Electable and Stable Insiders' Coalition Governments

Tryphon Kollintzas and Lambros Pechlivanos

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Motivation – Greece and other Southern   European Countries circa 1975-2015

- ❖ Sectors that are heavily regulated (network industries, etc) and are dominated by powerful unions

- ❖ Heavily protected professional associations behave similarly

- ❖ Sectoral regulation achieved through the political system

- ❖ Market power and duality in labor markets affects the economy-wide efficiency level (problems with: growth, duration and persistence of recessions, financial crises and debt sustainability)

Institution of "insider-outsider society" - manifestation of corporatist state in democracy
Political science literature: Baccaro, 2003

- **Fundamental Questions:**

  ➢ How does it come to power?

  ➢ How does it self-propagate?

Theoretical Background

- Chicago theory of regulation (Stigler '71 – Peltzman '76): Interest groups are organized in an efficient way to safe guard against opportunistic behavior and to avoid overly inefficient policies.

- "Coase – Williamson" institutional "Darwinian" argument: The most efficient governance structure should survive.

- Puzzle: How come "corporatist states" endure?

- Way out: Virginia Public Choice arguments – Acemoglu, Robinson and co-authors (2003-2011) and Rodrick (2020)

Our approach

- Ideology (Piketty 1995, Benabou 2008)

- Perceived Common Good (Tirole 2017)

- Self-serving bias about societal status (Passarelli & Tabellini 2017)

Figure 1: TIMELINE OF THE PERCEIVED GOOD REGIME SUBCASE

Voter

Insiders-Outsiders   Perceived Common G

π_t $1-\pi_t$

Insider   Outsider

Γ_t

Γ_t

Γ_t
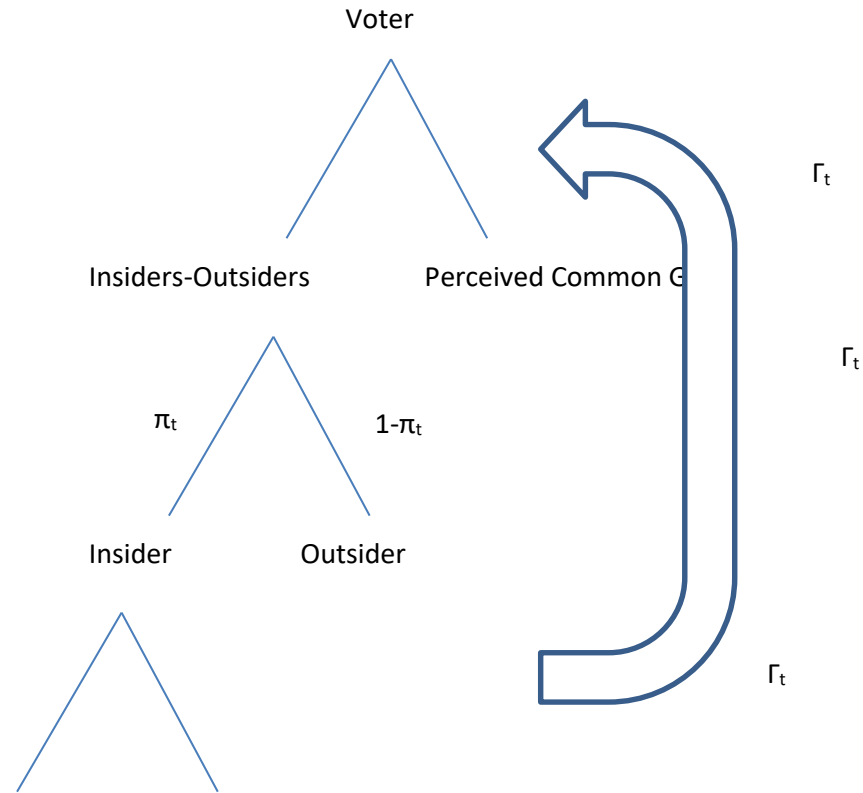
Key :

$\pi_{t:}$: probability of being an insider if the insiders - outsiders society is elected in period t

Γ_t : resources to change perceptions of the perceived common good regime in period t

Model Ingredients

- Economy populated by L individuals (consumers – workers – voters)
    - Supply inelastically one unit of labor in an intermediate good industry
    - Consume a homogeneous final good
    - Vote for the institutional structure of the economy
- There are N intermediate good industries (produce gross complement inputs for the final good), which *may* be separated into two sectors
    - Noncompetitive sector comprises K industries
    - Competitive sector comprises $N\text{-}K$ industries
- Workers working in
    - Noncompetitive sector are called insiders (there are KH^i of them)
    - Competitive sector are called outsiders (there are $(N\text{-}K)H^o$ of them)

What we do

- Solve for the steady state of the dynamic general equilibrium of such economy for any size of insiders' coalition *K*

- Find the set of self-sustainable coalitions, i.e., those that satisfy
  - **Ex post Stability** (*aka* a set of Incentive Compatibility constraints)

- Find the set electable coalitions, ie those that satisfy
  - **Ex ante Electability** (*aka* an Individual Rationality constraint)

Equilibrium Wages

<u>Proposition 1</u>: Given $[\boldsymbol{R.1.\ a}]$,

the equilibrium wage structure of insiders and outsiders is such that:

(a)

$$w^o(K_t) < w^o(K_t - 1); \forall K_t \in \{2, ..., N\}$$

(b) $\qquad w^i(K_t) < w^i(K_t - 1); \forall K_t \in \{2, ..., N\}$

$$w^o(K_t) < w^*; \forall K_t \in \{1, 2, ..., N\}$$

(c) $\qquad w^i(K_t) \begin{cases} > w^*, K_t < K^* \\ = w^*, K_t = K^* \\ < w^*, K_t > K^* \end{cases} \quad K^* \le \vartheta N; \vartheta \in (0, 1)$

Ex post Stability

- Assume the existence of a **K**-member insiders coalition

- The coalition is stable if no insider is willing to deviate and kill the protection in some industries,

$$V^i(K) \geq V^i(K, \kappa), \forall \kappa \in \{1, \ldots, K-1\}$$

where

$$V^i(K) = \frac{w^i(K)}{1-\beta}$$

$$V^i(K-\kappa) = \frac{(1-\beta)w^i(K-\kappa) + \beta\{[1-q(K,\kappa)]w^i(K) + q(K,\kappa)w^o(K)\}}{(1-\beta)}$$

and $q(K, \kappa)$ is the probability of being detected deviating

Set of Globally Stable Coalitions

Proposition 3: : Suppose that assumptions [**R.1. a**] and

$[\mathbf{R.2}]$ $q(K,\cdot)$ increases at a non-increasing rate with κ

hold and that M≤θN , where $\theta \equiv min\left\{1, \frac{\eta-1}{\xi\eta}\right\}$, and $\eta \equiv$

$\left[\frac{v-\beta}{v(1-\beta)}\right]^{\frac{\zeta}{1-\zeta}} > 1$. Then, all insiders' coalition governments with K∈{1,...,M} noncompetitive industries are globally stable in the steady state.

What determines stability?

- Essentially, the result highlights that if the deviation does not pay for a particular K-member coalition it will not be profitable for all smaller coalitions. This is due to the fact that the benefits from turning a non-competitive industry into a competitive one are smaller, the smaller is the insiders' coalition. Formally, given the concavity restriction we impose on $q(K, \kappa)$, necessary condition (17) is easier to be satisfied the smaller K is, for each $\kappa \in \{1, \ldots, K - 1\}$.

Implications of Global Stability

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- **Remark 1:** Suppose that $M \leq \theta N$ as in Lemma 1, and that there is a globally stable in the steady state insiders' coalition government with $K \in \{1, \ldots, M\}$noncompetitive industries, Then: (a) If $\hat{\beta} > \beta$, this government is a minority government (i.e., $\left(\frac{KH^i}{L}\right) < \frac{1}{2}$). (b) If $\breve{\beta} > \beta$, this government also runs an insiders - outsiders society (I-OS) (i.e., it is profitable for insiders and unprofitable for outsiders).

Ex ante Electability (II)
(Role of Ideology)

- Assume that perceptions about the efficiency of the competitive market economy can be manipulated (now called perceived common good Tirole (2017))

$$V_t^{pcg} = \rho_t \sum_{\tau=0}^{\infty} \beta^\tau w_{t+\tau}^*, \quad \rho_t < 1$$

Electable Coalition Governments

- **Definition:** A globally stable insiders' coalition government (GSICG) with $K \in \{1, \ldots, M\}$ noncompetitive industries is electable in the steady state if and only if, $V^{i-o}(K) \geq V^{pcg}$.

- Clearly, the latter condition is equivalent to:

$$\frac{K\ H^i}{K\ H^i + (N-K\ )H^o} w^i(K) + \frac{(N-K\ )H^o}{K\ H^i + (N-K\ )H^o} w^0(K\ ) > \rho w^* \quad (18)$$

Set of Electable GSICG

■ **Proposition 4**: Suppose that N is sufficiently large and restrictions $[R.1. \ a]$ and

■ $[\boldsymbol{R.1. \ b}]$ $\qquad \zeta \leq \frac{2\lambda}{1+\lambda}$ $\qquad$ hold and that $M \leq \theta N$. Then:

(a) If $\rho = 1$, the globally stable insiders' coalition government is not electable in the steady state for any $K \in \{1, \ldots, M\}$.

(b) If $\rho = 0$, the globally stable insiders' coalition government is electable in the steady state for all $K \in \{1, \ldots, M\}$.

(c) **and (d)** There exist subsets of $\{1, \ldots, M\}$, where the globally stable insiders' coalition government is electable in the steady state.

What determines electability

- The ratio of the expected wage rate of the voter in the insiders – outsiders regime to the wage rate of the voter in the perceived good regime.

- It is a rather complicated function of $x = \frac{N}{K}$.

- As K increases the wage rate of both insiders and outsiders falls (economic inefficiency), but as K increases, the probability of ending up as an insider rises (political)

- The economic inefficiency emanates from two sources: First, if an industry switches from competitive to noncompetitive, its output is reduced. Second, output in all other industries reduces due to gross complementarity.

Extensions (Electable GSICG where:)

1. **Self-Serving Bias (Inflated Subjective Probability)**

2. **Risk Aversion**

3. **Insiders' Dividends**

4. **Voter Heterogeneity**

5. **Endogenous Perceptions Manipulation**

6. **Synthesis**

Conclusions

- Construct a GE model in which sectoral regulation affects economy-wide efficiency

- Show conditions under which regulation is a self-enforcing political coalition

- Explain under which conditions (manipulated perceptions, self serving bias) such coalition comes to power (i.e., gets elected)

- Possibility of stability and electability of minority governments and governments implementing I-OS

- Extensions: Risk aversion, insiders' dividends, voter heterogeneity, endogenous perceptions manipulation