

# A Theory of Policy Reversal

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## **Abstract**

After decades of government growth, Western countries have witnessed major policy reversals. Prominent examples include the far-reaching policy reversals implemented by Thatcher, Reagan, and Douglas. This paper offers an explanation for these policy reversals. Our key argument rests on the assumptions that public decisions are made by majority rule and that voters have incomplete information about the aggregate consequences of all possible bundles of public projects making up the government. Unlike existing explanations, our theory is consistent with the observations that policy reversals are often undertaken simultaneously and that separate parts of the package of policy reversals are not welcomed enthusiastically by voters.

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## 1 Introduction

Public sector expenditures and public regulation have been growing continuously in almost all Western countries since World War II. Supported by a majority of the electorate, the public sector has gradually intensified its role on traditional fields of government intervention and, much more important, extended its role to *e.g.* providing social insurance and regulating labour and goods markets.

However, since the beginning of the eighties, drastic cuts in public spending were successfully implemented in many Western countries. Moreover, goods and labour markets have been forcefully deregulated. Prominent examples include the far-reaching policy reversals implemented by Thatcher in the UK, by Reagan in the US, and by Douglas in New Zealand. This sharp turn in policy making came as a real surprise to both economists and political scientists. Following a host of (affirmative tests of) theories implying continuous growth of public expenditures and regulation, government growth was generally seen as natural or inevitable (see Thomas E. Borcherting, 1985, and Dennis C. Mueller, 1987, for surveys of the literature on government growth).

Although the first wave of policy reversals started more than ten years ago, we still lack a good explanation of policy reversal in democracies. According to Christopher Hood (1994, p. vii) in his survey of the small literature on policy reversal, “theory remains tentative. Even in political science, accounts of these policy reversals are apt to take New Right ideas as meteorites from outer space.”

This paper offers a new theory of policy reversal in democracies which may help to explain the turn in policy making observed in many Western countries in the eighties. Stated differently, we try to explain why a majority of the electorate may prefer to repeal a number of policies which have been voted for by a majority in the past.

Thinking about policy reversal in a democracy, some possible explanations come easily into mind. Firstly, voters’ preferences may autonomously change such that a majority of the voters becomes in favour of repealing a policy. This type of explanation, which we will call the preference-shift explanation, fits generally well, but does not add much insight since the main cause of policy reversal (the shift in preferences) remains unexplained. Secondly, changing circumstances may raise the costs or lower the benefits to voters of specific types of public intervention. For instance, increased production factor mobility

may affect both the (indirect) costs and the benefits of publicly provided insurance (see Hans-Werner Sinn, 1990, and David E. Wildasin, 1995).<sup>1</sup> Thirdly, policy reversal may take place if information about the benefits and costs of government policy is revealed only after implementation of the policy. If a policy unexpectedly appears to hurt a majority of the people, the policy will be repealed. A special case of this ‘learning by doing’ explanation is the development of new economic theories or the availability of new empirical evidence, which may convince a majority of voters that policy reversal is in their interest.<sup>2</sup> If ‘learning by doing’ is followed by forgetting, a recurrent cycle of policy implementation and policy reversal may result (Albert O. Hirschman, 1982).

Although all these explanations may add to our understanding of policy reversal in general, they are inconsistent with at least two important features of policy reversals which have been undertaken in Western countries since the beginning of the eighties. Firstly, they do not explain why so many policies, of very different types, were repealed during the same period. Policy reversals during the eighties concerned many fields of government intervention and were typically undertaken simultaneously. Indeed, the turn in policy making in New Zealand has been characterised as a classic ‘big bang’ reform (Alan Bollard et al., 1996), which may also be a good description of the extensive reform agendas in most other Western countries. Obviously, the preference shift-explanation may apply to all these policy reversals, but why then did voters’ preferences change so dramatically? Neither do we know of an exogenous force which affected benefits and costs of so many programs simultaneously, nor do we observe a host of theoretical breakthroughs or new empirical evidence during the seventies which may have convinced voters that the role of the public sector had expanded too far on so many fields. Of course, the development of the theory of contestable markets in the sixties and seventies may

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<sup>1</sup>Other examples may include exogenous forces raising the costs of tax collection (James B. Kau and Paul H. Rubin, 1981), or increasing income inequality respectively income equality (Allan H. Meltzer and Scott F. Richard, 1981, respectively Sam Peltzman, 1980).

<sup>2</sup>This explanation goes back to at least John Maynard Keynes (1936, p. 383), who noted that ‘... the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else ...’.

explain deregulation.<sup>3</sup> However, most of the other 'New Right ideas' being popular since the eighties stem from the classical economists of the eighteenth and nineteenth century.

Secondly, none of the above explanations is consistent with the observation that separate parts of the package of policy reversals met rather great opposition among voters. According to the explanations above, policy reversal takes place because it is in the interest of a majority of voters. Hence, we would expect great enthusiasm among voters if policy reversal is proposed. This appeared not to be the case for several parts of the policy reversal agenda in Western countries during the eighties. Although there was consensus that the public sector had expanded too far in general, each policy reversal separately was felt as painful among a large part of the electorate. Nevertheless, proposals to repeal several parts of government policy succeeded to obtain majority support and were successfully implemented. Quite commonly, reference was made to the general necessity of policy reversals in order to justify separate parts of the agenda.

The theory of policy reversal developed in this paper is consistent with the two mentioned features observed in Western countries during the eighties. Our key argument revolves around majority decision making on separate projects. In our model bureaucrats are charged with the responsibility to invent projects which benefit a majority of voters. An important feature of invented projects is that they make some voters better-off and some voters worse-off. Voters (or their representatives) decide by majority rule whether or not an individual project will be implemented. Voters are assumed to be forward-looking, to vote sincerely, and to prefer the status quo to a cycle status quo - implementation - status quo. As a consequence, government activities consist of projects which separately are supported by a majority of voters. However, because projects differ in their distributive consequences, majority support for individual projects does not guarantee majority support for bundles of projects. The number of voters who loose from at least one project increases with the number of projects implemented. If the associated losses are not compensated by the benefits from other projects, these voters will support a proposal to repeal a bundle of implemented projects.

Clearly, our theory is consistent with the above mentioned features of policy reversal in

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<sup>3</sup>Clifford Winston (1993) however notes that most regulatory reforms were already initiated before contestable markets theory was developed.

many Western countries during the eighties. Simultaneous reversal of a number of policies is a necessary condition for our argument to hold. Moreover, our theory implies that reversal of separate projects is not welcomed enthusiastically by voters, since each project separately benefits a majority of voters. Voters do, however, see the need for policy reversal in general because they gain from repealing the package of policies. The argument will appear to apply to both welfare-enhancing and welfare-decreasing projects. Hence, policy reversal may be beneficial for society as a whole, but this is not necessarily the case.

Our paper is related to Raquel Fernandez and Dani Rodrik (1991). They show that uncertainty about the identity of winners and losers may create a gap between *ex ante* and *ex post* support for individual projects. Basically, we extend their analysis by looking at support for both individual projects and bundles of projects. In addition, this paper is related to the social choice literature (see Mueller, 1989, and Amartya Sen, 1995, for some topics). This literature has a dominantly normative flavour. Among other things, it shows that a simple majority rule may lead to severe policy instability, a phenomenon which is rarely observed in modern democracies. This paper deviates from the social choice literature in that it has a typically positive flavour. We use the properties of majority rule to provide an explanation of an observed cycle in public activities.

Apart from this introduction, this paper consists of two sections. The next section presents our basic argument. In section 3 we briefly discuss possible extensions of the model.

## **2 The argument**

In this section, we present our theory of policy reversal. The objective is to explain why parliaments may decide to repeal a number of policies which have been supported by a majority in the past in an environment with stable preferences. We start with analysing support for policies before implementation and determine which type of projects are implemented. Next, we show how support evolves after implementation both for an individual project and for a bundle of two projects. In order to make our argument as clear as possible, we use a very simple voting model. For the same reason, we restrict the analysis to policies whose consequences can be described in a simple way.

Suppose that a parliament, which is assumed to be a mirror of the people, decides under

majority rule whether or not the government implements a project. Each period, projects are invented by a bureaucracy. Each invented project is sent to parliament for approval. When evaluating a project, parliament has full and correct information about the aggregate consequences of the project. Thus, before implementation each member of parliament knows the share of the population that will end up as winner or loser from the project and the associated gains and losses. Furthermore, each member of parliament has correct information about the consequences of the project for his or her constituency. These consequences may be uncertain, however. If this is the case, for each member's constituency correct information is provided about the probability to end up as winner or loser.

Assume that a project is proposed with the following distributional consequences:

- i) proportion  $w$  of the population is certain to gain amount  $B$ ;
- ii) proportion  $l$  of the population is certain to lose amount  $L$ ;
- iii) the rest of the population  $(1-w-l)$  faces probability  $p$  to gain  $B$  and probability  $1-p$  to lose  $L$ .

What will parliament decide? Obviously, proportion  $w$  ( $l$ ) will vote for (against) implementation of the project. Support of the voters who are uncertain whether to gain or lose from the project depends on the probability to end up as winner or loser, the associated gain and loss, and the voter's risk attitude. Assuming for convenience that voters are risk-neutral, the uncertain group will vote for implementation of the project if the expected net gain from the project is positive. Thus, the condition for *ex ante* majority support for the project is:

$$w > \frac{1}{2}, \text{ or}$$

$$w + (1-w-l) > \frac{1}{2} \text{ and } pB - (1-p)L > 0 \tag{1}.$$

Clearly, if the certain winners (losers) constitute a majority, *ex ante* majority support is guaranteed (precluded). If this is not the case, *ex ante* majority support depends solely on the expected net gain from the project for the uncertain individuals.

How does support for a project evolve if it appears to obtain majority support *ex ante* and is implemented? *Ex post* support for an individual project differs from *ex ante* support

only if some of the voters are *ex ante* uncertain whether to gain or lose from the project ( $w + l < 1$ ). This can easily be seen by comparing condition (1) with the condition for *ex post* majority support for an individual project:

$$w + p(1-w-l) > \frac{1}{2} \quad (2).$$

After implementation, information is revealed about the identity of winners and losers among the group of uncertain voters. If the uncertain voters expected to gain from the project, and thus unanimously supported the project *ex ante*, support declines after implementation because only part of them (proportion  $p$ ) ends up as winner. *Vice versa*, uncertain voters may all oppose a project although some of them will end up as winner. By driving a gap between *ex ante* and *ex post* support, individual-specific uncertainty may thus lead to disapproval of a project which would benefit a majority and approval of a project hurting a majority *ex post* (Fernandez and Rodrik, 1991).

Obviously, the latter case is a first example of policy reversal. If parliament approves a project from which a majority will lose, the project will be repealed once the consequences of the project become visible.<sup>4</sup> However, this type of policy reversal is unlikely to occur. Because parliament has full information about the aggregate consequences of a project, each member of parliament knows *ex ante* that such a project will be repealed in the future. Parliament is likely to prefer the status quo to a recurrent cycle status quo - policy innovation - status quo (*cf.* Fernandez and Rodrik, 1991). Thus, lack of *ex post* majority support is likely to jeopardise *ex ante* majority support. In terms of the model, both condition (1) and (2) must be satisfied in order to obtain *ex ante* majority support for a project.<sup>5</sup>

Besides inventing new projects, the bureaucracy evaluates past policy. For example, each new government assigns a number of bureaucrats to evaluate all projects implemented by its predecessors. Because *ex ante* full information exists whether or not a project benefits a majority and preferences are assumed to be stable, these *ex post* evaluations

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<sup>4</sup>High adjustment costs may of course prevent that a project is repealed. The same is true in the analysis below.

<sup>5</sup>Individual-specific uncertainty thus implies a bias towards the status quo, which is the basic point of the paper by Fernandez and Rodrik (1991). A possible solution to the implied credibility problem can be found in Robert A.J. Dur and Otto H. Swank (1997).

mainly concern the aggregate effects of bundles of implemented projects. These multi-project evaluations lead to a proposal to repeal a bundle of projects if bureaucrats discover that a majority of parliament will favour a policy reversal. We will now show that these multi-project evaluations may indeed lead to repealing projects which have been voted for *ex ante* and benefit a majority *ex post*. Stated differently, there may be a discrepancy between *ex post* support for individual projects and *ex post* support for a bundle of these projects.

To illustrate this, suppose that in period  $t$  a project is proposed from which 10% of the population is certain to gain amount 1, 10% is certain to lose amount 1.25, and the remaining 80% of the population is uncertain whether to gain or lose. The latter group faces probability 0.6 to end up as winner and gain 1 and probability 0.4 to end up as loser and lose 1.25. It is easy to see that for a project with these characteristics both conditions (1) and (2) hold. Thus, the project is voted for *ex ante* (by 90% of parliament) and benefits a majority (58%) *ex post*. In period  $t+i$ , the bureaucracy has invented another project with identical *ex ante* characteristics as described above. Hence, also this project obtains majority support *ex ante* and *ex post*. Will these projects survive an *ex post* multi-project evaluation? Stated differently: what can be said about *ex post* support for the bundle of the two projects?

With respect to the aggregate effect of these two projects, three groups can be distinguished *ex post*:

- i) 39% ( $0.1 + 0.8 \cdot 0.6 \cdot 0.6$ ) of the population wins from both projects;
- ii) 38% ( $0.8 \cdot 2 \cdot 0.6 \cdot 0.4$ ) wins from one project and loses from the other;
- iii) 23% ( $0.1 + 0.8 \cdot 0.4 \cdot 0.4$ ) loses from both projects.

Clearly, group i) supports the bundle of projects while group iii) prefers to repeal them. Group ii) wins amount 1 from one of the projects, while it loses amount 1.25 from the other. The benefit from one project does not compensate for the loss from the other project. Hence, also group ii) will prefer to repeal the bundle of projects. Because group ii) and group iii) together form a majority (61%), a proposal to repeal the bundle of projects will obtain majority support. Hence, in this example a majority in parliament approves to repeal a bundle of projects which each has been voted for *ex ante* and benefits a majority *ex post*.

To determine to which type of projects the argument applies, let us derive the conditions for *ex post* majority support for a bundle of projects. For purpose of clarification, we



restrict the formalization to *ex ante* similar projects. As in the example above, three groups can be distinguished after two *ex ante* similar projects are implemented:

- i) proportion  $w + p^2(1-w-l)$  ends up as winner from both projects;
- ii) proportion  $2p(1-p)(1-w-l)$  gains from one of the projects while it loses from the other;
- iii) proportion  $l + (1-p)^2(1-w-l)$  loses from both projects.

The first (last) mentioned group will always support (oppose) the bundle of projects. Support from the group which wins from one project, while loses from the other depends on the sign of the net effect of the bundle on voter's welfare. Only if the gain from one project compensates for the loss from the other, they will support the bundle. Thus, they will only support the bundle if  $B - L > 0$ , *i.e.* if  $\frac{L}{B} < 1$ . This leads to the following conditions for *ex post* majority support for a bundle of two *ex ante* similar projects:

$$\text{if } \frac{L}{B} < 1 \text{ then } w + (2p - p^2)(1-w-l) > \frac{1}{2} \quad (3a)$$

$$\text{if } \frac{L}{B} > 1 \text{ then } w + p^2(1-w-l) > \frac{1}{2} \quad (3b)$$

The gap between *ex post* support for each individual project and *ex post* support for a bundle of two projects can easily be seen by comparing conditions (3a) and (3b) with condition (2). Condition (3a) is less restrictive than condition (2). Hence, *ex post* support for a bundle of two *ex ante* similar projects with  $\frac{L}{B} < 1$  is higher than *ex post* support for each project individually. Intuitively, part of the losers from a particular project will support a bundle containing that project because the loss is more than compensated by the gain obtained from the other project included in the bundle. Thus, a proposal to repeal two projects with  $\frac{L}{B} < 1$  will not obtain majority support, given that each project benefits a majority. In contrast, condition (3b) is more restrictive than condition (2). Hence, for projects with  $\frac{L}{B} > 1$ , a bundle of two projects may lack majority support *ex post*, even if both projects are individually majority supported *ex post*. A proposal to repeal these two projects will thus obtain majority support. Intuitively, part of the winners of a particular project may vote for repealing a bundle including that project because the benefit does not

compensate for the loss they bear from the other project included in the bundle. This can, of course, not show up if  $\frac{L}{B} < 1$ .<sup>6</sup>

As has been illustrated with the example, the conditions for *ex ante* majority support ((1) and (2)) do not preclude that projects for which our argument holds are implemented. However, analogous to the Fernandez-Rodrik-case of one project, one may wonder whether voters will support a project *ex ante* if they know that it may be repealed as part of a bundle in the future. Evaluation costs may prevent that *ex ante* support is lacking due to these *ex post* considerations.<sup>7</sup> For this to happen, each time a project is proposed, voters must evaluate *ex post* support for all possible bundles including the proposed project and some combination of historically implemented projects. In doing so, voters incur large costs since government policy generally consists of a large number of projects. Indeed, the associated number of possible bundles is exponentially larger than the number of historically implemented projects. These high costs are unlikely to weigh against the expected benefit of an *ex ante* multi-project evaluation. The benefit of such an evaluation is quite uncertain since our argument only applies to a limited number of all proposed projects. Hence, it is likely that voters rationally ignore these *ex post* considerations and vote sincerely.

Note that the lack of *ex ante* multi-project evaluations is crucial for our argument. If voters systematically evaluate *ex post* support for all possible bundles including the proposed project and some combination of historically implemented projects before deciding whether or not to support a proposed project, it sometimes pays to vote strategically and policy reversal will not take place. For instance, if we consider the above numerical example, it is obvious that the second project will not obtain majority support under strategic voting. The majority benefiting from the first project will foresee that both the first and the second project will be repealed after implementation of the second project.

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<sup>6</sup>Note that policy reversal does not require that some voters are *ex ante* uncertain whether to end up as winner or loser. This can be easily verified by using the above numerical example and assuming that the identity of winners and losers is common knowledge before implementation.

<sup>7</sup>Note that this argument does not apply to the Fernandez-Rodrik-case of one project because voters are fully informed about the *ex post* aggregate consequences of each individual project.

Hence, although they expect (or are certain) to gain from the second project, they will not support it. In contrast, all losers from the first project, which constitute a minority, will support implementation of the second project, even if they are certain to end up as loser from it. For implementation of the second project implies that both the first and the second project are repealed in the near future.

A final remark concerns the efficiency of projects to which the argument applies. Obviously, projects which are efficient in the sense of Pareto will never be repealed on the basis of our argument because no one loses from these type of projects. If we adopt a less strict definition of efficiency, the argument appears to apply to both efficient and inefficient projects. Following Fernandez and Rodrik (1991), let us define efficient projects as projects which yield a net gain to society. Now consider the example at the beginning of this section. *Ex post* 58% of the population ended up as winner and gained amount 1, while 42% ended up as loser and lost amount 1.25. On aggregate, this project yields a net gain to society ( $0.58*1 - 0.42*1.25 > 0$ ), and can thus be seen as welfare-enhancing. Nevertheless, a proposal to repeal a bundle containing two of these projects will obtain majority support, as we showed above. If we slightly change a parameter in this example, we can show that the argument may apply to inefficient projects as well. For example, assume that the certain losers lose amount 2 instead of 1.25, while the *ex ante* and *ex post* characteristics for the other groups remain the same. The project now yields a negative sum on aggregate to society ( $0.58*1 - 0.32*1.25 - 0.1*2 < 0$ ). Because the certain losers oppose to the project anyhow, a rise in the loss they bear does not change the outcome of the decision-making process (compare condition (1) and (2)). Hence, the argument may apply to inefficient projects as well. Thus, policy reversal may be beneficial for society as a whole, but this is not necessarily the case.

### 3 Discussion

Our model of policy reversal may disappoint economists who like complicated models. Fortunately, the analysis can be extended in several ways. Firstly, we may consider the conditions for *ex post* majority support for bundles including more than two projects. This extension appears to broaden the scope of projects to which the argument applies. Intuitively, for projects with a (very) high value of  $\frac{L}{B}$ , an additional project makes some of

the net winners from the bundle net losers, while all net losers remain net loser because  $B$  is (very) low relative to  $L$ . Thus, *ex post* support for the bundle declines and may become lower than  $\frac{1}{2}$ . Secondly, the analysis can be extended to projects with different characteristics. Clearly, this extension makes the analysis much more complicated. The main result remains unaffected, however. This can be easily verified by varying the value of the parameters in the above numerical example. Crucial for policy reversal to take place is that the loss from each project included in the bundle is not compensated by the benefit(s) from the other project(s) and that for each individual project the number of losers is sufficiently high. Thirdly, for each project more than three groups of voters *ex ante* (two groups *ex post*) may be distinguished. For example, a project may benefit winners (hurt losers) to a different extent. Alternatively, the probability to end up as winner or loser may differ between the uncertain individuals. Obviously, also this extension will make the analysis more complicated, while the basic argument may still apply.

The main objective of this paper was to provide an explanation for policy reversal in democratic societies. In principle, our explanation rests on the assumptions that public decisions are made by majority rule and that parliament has incomplete information about the aggregate consequences of all possible bundles of public projects making up the government. Since public projects in industrialized countries abound, the latter assumption seems highly plausible. Our explanation is consistent with the observations discussed in the introduction that often projects are simultaneously repealed, and that separate parts of policy reversals meet determined resistance. There remains the question what will happen after the policy reversal? Taken literally, our model predicts new cycles in public activities. Proposals to implement the old (repealed) projects separately will be supported by a majority of the voters. At the end, again a proposal to repeal a bundle of projects will be approved by parliament. However, if voters prefer the status quo to a recurrent cycle, it is likely that parliament rejects proposals to implement the old repealed projects. Still, new policy reversals are likely to occur when newly invented projects are implemented.

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