The political economy of structural reform

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Why focus on PESR?

• Sentiment that there is consensus about the diagnosis/prescriptions but lack of ability to implement
• Do not oversell:
  – Lagging implementation may often reflect disagreement on objectives
  – Crisis may weaken consensus
• In any case, OECD work programme on PESR since 2005
Approaches to study PESR

• Econometric approaches
  – combining information across OECD countries, time and different structural policy areas
  – Aiming to explain either
    • Progress in structural policy as represented by indicators of policy stance
    • Probability of major reforms taking place (identified as “large” changes in indicators of policy stance)
  – Explanatory variables covering economic conditions, macroeconomic policy, political institutions, international environment, demography, interactions across policy areas, etc.
Approaches to study PESR

• Case studies
  – 20 episodes of attempts at reform
    • 2 cases for each of 10 countries
    • Restricted to 3 broad policy areas: product markets, labour markets and retirement policies
    • one broadly successful and one broadly unsuccessful
      – Note: reality proved a lot more nuanced
    • Based on the literature, large numbers of direct interviews with people involved
    • Applying an approach of “focused comparison”, posing the same questions, covering the same bases across countries
Pros and cons of different approaches

- **Econometric approaches**
  - Pro: statistical rigour, degrees of freedom to identify influences
  - Con: only quantifiable influences covered, soft/political issues cannot be covered

- **Case studies**
  - Pro: richer coverage of context, ability to deal with process
  - Con: essentially judgemental, only reform attempts covered, symmetric case selection (success/failure) excludes role of country-specifics such as political system
Overview of results

• Role of macroeconomic conditions and policies
• Role of “exogenous” factors
• Interactions, sequencing and timing of reforms
• Political process
• Dealing with winners and losers
Macroeconomic conditions and policies

- Recessions/crises are good for reform [SLIDE]
- The role of unemployment is ambiguous
  - Little effect on average, good for major reforms, inconsistent effects at a detailed level
- Healthy government finances are good for reform and ongoing consolidation is bad
  - Ability to compensate losers
  - Ability to accommodate demand weakness in the wake of major reform
- Monetary and exchange rate policy
  - Conflicting arguments: TINA vs. ability to accommodate
  - Unclear empirical evidence: some signs that a fixed ER (single currency?) reduces the probability of major reform
Downturns lead to progress in labour and product market reform

(Annual percentage reduction in structural rigidity index)
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Fiscal policy and progress in labour and product market reform

Annual percentage change in synthetic indicator of labour and product market policy

- Total sample average (1985-2003, 21 countries)
- In periods following fiscal expansions
- In periods of government budget balance or surplus
Reform score and fiscal consolidation

Source: Case studies.
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Initial conditions and intensity of labour market reforms over 1994-2004

Ranks of initial NAIRUs and ranks of reform intensities: EMU countries

Ranks of initial NAIRUs and ranks of reform intensities: non-EMU countries

(Spearman’s rank) correlation coefficient: 0.19

(Spearman’s rank) correlation coefficient: -0.55
Role of “exogenous” factors

- Small countries may undertake major reform more easily
  - Homogeneity of population?
  - External trade as a shock absorber? [SLIDE]
- Ageing may not lead to greater conservatism
- International influences affect reform
  - EU membership, Single Market, reforms in trading partners, trade liberalisation tend to boost domestic product market reform (with ambiguous effects on labour markets). Confirmed in case studies.
Simulated unemployment adjustment to drop in the NAIRU
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Interactions, sequencing and timing of reform 1

- There is a pattern of sequencing running from “external side” over domestic product markets to labour markets
  - May reflect competitive pressures and rent destruction [SLIDE]

- Whether “bundled” or not, individual reforms tend to be easier to advance against the backdrop of a broad on-going reform process.

- More haste can make for less speed: complex reforms take time to design and adopt, as well as to bear fruit.
Changes in product market regulation over 1993-1998 and intensity of labour market reforms over 1999-2004*

Overall labour market reform intensity, per cent

Change in OECD index of product market regulation in non-manufacturing industries

Correlation coefficient: 0.40

T-statistics: 1.91 *
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[SLIDE]
Reform score and speed of reform

Source: Case studies.
Interactions, sequencing and timing of reform 2

- *Delay* can raise the cost of reform, but reform can be harder if a policy regime is not “ripe” for change.
- *Limited early reforms* can generate momentum for further reform. [SLIDE]
- Where elements of a reform are to be implemented with a delay, it helps to render them as “*automatic*” as possible.
Reform scores and reform history

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Political process 1

- **Electoral mandates** matter (particularly for pension and EPL reforms). “Reform by stealth” is rarely a promising strategy.[SLIDE]

- The *electoral cycle* appears to give newly elected governments an opportunity (most clear for labour-market reforms, least for pension reforms). But regression analysis finds more progress under mature government – possibly reflecting implementation lags.

- Government *cohesion* is key: it appears to matter more than the size of a government’s majority or the state of the opposition.

- “*Ownership*” of reforms is important: reform “orphans” are rarely successful.
Reform mandates and reform score

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In general, the government’s ideological orientation seems to matter little for the success of reform, though labour-market reform may be easier under a government of the left – sometimes it may “take a Nixon to go to China”. But regression analysis suggests that less labour market reform is done under left-wing governments.

There is little to support the view of sub-national governments as less reform-oriented than national governments, but neither are they always more reformist: the question of when and where decentralisation aids reform is highly issue- and context-dependent.
Communication, consultation and analysis

- Effective *communication* is critical, particularly for pension and EPL reforms.
- Public understanding of the costs of the *status quo* is often critical – and can be difficult to achieve when these are opportunity costs.
- Good and credible *analysis* of the costs of inaction/gains from reform is often crucial. Specialised "*reform institutions*" can be helpful in this regard.
- *Concertation* can have its advantages but also disadvantages.
Dealing with winners and losers

- *Involving potential opponents* may facilitate adoption of reforms – but at a price.

- Creating “*early winners*” or *new actors and institutions* early in the course of a reform can help to sustain the momentum behind it. [SLIDE]

- “*Acquired rights*” cannot easily be violated. Often this requires exempting some groups from the reform, but this is not always feasible.

- *Potential losers* are more likely to mobilise than potential winners, except in the case of some product-market reforms.

- Resistance tends to increase with the “*political cost-benefit ratio*” – the relationship between a reform’s redistributive impact and the efficiency gains it yields. This can be especially important when reforming product markets.
Reform score and emergence of new actors

Source: case studies.
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