

fondazione RODOLFO DEBENEDETTI
“Structural Reforms without Prejudices”
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discussion of:

How to win political support to reforms?

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Political economy of reforms from an empirical perspective

- The objective of the reform or “What we know that (possibly) ain’t so” (Rodrik, 2003, Easterly, 2001):
 - The growth record is consistent with some of the *higher-order* economic principles. A semblance of property rights, sound money, fiscal solvency, market-oriented incentives (Summers, 2003).
 - BUT “higher-order principles of sound economic management do not map into unique institutional arrangements”
 - China dual track approach with *agricultural liberalization at the margin*;
 - South Korea and Taiwan no trade liberalization until mid 1980s and heavy reliance on public enterprises and extensive industrial policies
 - Japan *team-centered approach to work organization* with lifetime employment in core firms
 - Latin America: Liberalization, deregulation and privatization → very little acceleration in growth.
 - ...and “there may be multiple ways of packaging these principles into institutional arrangements”

OECD countries : commitment and coalition building

- **“Back against the wall: prolonged periods of weak or negative growth and high UR promote reforms (Elmeskov et al. 98; IMF '04 WEO, but also Rodrik, '96; Drazen and Easterly, 2001).**
- **Majoritarian → ambitious reforms but greater risk of reversal; proportional → moderate and gradual changes low risk of reversal (WEO, Persson, 2003)**
- **Potential to exploit complementarities within policy areas (e.g. tax cut + reduction in unemployment benefits, Orzag and Snower, 98) or across policy areas (product – labor market, Blanchard & Giavazzi, 2002; macro and labor, Bean 98 and Calmfors 98 for EMU).**
- **Room in the budget to accommodate compensation packages in labor and tax reforms (primary surplus +ve; fiscal adj. –ve)**

The main messages of this report

- No “one size fits all” policy recommendations can be drawn: market or country-specific packaging of politically successful reforms
- “Relevant framework conditions” are essential for the success of reforms
- A case-study approach instead of generalized guidelines
- The commitment building:
 - Large inefficiencies
 - “Emergency” situations
 - Ideology
- Coalition building
 - Consensus democracies: buy out approval of opponents → long transition periods
 - Majoritarian countries: can implement more sudden and radical reforms
- “Divide and conquer”: in certain markets (e.g. product market), vested interests cross traditional interest groups. A successful strategy ought to separate the entrenched vested interests → gradualism is essential
- External forces: international agreements, technological developments are important devices for efficiency-enhancing reforms

I will discuss three case studies: 1) pension reforms in Italy and UK; 2) Labor reforms in DNK and Spain; and 3) Product market reforms in OECD

How to rationalize the welfare state: pension reforms in Italy and UK

➤ The commitment building:

- Italy: external forces (Maastricht Treaty; large speculative attacks on the Lira) which imposed the downsizing of the generous public pension system (pension expenditures ~ 12% of GDP in early 1990s)
- UK: Ideology (the “Thatcherite”) and strong majority

➤ Coalition building

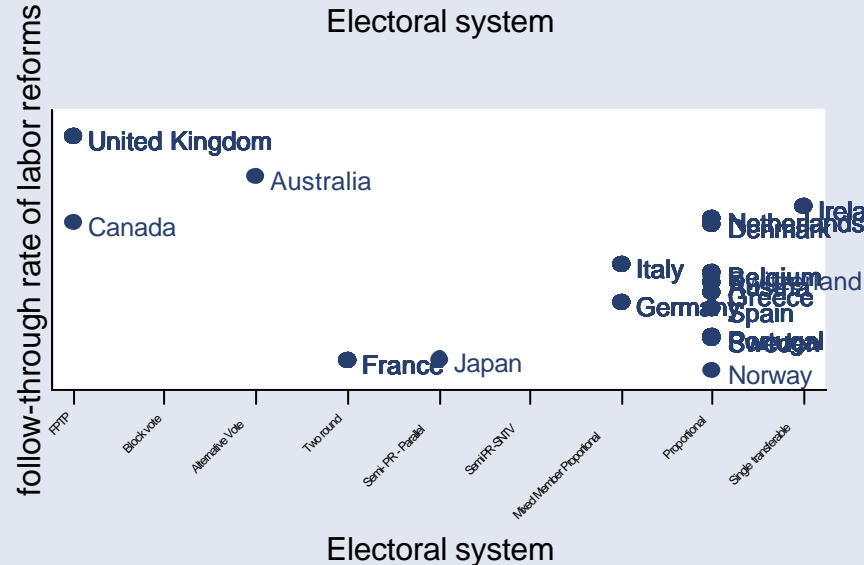
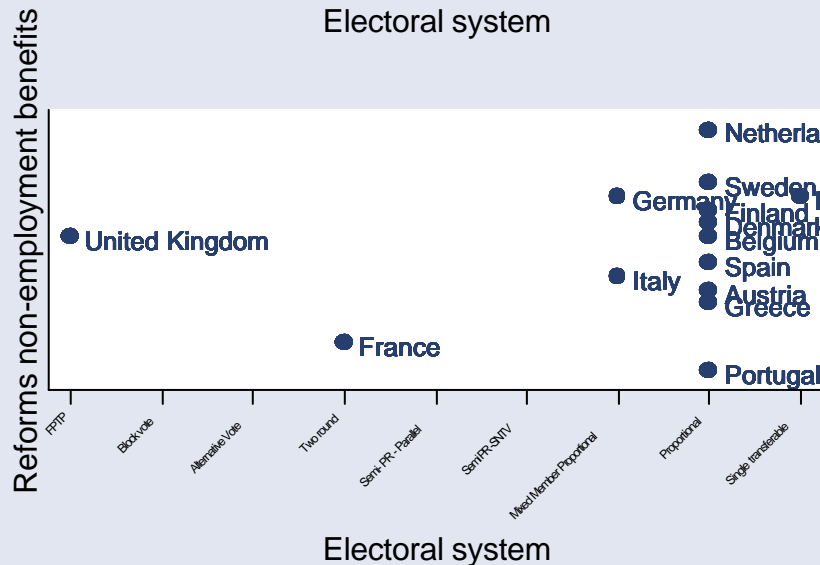
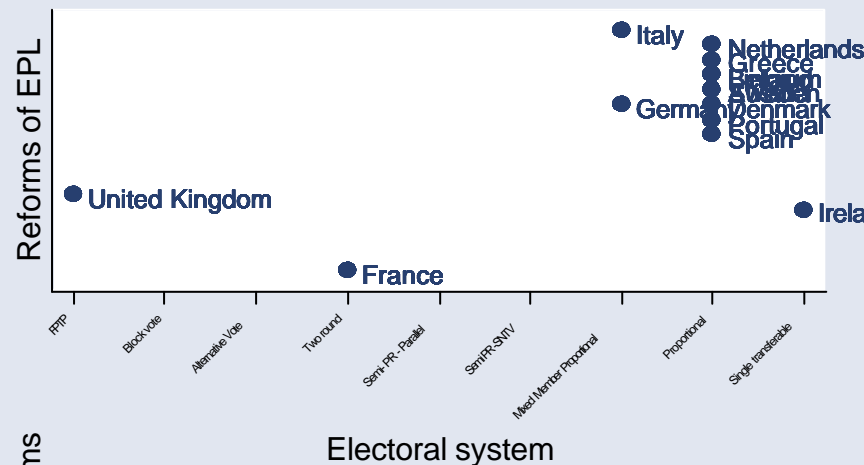
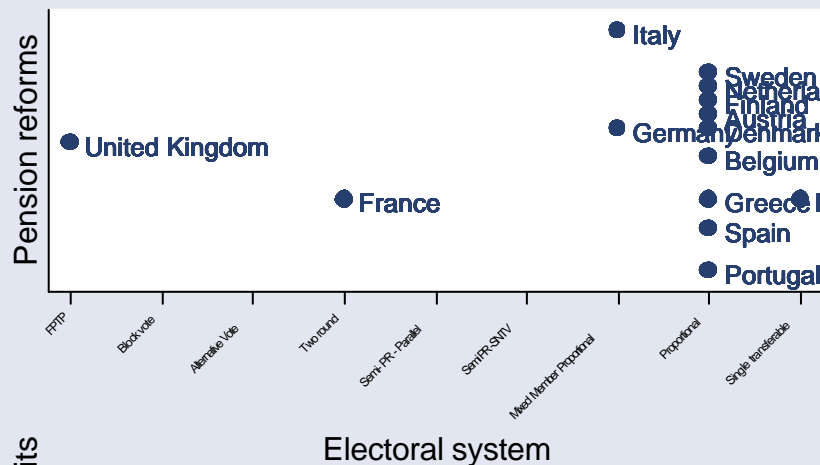
- Italy: long transition period that sheltered insiders from the effects of reforms
 - But the change of indexation from nominal wages to inflation (Amato 1992) affected all pensioners: i.e. at 2% LP growth -30% in leaving standards in 20 years
- UK: strong majority reduced the need for building a consensus behind the reform

➤ Lessons:

- Gradualism or long transition periods are needed to buy support from insiders
 - Yes, but how to ensure consistency in the reform path and credibility
- Are majority electoral systems necessary and sufficient conditions for implementing social security reforms?
 - NO: Italy moved to a more majoritarian system in 1994 , since then Italy had 7 governments in 8 years
 - More generally there is much more variance in social security reforms that there is in the electoral systems in Europe, and some majoritarian countries have been much less pro-reforms than many proportional system countries.

Is there a link between electoral systems and structural reforms?

Structural reforms and the electoral system
FRDB or OECD (Labor Market) reform indicators and electoral systems



How to rationalize the welfare state: pension reforms in Italy and UK

- UK and Italy fit well in the “back against the wall” hypothesis
 - UK in the early 1980s (“Winter of Discontent”, large fiscal deficit, high inflation and 12% UR etc. – Bean and Symons, '89 “Ten years of Mrs. Thatcher”)
 - Italy, devaluation, generalized perception of large gaps from Maastricht criteria leading to not only the pension reforms but also wage agreements and other reforms.

Labor market reforms: Denmark and Spain

The commitment building:

- Both DNK and ESP suffered from high unemployment in early 1990s
 - BUT DNK max UNR ~10% ('93) in Spain ~ 23% ('94)
- DNK “flexicurity” focused on reducing generosity of UBs; Spain reduced EPL
 - BUT DNK maintained very generous UBs and reinforced “activation” of LTU; unions co-manage UI funds; Spain made several attempts to reform EPL (since mid 80s)

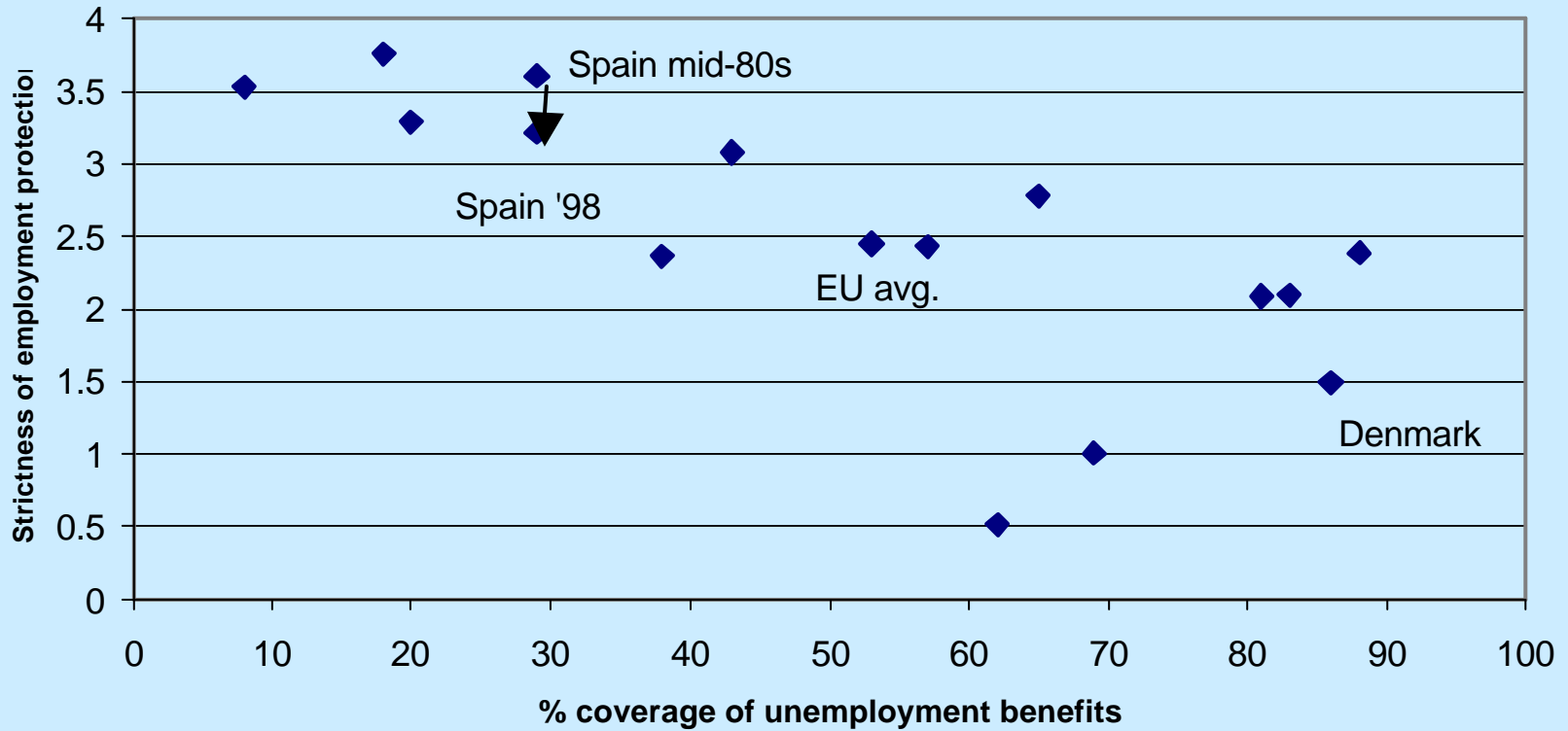
Coalition building

- Given proportional representation systems, both countries built support from social partners through social dialogue
- In DNK in 2001, government failed because it did not seek support from social partners

Lessons:

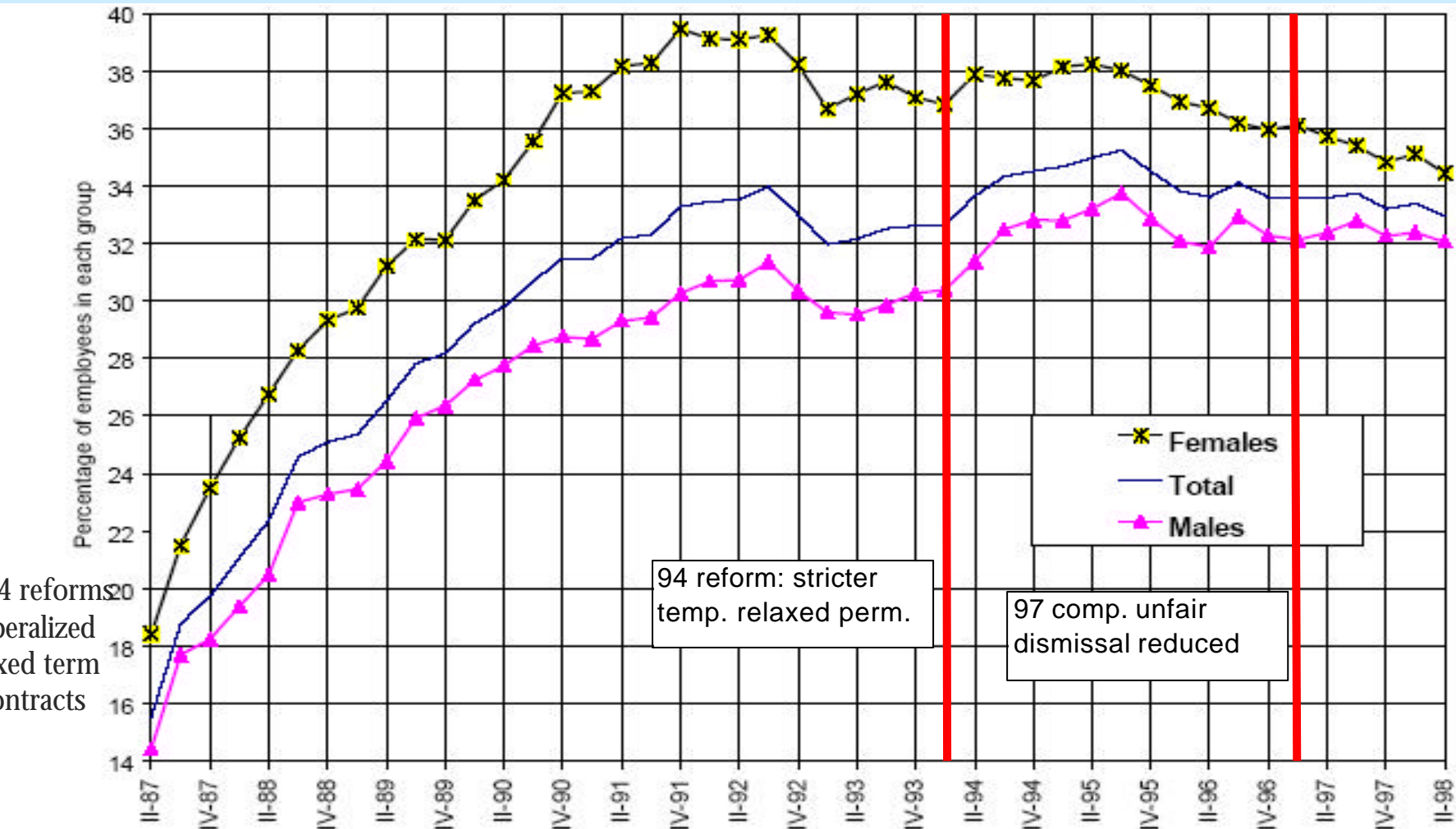
- The importance of involving social partners to build support for structural reforms
 - YES, true in many other European countries; the best example is the Netherlands with the Wassenaar agreement of 1982 (see e.g. Nickell, van Ours, 2000) → but with more than a decade of stagnant real wages
 - BUT, what if social partners are not highly representative, fragmented etc., but still very vocal? e.g. Latin America (Heckman and Pages, 2004; Pencavel, 1996)).
- Learning by doing: The EPL reforms in Spain in mid-90s were preceded by other (unsuccessful) attempts to liberalize the labor market: '84 liber. temporary contracts; '94 tightening of temp. contracts; '94 adv. advance and procedure perm. relaxed; '97 compensation for unfair dismissal reduced...
- Exploit complementarities (e.g. Orzag and Snower, '98): DNK reinforced the principles of “flexicurity”; the UBs reform (generosity increased in previous 2 decades) was perceived to increase fairness → stricter eligibility conditions including activation of unemployed

Protecting jobs or protecting workers



Asymmetric reforms in LM can reinforce dualism in the labor market with limited effects on adaptability

The evolution of temporary employment in Spain - 1987 - 1998



4 reforms
generalized
fixed term
contracts

Reforms in non-manufacturing sector

The commitment building:

- Partly exogenous:
 - Technological advances
 - Pressure from other markets (e.g. manufacturing)
 - External commitments (treaties, Single Market; EC directives)

Coalition building

- To un-bundle private interests. Targeted changes can open up opportunities for market players, breaking up entrenched coalitions.
- “Band wagon” effects: reform in one sector spills over to other sectors
- Pay attention to interaction with labor: lower rents promote reforms in labor, but strong labor may oppose reforms

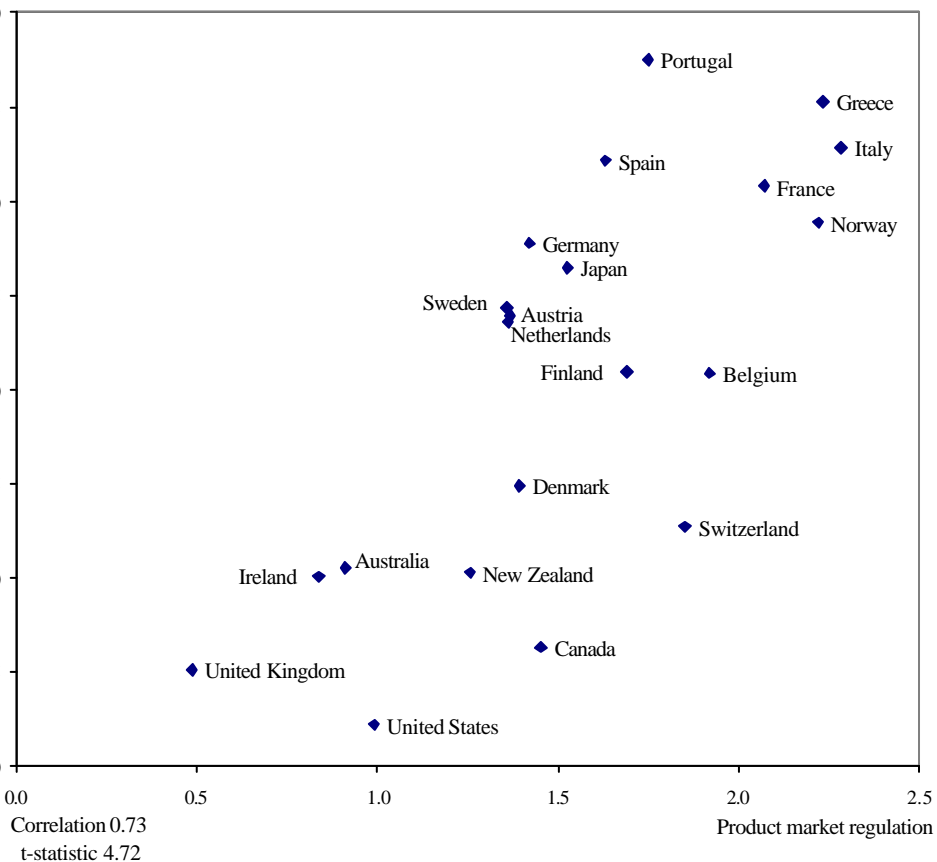
Lessons:

- Piece-wise reform strategy leads to progressively larger areas of liberalization
- Framework conditions important:
 - eliminate price distortions – countries with larger distortion postpone reforms
 - “phase out” institutions that provide voice to special interest → new independent regulatory authorities; insure application of national policy locally (how??)
 - reinforce pro-reform voice (how ???) communication strategy
- But also: Exploit possible interactions between reforms in product and labor markets: PM reforms may promote unions’ behavior more conducive to growth and job creation (Calmfors, 93); LM reforms may enhance the effects of PM reforms on labor (Blanchard & Giavazzi, 02); there could be synergies (Coe & Snower, 97)

PM and LM regulations are closely correlated, and reforms often go hand in hand

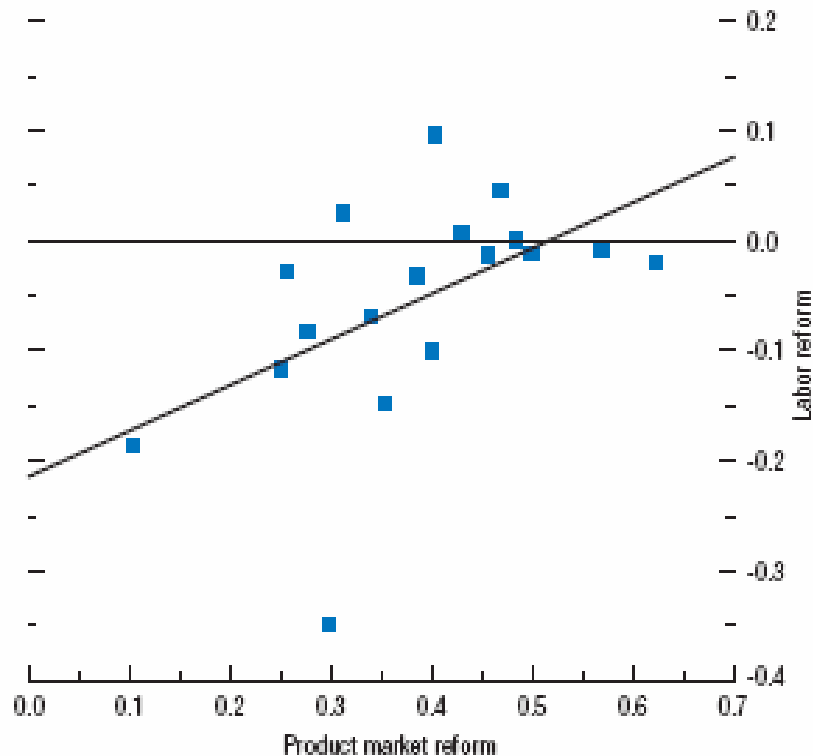
Product and labor market (EPL) regulations- 1998

employment protection legislation



Product and labor market (EPL) reforms – 82 - 98




Product and labor market reforms tend to go hand in hand.



OECD indicators of product market regulations and employment protection legislation.

Entry costs or barriers to expansion?

The role financial markets, labor markets and integration, evidence from firm-level data (1989 –1995)

Average employment gains of surviving firms:  after 2 years
 after 4 years
 after 7 years¹

Total economy

