How to Gain Political Support for Reforms?

by

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Executive summary

During the last thirty years, OECD countries have experienced a large number of structural reforms in several crucial sectors of the economy, such as the labour and product markets, and the welfare state. Most of these reforms went in the direction of liberalizing the product market; reducing rigidity in the labour market; and decreasing the generosity of the welfare state to contain pension spending. Alongside this movement of reduced state intervention, many governments also reduced their involvement in production, through privatisations. In particular, liberalisation and privatisations were central in transition economies, where government intervention used to be extensive under communism, and firms were state owned as a rule.

Alongside this liberalisation trend, other reform measures aimed at maintaining the generosity of the public pension system, at preserving the level of employment protection for some categories of workers, or at increasing the coverage provided by the unemployment benefit schemes (see Chapter 2). Although this ambivalent approach may appear contradictory, many of these measures may actually have been introduced as compensating measures; to obtain public support for the former reforms, through a "quid pro quo" exchange. Finally, some "protected" markets were left virtually untouched by the reform process; and some reform efforts turned out to be simply unsuccessful, as some reform proposals were turned down due to the strong opposition of some crucial economic, social and/or political forces.

The aim of this report is to explain why these different patterns emerged in the OECD countries. Why did crucial sectors of the economy undergo major liberalization, while no reform was implemented in others relevant non-manufacturing services? Why were structural reforms aimed at retrenching the welfare state carried out in some countries – such as Italy, Sweden and the UK– and not in other countries, equally in need of reforms, such as France and Germany? Why was Employment Protection Legislation, which leads to rigid labour markets, relaxed in Spain, but not in Italy? Why were state-owned enterprises privatized in some countries or sectors, but not in others? Our analysis isolates the political economy factors that have lied at the heart of both successful and failed attempts at reforming these markets.

By studying the process through which these (sometimes aborted) reforms went, we provide some answers to these crucial questions, and address the issues faced both in Western and in Eastern European Countries. Reform processes undergo several important stages –beginning with the initial motivation for a reform to its final implementation, when the process proved successful–, which eventually determine its political success or failure. As we show, the path to reforms may vary according to the economic sector featuring the changes or the country where the reform is debated. We thus identify both common and specific elements of this process.

The initial step corresponds to identifying what triggers the reform. Why do some reform measures become a debated issue in some specific sectors of the economy or countries? And, more importantly, why does a relevant political player, such as the government, or a Party or a Minister, ever decides to commit its political capital to push forward this reform? In the following chapters, we apply a "case study" analysis to different structural reforms and countries. This analysis suggests that several *different* reasons may initiate a reform process. One of the important lessons of our exercise is that there cannot be a unique answer to these questions, and no "one size fits all" policy recommendation to be drawn. On the other hand, our case study approach provides guidance as to which are the relevant “framework conditions” that a reformer must address to make his or her reform attempt successful.

A first, purely economic, driver of reforms is found to be the need of correcting large inefficiencies that emerge in specific markets or economies, for instance when the existing legislation is not any longer consistent with the current economic environment. This mismatch is typically due to technological developments or trade liberalization. This occurrence turned out to be recurrent in the product and labour markets. In other instances, structural reforms are instead triggered by emergency situations. This is the case for instance for the Italian season of pension reforms of the 1990s. A second driver of reforms is ideology. That is, as suggests our analysis, the demand for reform can be essentially politically driven in some occasions. When the political system permits, these ideological motivations may induce a shift in the balance between private and public ownership, or to a shift in the degree of state intervention in the economy. Many reforms led by the Thatcher governments in the UK, for instance, were essentially pursued by a given political Party, at least partially for ideological rather than pure efficiency reasons. Third, external constraints –such as EU policies or the commitment to join the Euro– proved a very powerful instrument to get relevant economic reforms started. Examples of the effectiveness of these external constraints may be found in the reforms of specific sectors of the product market, in the Italian social security reforms, but also in the different experiences of privatizations enjoyed by transition economies, as the prospect of future EU membership helped governments build commitment and pursue efficiency-enhancing privatization efforts.

Even when relevant political players, such as leading Parties or the government, are convinced of the need of structural reforms, however, a further crucial step has to be taken on the path to their actual implementation. Structural reforms often have to overcome strong popular opposition –typically due to the existence of vested interests that may lose from the reforms or to the ex-ante uncertainty on the identity of these winners and losers. This opposition is channelled to the political, social, and economic arena differently, depending on some characteristics that are specific to each country (including for instance the system of political representation).

Hence, political actors committed to structural reforms have to undertake a *coalition building* effort, in order to gain sufficient popular support for their implementation. The scope for coalition building and the extent of the consensus needed to implement a reform depends on the framework conditions facing the government, as well as on the determinants that initially triggered the demand for reform. In fact, the seminal reason for reforming –economic, political or external constraints– must be used by the committed government to generate momentum and to gather sufficient endorsement to reform. Framework conditions will however define the government's authority within the institutional political system, and hence its leeway to reform. They also determine the identity of the main actors who can interfere with the reform process, which will typically depend on the status quo of the scheme or market to be reformed. These framework conditions prove crucial, since the actual implementation of successful reforms is typically shaped by the political requirements of forming sufficiently large political coalitions and of "buying out" the opposition of relevant veto players.

Thus, to repeat, our "case study" analysis in the following chapters suggests that there is no unique recipe to implement structural reforms. Although several common lessons are learnt from these reform episodes, we also observe that framework conditions in the different markets and countries tend to lead to a rather market- or country-specific packaging of politically successful reforms. For instance, our analysis of the labour market and of the welfare state illustrates that clearly defined groups with vested interests –namely, insiders for the labour market, and retirees for the welfare state– emerged in opposing the reform measures. In consensus democracies –such as Denmark, Italy and, to a lesser extent, Spain– the packaging and the pace of reforms had to be targeted to circumvent opposition; to buy out approval by the unions that represent the interests of these groups. Long transition periods, which effectively sheltered middle-aged workers and retirees from the effects of pension reforms, were engineered in the Italian pension reforms. Gradual, piecemeal, labour market reforms were implemented in Spain, to reduce their impact on tenured workers. In these occasions, the pace of the reform process was rather slow, but the large public consensus ensured wide political support for the reforms, and hence reduced the risk of reversal. The experience proved different in majoritarian countries, such as the UK. Under that type of political representation system, governments face little resistance. Therefore, reforms can be more sudden and radical in majoritarian countries, as shown by the Thatcher experience in the UK, which included the 1986 pension reform and the privatisation of several major state-owned enterprises. These reform measures clearly hurt some fringes of the population but were used by the conservative government of Mrs Thatcher to build stronger support for the Tories in the middle and upper classes of the population. Yet, the lack of a widespread popular consensus led to the subsequent reversal of some of these reforms. Some of the Thatcher pension reforms, for instance, were challenged in the following decade, as it become clear that their economic efficiency was questionable. This “learning by doing” led to these measures being largely modified (reversed) by the 1999 Blair pension reform.

By contrast, the process of reforms is less contrasted across political systems when *product market* reforms are concerned. The essential reason may be that the interest groups that emerge there, are less clearly divided along the ideological party line. Vested interests cross the left-right, worker-employer division lines, and develop instead converging incentives. Workers and employers, blue and white collars, bureaucrats and consumers, therefore tend to join their forces in many non-manufacturing industries. In these markets, the packaging of successful reforms seem to follow a “divide and conquer” strategy, as targeted changes to existing regulations may lead to the separation of entrenched vested interests. To achieve these ends, the pace of the reform ought to be slow; it must create the conditions for a smooth and continuous reform process rather than appeal to a big-bang reform. Sometimes, this process also calls for reforms in other markets. Our analysis suggests that reforms on one market –for instance the product market– may well spill over to other markets –such as the labour market– both by helping to create the political momentum and by modifying background economic conditions.

Interestingly, the reform experience of transition economies largely differs from those in OECD countries. External constraints played a stronger role, as most reforms were inescapable. Moreover, transition countries had to establish simultaneously the role of economic and political governance. We review the various mass privatisation programs that occurred in transition economies, and show that many were precisely designed to target political motives, rather than purely economic efficiency ones. To exemplify the role of political governance and external constraints, we also detail the privatization of the main Czech and Ukrainian car makers. That case study clearly illustrates that, while the prospect of a future EU membership allowed the Czech government to commit to an efficient privatization plan, the excessive freedom of action of the Ukrainian government led to the protection of particular lobby groups and politicians, at the expense of the population at large. Similarly, the power vacuum after the collapse of the Soviet Union largely explains the failure of many reforms in Russia. In Russia as well, weak legitimacy made the Yeltsin government vulnerable to the support of special interests, and led to the capture of state decisions. A distorted corporate and regulatory governance system, in which strong interests sought to maximize and secure short term gains, produced a massive build-up of non-payment, tax evasion, and barely conceived asset theft. Moreover, the failure to restrain these non-cooperative strong interests had a reinforcing impact on the perception of poor legitimacy and credibility, leading to diffused non-compliance, cash-stripping and rational collective non-payment, and eventually to a fiscal and banking crisis.