 40 voters share the total gain of $600 (at $15 per head) and the remaining 60 voters share the total loss of $200 at $3.33 per head. Thus, uncertainty amongst risk-neutral voters allows a reform process to be initiated but once actual outcomes become clear, "reform fatigue" sets in and voters would reverse the reform process if this were feasible.

It is evident that an asymmetry arises once we allow citizens to exercise votes both *ex ante* and *ex post* which favours the *status quo* over reforms. In the former example, voters reject the reform proposal notwithstanding a net social gain and a majority of winners. In the latter example, voters who initially support a reform proposal would reject it if they could vote again *ex post* once the distributional outcomes of the reforms are known. Rodrik (1994) has generalised these arguments in a way that clarifies the nature of the microeconomic reform process in Australia further. A "political cost-benefit ratio" (PCBR) is defined as the ratio of total redistribution induced by a reform program relative to its efficiency benefits, and can take values between zero and infinity. In essence, this implies that income redistribution contingent upon microeconomic reform has an opportunity cost which must be traded off against the benefits of the reforms. Put differently, the PCBR informs us about the magnitude of redistribution in proportion to the magnitude of efficiency gains. Since redistribution carries distinct political costs, the higher the value of the PCBR, the more difficult it will be to undertake microeconomic reform.[1]

Rodrik (1994) has argued further that many microeconomic reform policies typically involve "price reforms", like tariff reductions, the removal of differential taxes, and the abolition of subsidies. These kinds of reform usually involve relatively large amounts of income redistribution in comparison to efficiency gains, and thus involve high PCBRs. If an element of uncertainty is added in the *ex post* redistribution of benefits and costs associated with a particular reform program to the inherent political difficulties in high PCBRs, then it can be readily appreciated why comprehensive microeconomic reform programs are rarely implemented. This helps explain why microeconomic reform took so long to occur in Australia. By invoking the logic of the Rodrik-style model an argument for why microeconomic reform was delayed, why reform could go ahead despite a bias toward the *status quo*, and why "reform fatigue" can arise in

[1] It is interesting to speculate on the actual distributional effects of microeconomic reform in both Australia and New Zealand. It would appear that gainers have included the export sector, the financial sector, the tourist sector, owners of capital and higher-paid workers. On the other hand, losers seem to have included the import-competing sectors of the economy, public sector employees and lower-paid workers. Recipients of welfare benefits appear to have lost in New Zealand, but held their own (or maybe improved their position somewhat) in Australia. Many of these categories can overlap. In any event, Quiggin (1998) suggests that the proposed gains from microeconomic reform have been much less than anticipated. (We are grateful to an anonymous referee for these arguments.)

the wake of a reform progam is developed. This argument is consistent with the standard *homo economicus* behavioural model, and does not rely on any form of "irrationality" by citizens.

It is still necessary to explain why citizens would believe *ex ante* that a majority would benefit from reform despite the uncertainty of *ex post* outcomes (as in the second example). Drawing on Kingdon's (1994) concept of policy entrepreneurship, Wallis (1997) has argued that policy coalitions can arise and take advantage of "a window of reform opportunity". The dramatic nature of the microeconomic reform process in New Zealand is instructive in this regard and formed the basis of an explanatory model developed by Wallis (1997). The microeconomic reform process in New Zealand was advanced, in a selectively radical fashion, first by a centre-left Labour government over the 1984-1990 period and then by a centre-right National administration over its first term between 1990 and 1993. Moreover, the coherence of this process was sustained by the strong policy leadership collectively supplied by a reformist network comprising the New Zealand Treasury, reformist factions in both major political parties, and a group of "change agents" who oversaw the restructuring of public institutions (Easton, 1997). These key players shared a commitment to advance reform according to principles the Treasury derived from a policy paradigm it constructed from various economic theories (like public choice theory, agency theory, the new institutional economics and "new classical" macroeconomics) that tended to highlight problems of government failure. As the dominant source of policy advice to Cabinet, the Treasury could play a "gatekeeper" role, screening policy proposals according to whether or not they advanced parallel processes of liberalization, stabilization and privatization that were expected to limit the scope for government failure in the form of rent-seeking, agency capture, bureaucratic empire-building and "populist" interference in the setting of monetary and fiscal policy. Although the Treasury could, in this respect, be regarded as the domestic guardian of the "Washington consensus" with New Zealand pursuing a reform direction similar to that being prescribed for other countries by the World Bank and the IMF, it also devised bold and innovative proposals of its own, particularly in the area of public sector management.

Wallis' (1997) model has six main elements. Firstly adopts Williamson's (1994) taxonomy of factors which create the opportunity for newly-elected reformist governments to undertake comprehensive reforms. These include the "crisis" hypothesis which holds that public perception of a crisis is needed to create the conditions under which it is politically possible to undertake comprehensive reforms; the "mandate hypothesis" which holds that the size of the government's winning majority may be interpreted as giving it the mandate to introduce the reforms it campaigned for; the "honeymoon hypothesis" which holds that incoming governments enjoy a period during which the public will give them benefit of the doubt and blame any sacrifices and difficulties on its predecessor; and the "weak discredited opposition hypothesis", which holds that comprehensive reform is made easier by the presence of a fragmented and demoralized opposition which is identified with past policy failures. It is evident that this proposition has much in common with Gerritsen's (1992) "preliminary model", and especially his first factor. In particular, the "crisis" hypothesis appears to fit Australian experience in 1986.

Wallis (1997) then emphasises the need to break the "political gridlock" in order to implement reform policies. This requires the exercise of "considerable political skills" and the need to "follow the path of least political resistance in sequencing its reforms".

Wallis (1997) goes on to argue that once the "political gridlock" has been broken, policy coalitions must "maintain the momentum". The primary mechanism for achieving this resides in the "spillover effects" (Kingdon, 1984) generated by successful reforms, an important aspect of which is to place key members of the policy coalition in pivotal positions to influence the reform process.

Wallis (1997) then argues that policy coalitions must "enhance technocratic insulation" by ensuring the policymakers receive policy advice from bureaucrats which is favourable to ongoing reform. Pivotal policy agencies, like the Commonwealth Treasury, must thus perform a "gatekeeper function" to Cabinet to filter policy advice. This has obvious similarities with Pusey's (1991) argument about the ascendancy of "economic rationalists" in the Commonwealth bureaucracy.

Wallis (1997) contends that policy coalitions need to withstand the "backlask" attendant upon successful reform programs. In order to maintain the inherently limited "window of opportunity", policy elites must be insulated from the pressures of the "political marketplace" for as long as possible. However, problems associated with the excessively vigorous pursuit of reform objectives may arise from a "tunnel vision" of the policy process.

Finally, Wallis (1997) draws on Haggard and Kaufman's (1992) two conditions for the consolidation of a reform program once the "window of reform opportunity" has closed. In the first place, consolidation requires the formation of an "ideological consensus" in society and the major political parties on the nature of appropriate economic policy. This appears to have been achieved in Australia, as evidenced by the convergence of the policy positions of the Coalition and Labour party. And then "a powerful base of beneficiaries" must come into being with a vested interest in the maintenance of reforms.

4. Concluding Remarks

This short note has sought to augment the paucity of research effort directed at explaining why microeconomic reform occurred when it did in Australia and the subsequent emergence of "reform fatigue". It has attempted to show that Rodrik-style arguments can explain the infrequency of microeconomic reform in advanced democracies like Australia without relying on *ad hoc* claims of irrationality on the part of the electorate. Moreover, in order to explain why citizens come to believe that a majority would benefit *ex post* from the microeconomic reform process in the mid-1980s, the paper has invoked the Wallis (1997) model based on policy coalitions. The result appeared congruent with real-world events in Australia over the past few decades and had at least some elements in common with earlier explanations, most notably, Gerritsen (1992) and Pusey (1991).

Of course other credible explanations for the timing of microeconomic reform in Australia also exist. For instance, it can be argued that policy elites have simply imposed and maintained microeconomic reform despite majority opposition. Similarly, the successful implementation of microeconomic reform in other countries, perhaps most notably privatisation in the United Kingdom, may have had a demonstration effect on Australian policymakers. It could also be emphasised that in some cases international pressure for reform, especially in New Zealand, may have proved a potent catalyst for microeconomic reform.[2]

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[2] The authors are grateful to both the editor and an anonymous referee for these observations.

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