

Why Groups' Size Matters? A Cognitive Analysis of *Status Quo* in Reforms Process.

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Abstract

We study the question of deadlock situations in reform process. More precisely, why some States achieve reform while others don't ? We present a new approach: the cognitive approach, which takes agents' beliefs and cognitive bias into account. We propose a model which explains why reform is allowed or refused in the presence of veto players and groups, taking into account the institutional environment. We conclude to the existence of groups' optimal size which allows to reform. These sizes are linked up agents' beliefs. We confirm the existence of *status quo* bias.

Keywords: social groups, reform, veto players, *status quo*, cognitive bias.

Code JEL: D7, D71, D78, D8

Section 1 Introduction

Reform has two main aspects: the first is a collective aspect; it questions society on its collective choices and its future. The second aspect is a personal dimension: reforms can modify the distribution of gains and losses for each person. This duality is at the heart of the problem of the acceptance of the reform process by people. Reform will be defined as a modification of the rules governing the agents' behaviour. With this definition we distinguish four different approaches in literature on the question of why some States reform while others don't. At the confluence of the third and fourth approach we propose a new explanation built on the perception of the agent and on subjective probabilities (section 3). We conclude our model by the implication of the model with regard to different strategies of governments which wish to reform. We present the case of the reform of work-time in The Netherlands since the Wassenaar Agreements in 1982 (section 4). This example shows the accuracy of the theoretical model. We conclude by a discussion on the possible extensions of the model.

Section 2 The Classical Reasons of Reforms and *Status Quo*

Let us now consider three approaches that are seen as classical by the literature on the economy of the reform. Then we will present a fourth approach based on both economy and psychology.

Rational Calculus and Social groups

Society would be a place in which different groups confront each other, in an effort to maximize their utility. Here there are lots of variations, such as rent-seeking, crisis hypothesis (Drazen and Grilli, 1993), individual uncertainty (Fernandez and Rodrik, 1991), median voter and so on (Rodrik, 1996)¹.

Moreover, it's important to consider the institutional aspects which would make the acceptance of reform easier, and opposed to them, inefficient structures acting as important brakes (Spiller and Stein and Tommasi, 2003).

However, the question of reforms cannot be totally comprehended by these ways : majority of these models present either the individual side or the collective side. None of them consider the two sides in the same model, this lack spoils the significance of their conclusions. For example, Fernandez and Rodrik (1991) explain the status quo bias by the individual probability of winning at the reform. Furthermore, this probability is considered as exogenous and independent from the agents' experiences, beliefs and institutional framework.

In the purpose to renew the analysis it is necessary to remove the partitions between social groups, individual agents and institutional environment. That's why we use the cognitive approach, this latter unifying all these dimensions and allowing a more pertinent analysis.

We are going to review briefly this approach that we call the cognitive approach.

The Cognitive Approach

Agents have preferences, beliefs and cognitive bias. Now we will proceed to study aspects, concentrating on the last two.

Cognitive biases have been studied in literature linking experimental economy and psychology (Rabin, 1998). These studies show the behaviour of agents in different situations.

In addition to those analyses, studies have been carried out on the agents' beliefs and on how the agents perceive their own environment.

Alesina and Angeletos (2005) show that Americans think that agents who succeed in their lives owe it to their work and efforts whereas, for Europeans, chance, birth, relations, even corruption explain success. As a result, to restabilize this phenomenon Europeans want more redistribution to even out the inequalities. Indeed, Americans and Europeans have a common preference: fairness. Hence, this approach helps to explain why the agents perceive the politics of redistribution in the United States and Europe in a different way.

At the same time Pernice and Sturzenegger (2003) tried to explain the support or level of criticism to which a process of reforms would be subjected. They analysed Argentina's case and came to the conclusion that public opinion imposes constraints on the government's behaviour way beyond the electoral process. These constraints determine macroeconomics performances and in doing so, the potential chances of the reform being a success.

They built their reasoning by using the works of psychology applied to economy. Thus they explain the choice of public opinion in the light of cognitive bias such as the phenomenon of "self serving bias", at the root of the lack of support given by the population to reforms: it's the tendency that people have to believe true hypothesis that serve their interests. Despite good results of reforms during the nineties in Argentina, the agents focused their attention on the negative aspects of the reforms, such as unemployment and wealth concentration. From this moment on, a succession of events reinforced the beliefs against reforms, favouring the opposition to reform and to foreign influence.

Benabou and Tirole (2007) show that beliefs can be seen like investments. Hence, the more agents believe in their values the more it is difficult to break the deadlock (if reforms are opposed to the agents' values) because the amount of compensation to convince agents will be very high.

To conclude, the cognitive approach covers in a more realistic way the problematic of reforms and deadlocks but it is unfortunate to note the absence of institutional framework.

That's why, in the purpose to fill this gap, we present, in the following section, a model explaining why some reforms are accepted while others are rejected in a specific institutional framework which shows the importance of this dimension. Our framework consists of the existence of veto players and of groups made up of a leader and base. We present it in the cognitive approach framework by using the agents' beliefs.

Section 3 The model

In this section we present a model to explain why reforms occur or not.

3.1 Institutional Framework

In the political process there exist veto players. This is an agent who has the capacity to block reform alone. It's the case when there exists powerful trade union or in presence of certain institutional actors (Alesina and Drazen, 1991). Our purpose is to show that the acceptance of reform with multi veto players depends not only on the size of the groups of veto players, but also on the position of the veto players about the reform. We show that reform is not always possible and when relation is possible there exists an optimal size. The optimal size depends on the group and leader's beliefs about the future position.

We suppose two groups: L represents union of workers and K a federation of employers. They are made up of a leader and a base. The decision making process is composed of a government which proposes a reform to the leader of each group². They choose to use their veto or not. We suppose that the leader of each group is influenced in part by the position of his base and a personal idea about the reform. This personal idea comes from his particular position about the

decision process, he can have a different point of view from his base. There is an asymmetry of information between the base and the leader. The base has a point of view on the reform that we suppose exogenous and identical for all agents of the base. People join groups because they agree with the groups' idea. To simplify, there exists a single belief concerning one question for the members of the base of a group: the ideological belief, noted \bar{p} . It's base's subjective probability that it will win, it's a prior belief, and it's invariable.

Leaders of each group make their choice in function of their expected gain to be winner. They support reform if the expected gain is positive. Leaders and bases calculate:

$$E^G = pG^+ + (1-p)G^- \quad (1)$$

p is the subjective probability to be winner of the reform and $1-p$ the probability to be loser.

The base and the leader have different values of p .

G^+ and G^- are gains and losses associated with each situation, indeed $G^+ > 0$ and $G^- < 0$. We suppose that they are known by everybody and fixed for a specific reform. If $E^G \geq 0$, the veto-player supports the reform because he thinks that it's good for him. If $E^G < 0$, veto-player does not support reform and he blocks it.

With (1), we find that reform is accepted if:

$$p \geq -\frac{G^-}{G^+ - G^-} \text{ (see mathematical appendix I)} \quad (2)$$

We note, by definition, $\alpha := -\frac{G^-}{G^+ - G^-}$

Agents compare p and α . Each group has a different value for α . Bases compare their ideological belief with α . In others words, the more gains are high the less p needs to be high: reform is easier accepted when α is weak.

3.2 The leader's probability

Leaders build their probability in a different way. Their special positions lead them to conceive their probability to be winner in a different way. We suppose that they build it with the formulation of Murphy and Shleifer (2004). We have kept the structure of the equation but we have changed the signification of the variables.

The leader is the veto player of one group. He has the power of veto. Members of his organisation are the base of the group. Members can influence the leader between a function of influence $f(n)$ where n is the size of the group in comparison with the total population: $0 < n < 1$, it's a proportion. It can vary with the time. We make the hypothesis that $f(n)$ is increasing. The more the group is important in the society the more the group is influent on the leader³. In addition to this, we make the hypotheses that $f''(n) < 0$, the first agent in the group is more influent than the last. $f(n)$ is concave and $f(0) = 0$ and $f(1) = 1$. We also suppose the function is given for a precise reform.

We make the hypotheses that the leader has a positional belief to win if the reform is accepted. This is a subjective probability noted p^0 and $0 < p^0 < 1$. This belief comes from the leaders particular situation which allows access to private information about reform. It is given to each reform. Moreover, we suppose that the ideological belief, \bar{p} , with $0 < \bar{p} < 1$ is taken into account by the leader.

We can, now, write that the final belief p_f of the leader to be winner to the reform is:

$$p_f = p^0 + f(n)(\bar{p} - p^0)$$

The group's leader has a belief which is different from the base. p_f represents the final belief of the leader $0 < p_f < 1$.

Cases where the group's size is null or equal to all the population

In this case where the veto player is alone we have $n = 0$ and $f(0) = 0$, we obtain $p_f = p^0$, the initial belief is equal to the final belief. In this case the leader is not influenced by the group pressure.

In the case where all the population represents the group, we find that $p_f = \bar{p}$: there is one leader and one group, so there is no reason to have negotiations: the position is the ideological position and $f(1) = 1$.

We have presented a way in which the leader builds beliefs about reform with veto-players.

3.3 Definition used

To the two groups L and K we have:

E_i , for $i = K, L$: expected gain of the leader of group i .

p_i^f , for $i = K, L$: the leader's final belief that group i will be the winner.

\bar{p}_i , for $i = K, L$: the ideological belief of group i that they will be the winner.

p_i^0 , for $i = K, L$: the leader's positional belief of the group i that it will be the winner.

n_i , for $i = K, L$: the proportion of the population which belongs to group i .

$f_i(n_i)$: the influence exerted by the group i on the leader i .

Each element is associated with a particular value to a given reform. Only the size of the group remains is the same despite the different reforms.

With these previous elements we present a model explaining why a reform can be accepted or rejected.

Results

We make the hypothesis that the leaders decide for the groups. Each leader calculates his expected gain without knowing the position of the other leader. They both use the same way to calculate, that's why we present a general framework, before discussing interactions which exist between the two leaders.

$p \geq -\frac{G^-}{G^+ - G^-}$ can be noted $p_f \geq \alpha$, this condition is both necessary and adequate for the acceptance of the reform by the leader.

This relation can be written:

$$p^0 \geq \frac{1}{1-f(n)}(\alpha - f(n)\bar{p}) \text{ (see mathematical appendix II)} \quad (3)$$

If (3) is verified the leader accepts the reform because he thinks it's good for him. If (3) is not verified he uses his veto power.

We can, now, search for the value of n where (3) is verified. We define a

function $h(n) = \frac{1}{1-f(n)}(\alpha - f(n)\bar{p})$ to $n \in [0, 1[$. We study $h(n)$ to determine the values for which

(3) is right.

$h'(n) = \frac{f'(n)}{(1-f(n))^2}(\alpha - \bar{p})$, we know that $\frac{f'(n)}{(1-f(n))^2} > 0$, the sign of the derivative depends on

the sign of $\alpha - \bar{p}$ (see mathematical appendix III).

If $\alpha > \bar{p}$, $h(n)$ is increasing and if $\alpha < \bar{p}$, $h(n)$ is decreasing.

We now look at the two cases to determine the optimal value of n to reform. The first case is $\alpha > \bar{p}$ and the second is $\alpha < \bar{p}$. We study more cautiously the first case because the resolution of the second case follows in the same way.

First case: $\alpha > \bar{p}$.

$h(n)$ is increasing because $h'(n) > 0$. The minimum of the function is reached when $n = 0$ and $h(0) = \alpha$.

We suppose that the gains and losses associated with each situation are known, hence, α is known. Moreover, we suppose that the leader knows the proportion of his group in relation to the total population, n^0 the size of the group is known. We suppose that \bar{p} is known by everybody. Finally, the leader's positional belief p^0 is known only by him.

We can find the interval of determination of the reform for the leader. We can determine values of n to obtain $p_0 \geq h(n)$. n^* is the maximum value for which the leader supports the reform. We

find $n^* = f^{-1}\left(\frac{\alpha - p^0}{p - p^0}\right)$. This value corresponds to the maximum size of the group in which

reform takes place. There is reform if n belongs to the interval $\left[0, f^{-1}\left(\frac{\alpha - p^0}{p - p^0}\right)\right]$ (see mathematical appendix IV).

In the same way reform will be impossible if $h(n) > 1$ because $p_0 \in [0, 1]$.

The graph 1 is an illustration of the case where $\alpha > \bar{p}$.

<Graphic 1>

We present, now, the case where the losses' relation is inferior to the ideological belief of the base. Here, we have a base which thinks that reform is a good thing for them. So the Leader is under the pressure to accept reform.

Second case $\alpha < \bar{p}$

We have values of α, \bar{p} different from the first case. The function $h(n)$ is decreasing. It has its maximum when $n = 0$, we obtain $h(0) = \alpha$ (see graph 2). We show that there exists an interval in which the reform will be accepted. The greatest lower bound of this interval is $n = f^{-1}\left(\frac{\alpha - p^0}{p - p^0}\right)$.

It's the value of n^* . In the contrary if $n < n^*$ we have the *status quo*. The interval of acceptance

$$\text{is } n \in \left[f^{-1}\left(\frac{\alpha - p^0}{p - p^0}\right), 1 \right] \text{ (see mathematical appendix V)}$$

This is illustrated by the graph 2.

<Graphic 2>

The study of the two cases shows the different possible cases and the different conditions for rejection or acceptance of the reform. We present, now, in table 1, the different possible results when there are interactions between the two leaders.

<Table 1>

L: acceptance depends on the labour union's size.

K: acceptance depends on the federation of employers' size.

K,L: acceptance depends on the two unions' size.

n r(L): L rejects systematically.

n r(K): K rejects systematically.

n r(L,K): L and K reject systematically.

t,r the reform is accepted automatically.

Table 1 shows us that there exist four cases in which reform is accepted by the two players (t,r).

We have twenty situations in which the reform is refused. More precisely, in four cases two

groups reject the reform. In the other sixteen cases, a single group is against reform. The position of the other group depends on the value of its size (n). A third establishment is that there exist eight cases in which the acceptance depends on the value of the size of just one group and four cases where it depends on the value of the size of each union. This table permits us to characterize the existence of a *status quo* bias in this institutional environment, because we have twenty cases out of thirty-six which result in a refusal of the reform, in the hypothesis where the different cases have similar proportion. There are just four cases in which reform is sure to be accepted.

What are the solutions which could free us from these constraints, so the reform can take place?

To answer these questions we present in the following section possible solutions to break the deadlocks.

Solutions to the status quo

We analyse the question of breaking the deadlock in its temporal aspect. Impact of the variation of the group's size on a process of reform is a phenomenon which takes time. Reform is a question which also must be understood in a long time perspective. Sometimes the implementation of reform is rapid: however we mustn't forget that reforms have been negotiated over several years.

A short time perspective

Table 1 shows us that deadlock is sometimes due to unions workers or confederation of employers, or both. There exist several types of deadlocks, that aren't due to the same reasons. A possible solution is to compensate losers (Dür and Swank, 1998). Compensation permits leaders with an expected gain to modify their position and to become positive. It's a transfer between winner and loser. Here, we don't deal with, here, questions about the credibility of promises or intertemporal compensations between winner and loser. We suppose the existence of institutional

agreement making credible the engagement⁵. We focus more particularly on the necessary conditions to permit acceptance of the reform.

Does compensation ensure acceptance of the reform?

Compensation is possible only if there is a winner. We have showed that we can have solutions where there are no winners. In our model, the phenomenon of compensation appears by a variation of α .

The first case is when leaders are losers, it's impossible to reform because every leader is against the reform. There are four cases where the reform is rejected without the possibility of compensation. There are others situations where one leader is winning and the position of the other depends on n . If leader of L refuses to reform, the leader of K can propose to compensate. In this way he tries to modify the vote of L. But this compensation can only be given if it increases the winner's value of α_K . Compensation can only be given in a limited interval. The limit of this compensation is when the expected gain has a value of 0 ($E_K = 0$). The reform is accepted if compensation allows the loser to obtain ($E_L \geq 0$). If it's impossible, the reform is rejected.

In the case where one player is sure to lose and the choice of the other depends on the value of the group's size, we have a game with two levels. The first level consists of making sure that just one leader is opposed to reform. If all leaders support *status quo*, there is no possibility of compensation. The second level is to know if the winner can compensate the loser sufficiently to break the deadlock.

We find the same process if the positions of the leaders depend on the size of their group. We must, firstly, discover the level of n_K and n_L to know if leaders are favourable to the reform. The second level exists if one of the two leaders supports reform while the other fights against it.

Intuition leads us to believe that the more levels there are the lower are the chances that the reform will be accepted because it increases the necessary conditions for reform. We have presented an analysis in a short term perspective. The question of structural reform must be seen in a long term perspective.

Reform in a long term view

This allows us to show the importance of the variable size of network. The notion of *status quo* implies there aren't exogenous shocks which modify values of others parameters like a modification of gains and losses. Besides, when a proposition of new reform appears agents give new values to the gains and losses and their ideological position. There is just the group's size that doesn't change. That's why it's the link between two different reforms or more generally between short term and long term.

We will illustrate our model, using the example of the reform of work-time in The Netherlands from the historical agreements of Wassenaar in 1982 to now. This allows us to confirm the results of our theoretical model, in particular about differences between leaders and bases. Moreover, the accuracy of our example is reinforced because it treats questions in the short term and long term.

Section 4 An Example: Work-time Reform in The Netherlands since 1982

1982 showed a radical modification in the relations between labour unions and the federation of employers. The seventies have been characterized by the "Dutch Disease": high level of unemployment, important budget increases to different allocations and weak competitiveness.

Parallel to this phenomenon, the Dutch unionism was dominated by the merger of two labour unions which created the FNV⁶. Today it represents more than 60 % of Dutch union members and signs 95% of agreements with employers.

Implementation of an agreement between unions and employers can be made if just one union signs the agreement. In fact, employers search for an agreement with all labour unions especially with the FNV because it's the biggest labour union. In table 2, we present its evolution, in numbers of FNV's adherents and in table 3, we show the percentage of persons which it represents among workers, over the same period (Streek and Visser, 1998).

<Table 2>

<Table 3>

For fifty years the FNV has shown by an important increase in its number of members, which rose from 750,000 in the fifties to 1,200,000 in 1996 (see table 3). At the same time its representativeness tends to diminish (from 25% during the fifties to 17% in 1996), despite a slight increasing trend since the middle of the eighties (see table 3). It's interesting to note that the agreements of Wassenaar took place at a particular moment for the FNV, when its percentage of representation reached its worst level in its history.

1974-1982: the time of deadlock

Since 1973, the economic situation has been very bad; the federation of employers and labour unions couldn't reach an agreement: employers wanted a return to competitiveness and moderation of wages and to put an end to the indexation of wages based on inflation. The bases of labour unions were opposed to these requirements and accused employers of being responsible for everything.

The two sides refused to negotiate and hoped the other side would back down. Social cohesion worked when economic growth was present, but as soon as conflicts appeared, it faded. These situations correspond in the table 1 to row 6 and column 3. We find ourselves in a situation where

both (the employers and the union leaders) are sure to be winner whereas the base of the union is convinced of losing.

After eight years of *status quo*, labour unions and employers found an agreement to break the deadlock. By then, the situation had changed: the number of members of the FNV was decreasing rapidly and the social situation was very bad (10 000 more unemployed every month). The agreement took place at a particular moment (the FNV was in a very difficult position (Streek and Visser, 1998)). We are witnessing a decrease in the value of n_L and we are in the situation where $\alpha > \bar{p}$. (see graphic 1). As expected by our model leaders of the FNV did not follow the opinion of their base.

Agreements of Wassenaar reduced the work-time length from 40 hours per week to 38 hours, and their implementation staggered over three years. The conjunction of different elements allowed to break the veto of the FNV's direction. Labour unions accepted the moderation of wages in exchange for a decrease of work time (Visser and Hemerijck 1997). This reform permitted the restoration of competitiveness and economic growth (Visser, 1998).

The second half of the eighties

Labour union leaders wanted to obtain a 36 hours of work-time per week. They wanted to create new jobs by decreasing the work-time. But employers were strongly opposed to this idea. The leaders of this opposition were Philips and the National Federation of Metallurgy. They represented the export firms, with strong international competition. In the FNV, the base rejected the idea of a work-time reduction because they favoured wage increases, that's why they put the pressure on the leader of the FNV. In our model we are in the situation where the ideological belief \bar{p} is so low that the value of union's size is not sufficient to provoke reform (see graphic 3). In reference to table 1, we are in the situation row 6 and column 4. Employers and union's

base were opposed to the reform. After the failure of this tentative of reform, the leader of the FNV didn't make a high priority of the reduction of work-time. The debate returned 1992 with the economic crisis.

The Agreements of 1993: "A new way"

The return of the crisis in 1992 has had a strong impact on export firms (disappearance of DAF, important difficulties for Philips), the reduction of work-time appeared as a solution to resolve the crisis. This time, the most important support of the reform was the base of FNV which wanted to keep its job. Employers were submitted to very strong losses, they needed to find an agreement to break the deadlock and to restore the competitiveness. Each actor had a high value of belief to win. They reached an agreement in December 1993 in the continuation of the agreements of Wassenaar: a new way. It resulted in a moderation of wage increases and the implementation of the 36 hours of working-time per week. The agreements of 1993 can be interpreted as the situation of row 2 and column 3 with employers having to agree due to their losses which were linked to the *status quo* that was unsustainable and a base persuaded to be winner as well (see graph 2). "A new way" was implemented little by little during the following years. It ensured the breaking of the refusal of the 36 hours of work-time per week by employers.

Now, the social debate in The Netherlands is focused on the flexibility of labour and pensions. Hence, the decrease of work-time is not a priority anymore although; on principles, it remains a claim of labour unions.

This overview of the decrease of work-time illustrates the model of section 3. The logic of the model integrates the behaviours of actors, phases of *status quo* and phases of renegotiations and reforms. Our model explains the actors' decisions by taking into account the classical contributions of the economic theory. Besides, we have presented a psychological dimension

which is fundamental in order to understand the reasons for social deadlocks and the breaking of deadlock.

Section 5 Conclusion

Beyond the usual frameworks to explain the acceptance of reforms, we present a model in which we use the cognitive approach taking into account the institutional framework. This new approach induces better understanding of the roots of the acceptance or rejection of reforms. Our analysis shows that there are lots of situations where a minority has the institutional power to block a reform. Therefore, we have presented a model to understand why some reforms are accepted while others are rejected. Our model shows the importance of agents' perception about the reform. For this purpose, owing to the cognitive approach, we generalise Fernandez and Rodrik's notion of probabilities by the introduction of subjective probabilities which allows us to endogenize the probability to be winner. Moreover, we demonstrate that there exists optimal levels of group size and a *status quo* bias. The question of reform must be seen in a temporal dimension because it's a phenomenon which mixes short term and long term. In the short term fundamental elements are the levels of gains and losses and the size of the groups. But in the long term, there are the changes of leaders, new leaders can have different points of view. Moreover, the size and the composition of groups can change during the time. These modifications have an impact on anticipations of groups and the results of reforms. We have completed our study by the presentation of the case of reduction of work-time in The Netherlands since 1982.

It could be interesting to deepen the institutional interactions in the groups between the leader and the basis to have a better understanding of the internal running.

Endnotes

¹ Tommasi and Velasco (1995) and Drazen (2000) present complete analysis of the literature of the political economy of Reform.

² The government presents a reform in the purpose to increase the welfare of a majority of the population. The government hopes to ensure its reelection.

³ The leader is subjected to the pressure of his group's members because the base can vote with its feet. For example; the French syndicate CFDT lost many of its members because its leader, François Chérèque accepted the French reforms of retirements in the spring of 2004.

⁴ We don't discuss the cases where α is outside of the interval defined by p^0 and \bar{p} because in these cases, there is no possibility to modify the outcome of the negotiation process by the sole variation of n .

⁵ See Roland (2000) for a complete discussion about the compensation.

⁶ Federatie Nederlandse Vakbeweging was born from the merger of two unions en 1976.

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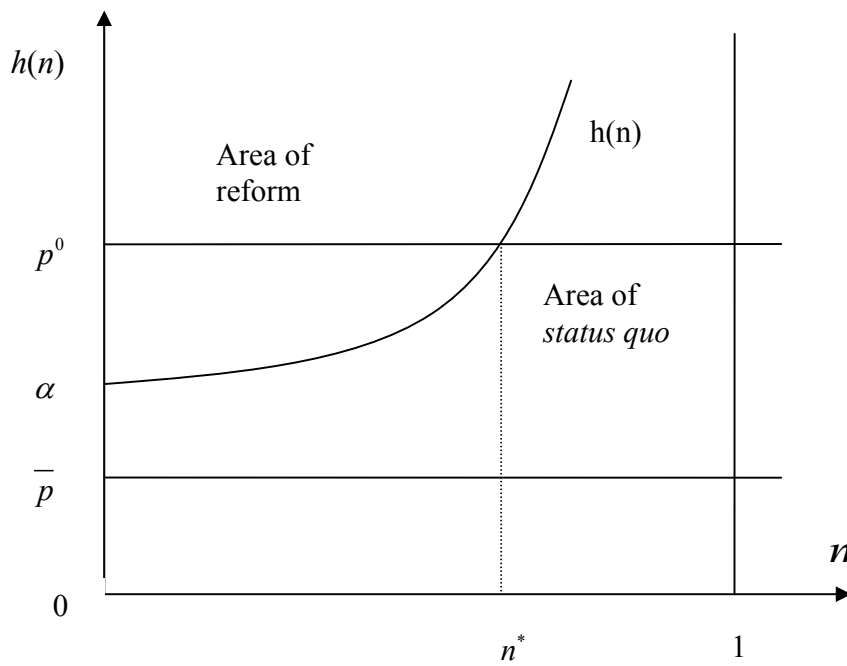
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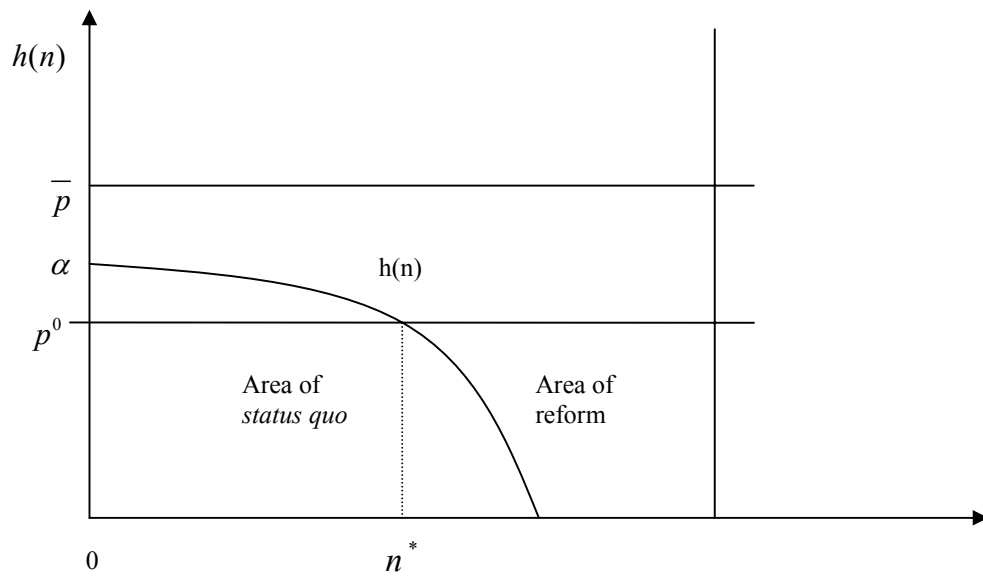
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Graphic 1: Representation of zones of acceptance and rejection of the reform by the leader

when $\alpha > \bar{p}$



Graphic 2: Representation of areas of acceptance and rejection of the reform by the leader when $\alpha < \bar{p}$.