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Reputation-concerned policy makers and institutional status quo bias☆

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ABSTRACT

We study the policy choice of an office-holding politician who is concerned with the public's perception of his capabilities. The politician decides whether to maintain the status quo or to conduct a risky reform. The reform's success depends critically on the politician's capabilities, which are privately known to the politician. The public observes both his policy choice and the outcome of the reform, and assesses his competence. We show that the politician may engage in socially detrimental reform in order to be perceived as more capable. We investigate the institutional remedy that balances the gains and costs when the policy maker is subject to reputation concerns. Conservative institutions that thwart beneficial reform may potentially improve social welfare.

1. Introduction

> She (Emma) was not much deceived as to her own skill either as an artist or a musician, but she was not unwilling to have others deceived, or sorry to know her reputation for accomplishment often higher than it deserved.
>
> [Jane Austen, *Emma*, vol. 1, ch. 6]

> Love of fame brings about eccentricity, and being eccentric brings danger to oneself; therefore the sages exhorted against the love of fame.
>
> [Li Bangxian, *Xing xin za yan*]

We are often concerned about the inferences that people draw about us based on our actions and their consequences. These inferences shape our reputations and often determine our prospects for success, professional or otherwise. Reputation concerns are an important part of the informal incentives that motivate many economic agents in the public sector, where formal contracts based on explicit performance-based incentives are usually rare.

In this paper, we identify one particular context in which reputation concerns affect policy makers' behaviour and explore institutional remedies for the resultant adverse consequences. We demonstrate that policy makers may embark on innovative but risky initiatives ("reforms") to convince the public of their competence. Such initiatives, however, can leave the public worse off. To mitigate the potential harm of risk-taking induced by reputation concerns, it may be necessary to establish "conservative" political and social institutions that restrict policy makers' discretion to initiate reform. Such institutional conservatism, however, may have to reject valuable reform proposals that, if implemented, could benefit the society.

Reputation concerns loom large especially in the public sector. Technocrats, such as officials of the Securities and Exchange Commission, often rely on their reputation for professional competence to climb the institutional hierarchy or attract job offers from the private sector.

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More salient examples are provided by career politicians, whose prospects for reelection are largely determined by public perception of their capabilities. For instance, in the aftermath of the economic turmoil, former British Prime Minister Gordon Brown was said to have lost his "reputation for economic competence" "through a combination of appallingly bad luck and even worse misjudgment,"[2] which eventually cost him the premiership. Similarly, a politician in office may have strong concerns about how the public evaluates his legacy when he steps down.

In this paper, we first examine how policy makers' reputation concerns are manifested in their decisions on whether to initiate risky policy that challenges the status quo. We then explore the optimal institutional arrangement that reconciles the benefits and costs of such initiatives. The policy maker is generically referred to as a "politician,"[3] whose capability can be either low or high. When the politician chooses to maintain the status quo, his policy outcome is independent of his capability. When he chooses reform, however, the performance depends not only on the intrinsic value of the available reform proposal, but also on how well he implements it—which, in turn, is determined by his inherent capability. For instance, a fiscal stimulus plan may help rescue the economy from recession, but its ultimate success depends largely on how funds are allocated to optimize its effectiveness. A new policy spawns uncertainty, and its success demands the politician's ability to take appropriate action under each contingency. A competent politician is thus better at implementing reform and more likely to succeed.[4] A politician's capabilities are known only to himself. The public assesses his competence based on observations of both his policy choice and the resultant performance. The politician makes his policy moves to maximize the public's perception of his competence.

We characterize the most plausible equilibrium of the game. In the equilibrium, driven by reputation concerns, the politician "postures" in the form of initiating too much reform: A low-type politician mimics his high-type counterpart and initiates reform in spite of his poor chance of success, because not doing so would lower the public's assessment of his capabilities. This hurts social welfare.

As frequently expressed as the *concern* that politicians act to enhance their reputations, however, is the *regret* that their well-meaning and ambitious reforms are being thwarted by entrenched institutions. As pointed out by Fernandez and Rodrik (1991), "one of the fundamental questions in political economy" has been why governments often fail to carry out efficiency-enhancing reforms. In the United States, for instance, the filibuster rule in the Senate has frequently been used to derail reform efforts with broad-based support.[5] Such institutional rules impose checks and balances, and clearly favour the status quo over reform initiatives. Our equilibrium analysis allows us to consider the design of the welfare-maximizing institutions (e.g., constitutions) or bureaucratic protocols that restrict the politician's executive discretion, so as to remedy his inefficient risk-taking. We explore the proper amount of discretion that should be afforded to a reputation-concerned politician in office, in the form of establishing a standard for "qualified" reform. An "institutional status quo bias" emerges endogenously in the optimum, in the sense that socially beneficial reform may have to be rejected.

Assume that a generally defined "legislature"—e.g., parliament, supreme court, advisory committee, or board of directors—regulates and monitors the policy choice of the politician. The legislature abides by a "constitution" that is embodied by a threshold rule: It prohibits reform unless the intrinsic value of the reform proposal exceeds a threshold. A higher, or more conservative, threshold rule exercises two effects: (1) a direct *prohibition effect*, which limits the set of qualified reforms and prevents both types of politicians from moving forward with their initiatives, and (2) an indirect *pressure-relieving effect*, which further leads the low type to refrain from undertaking reform even if such reform is not expressly forbidden. We show that the social optimum requires a proper level of institutional status quo bias such that the optimal threshold rule must thwart otherwise beneficial reform. Our analysis lends support to the institutions or bureaucratic rules present in various organizations that restrict the ability of politicians or bureaucrats to carry out risky activities at their discretion. It also provides an alternative rationale for the often observed organizational resistance to policy reform and the widely discussed bias toward the status quo, in addition to those provided in the literature—for instance, that by Fernandez and Rodrik (1991).

Our framework, with moderate variations, allows us to explore the ramifications of information transparency as an institutional element. We consider two types of transparency: "decision transparency" and "consequence transparency." The former allows the public to learn more about the politician's choice set in making policy choices, i.e., the values of foregone reform opportunities that the politician decides not to implement. The latter allows the public to more precisely evaluate the politician's performance in his reform. The two types of transparency give rise to contrasting welfare implications. A higher level of decision transparency exacerbates the adverse incentive problem caused by reputation concerns, which compels the low-type politician to take more risk to avoid even more unfavourable inference. As a result, it harms social welfare. A higher level of consequence transparency, in contrast, disciplines the low-type politician, and therefore is always beneficial.

The paper is organized as follows. In Section 2, we discuss the related literature. In Section 3, we set up the model. In Section 4, we characterize the model's equilibrium and present comparative statics of relevant environmental factors. In Section 5, we discuss the welfare implications of our equilibrium results and consider institutional design. In Section 6, we conclude. For brevity, all proofs are collected in an Online Supplement.

2. Relationship to the literature

The notion of career or reputation concerns is featured prominently in the pathbreaking work of Holmström (1982, 1999). Since then, an enormous amount of scholarly effort has been devoted to the incentive effects of reputation or career concerns in a wide array of environments, including corporate decision making (e.g., Holmström and Ricart i Costa, 1986; Zwiebel, 1995, and Brandenburger and Polak, 1996), economic agents' effort supply (e.g.,Holmström, 1999 and Alesina et al., 2007), and experts' strategic provision of advice (e.g., Morris, 2001 and Ottaviani et al., 2006). The literature reveals in various contexts that concerns regarding public or market perceptions distort economic agents' decision making. Such incentives lead economic agents to ignore their own useful information, and instead strategically manipulate the beliefs of the public or the market.[6]

Our paper belongs to the strand of career concerns literature that focuses on agents' incentives to undertake risky projects. Our paper's setup is a variation of the example introduced in Section 3.2 of Holmström's (1982, 1999) seminal paper. The common feature is that the politician's (decision maker's) talent is only relevant when the

[2] Source: Fraser Neslon, "Brown's Reputation for Economic Competence Has Gone. The Tories Should Seize the Chance." http://www.spectator.co.uk, January 23, 2008.

[3] Our analysis applies to a variety of environments, including a judge who has to decide whether to exercise his power to strike down a law, a prosecutor who has to decide whether to file charges against a crime suspect, a CEO who has to decide whether to implement an expansion plan, and a doctoral candidate who must decide whether to pursue an innovative research project.

[4] This assumption can be related to the concept of "state capacity" proposed by Skocpol (1985). She argues that ambitious reform attempts often fail because bureaucrats frequently lack the required competence to administer their reform.

[5] A recent example is the defeat of the immigration reform bill championed by President Barack Obama. See *USA Today*, December 18, 2010, "Senate blocks DREAM Act," available at http://content.usatoday.com/communities/onpolitics/post/2010/12/senate-dream-act-/1.

[6] For instance, Brandenburger and Polak (1996), Scharfstein and Stein (1990), Ottaviani et al. (2006), and Benoît and Dubra (2010) all share this feature.