

# **The political economy of structural reforms: Lessons from Europe**

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**Presentation prepared for the Seminar on Small Middle-Income Countries—Raising the Bar**

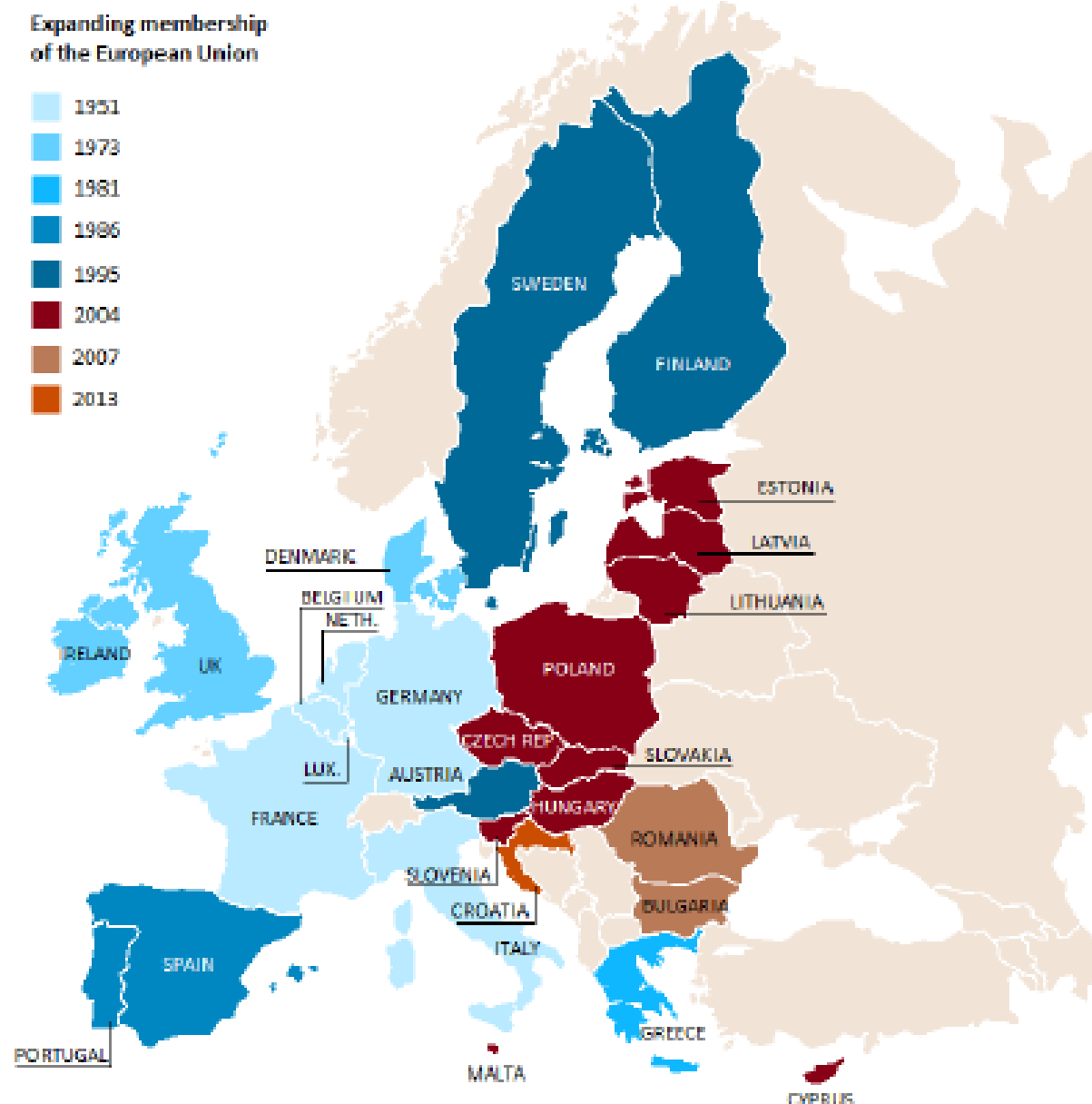
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# The EU as a laboratory

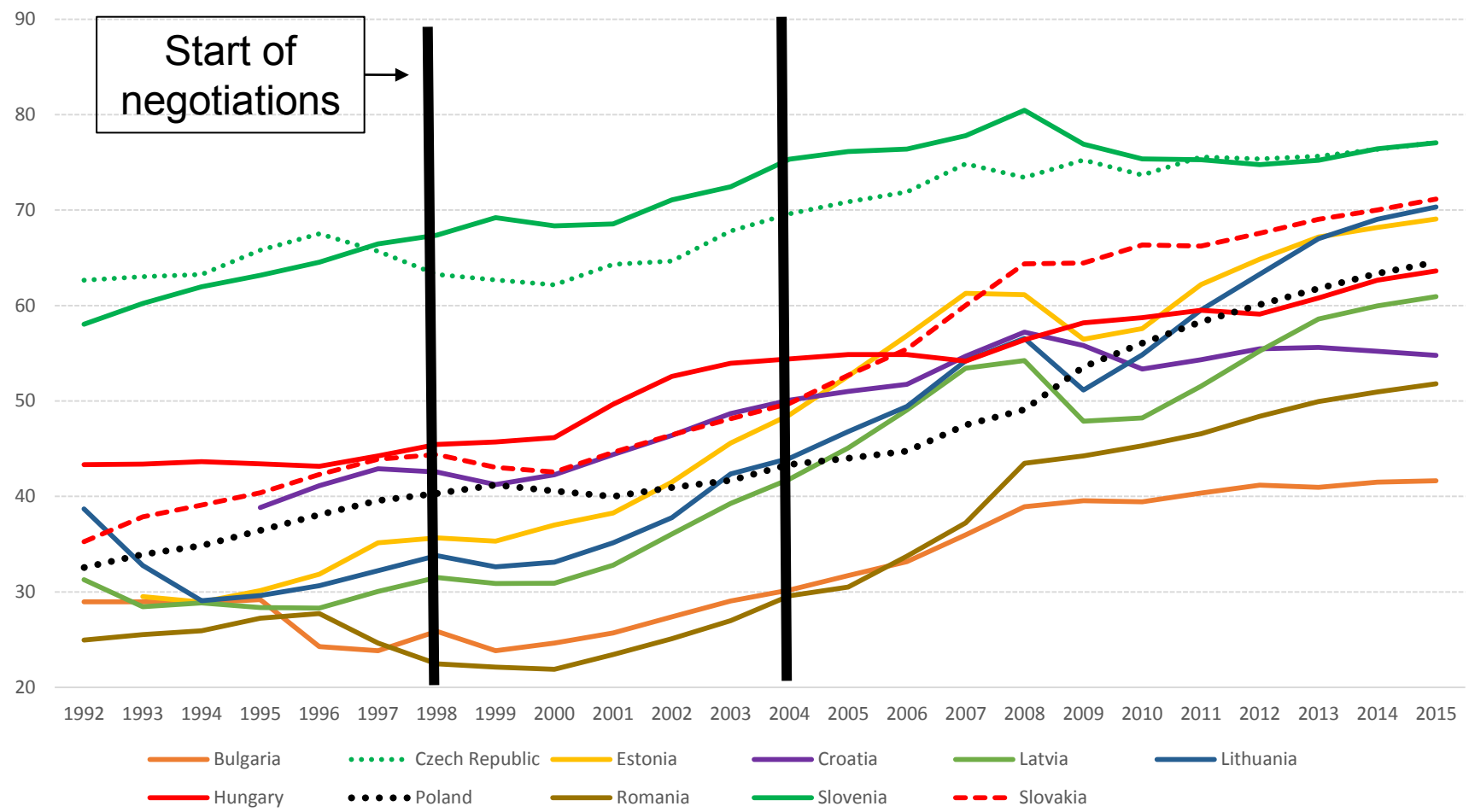
- With 28 members, lots of diversity in performance
  - » Growth trajectories, GDP per capita
- From accession members share important product market policies which have fostered crucial structural reforms and convergence
  - » Single market: free trade inside the EU
  - » Trade policy: liberal trade with countries outside the EU
  - » Competition policy: antitrust and state aid control
- But members have significant diversity in other relevant structural policy areas which explains their diversity in performance
  - » Regulatory and governance quality
  - » Labour market and social policies

# From 6 to 28 members, with increasing heterogeneity

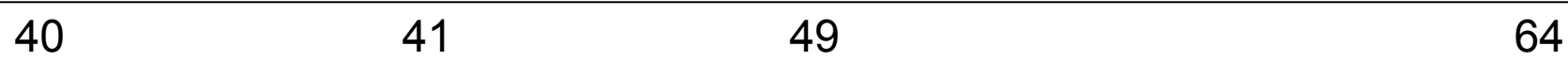


# Convergence in the 11 Central and Eastern European Countries who joined the EU in/after 2004

(GDP per capita at PPP, EU15 =100)

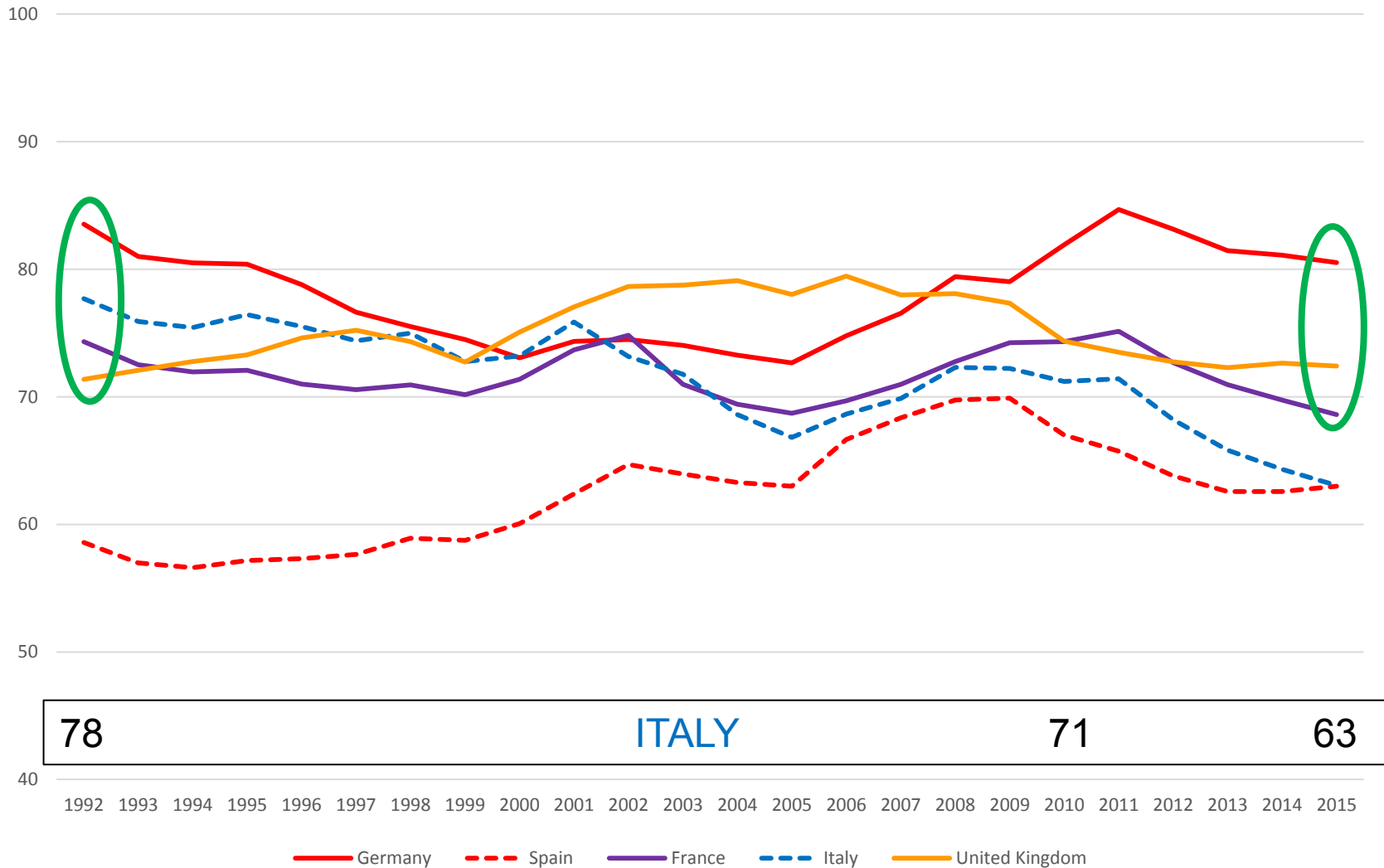


Simple average for the 11 countries



# But the EU15/US gap is not closing - Large countries

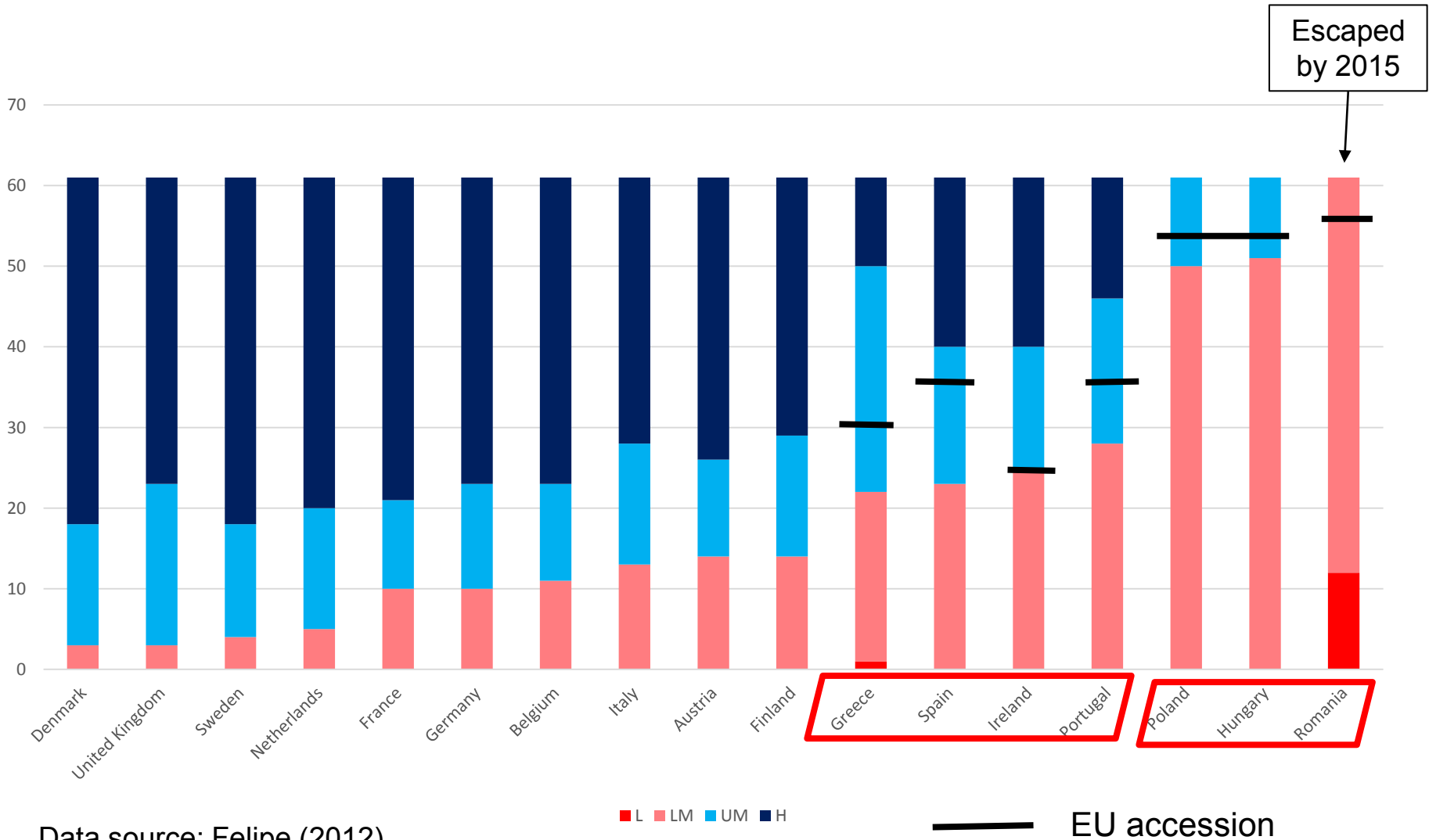
(GDP per capita at PPP, US =100)



# Escaping the middle income trap

## GDP per capita growth trajectories, 1950-2010

(selected EU countries)



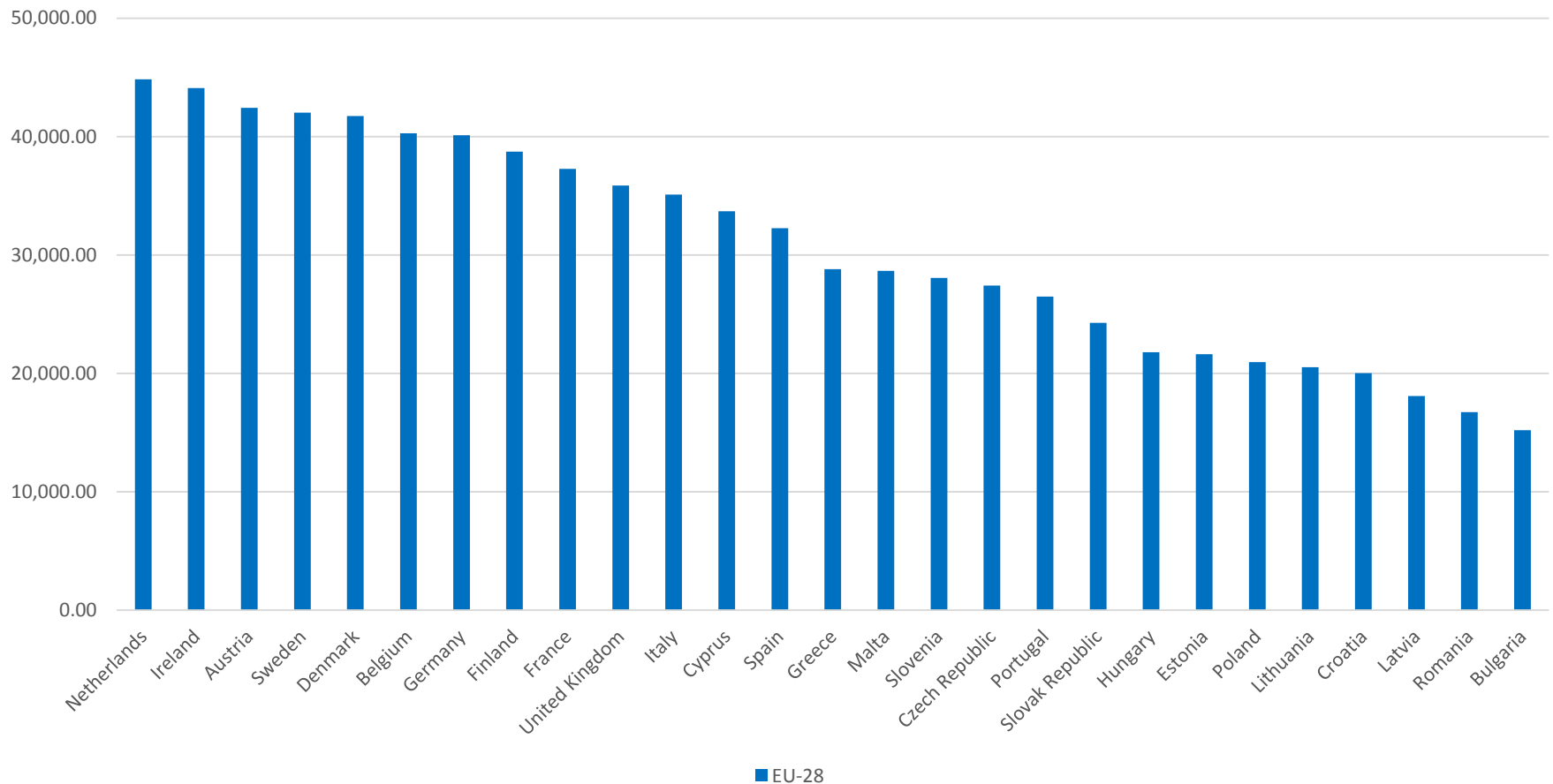
Data source: Felipe (2012)

■ L ■ LM ■ UM ■ H

— EU accession

# Despite convergence, GDP per capita still varies a lot

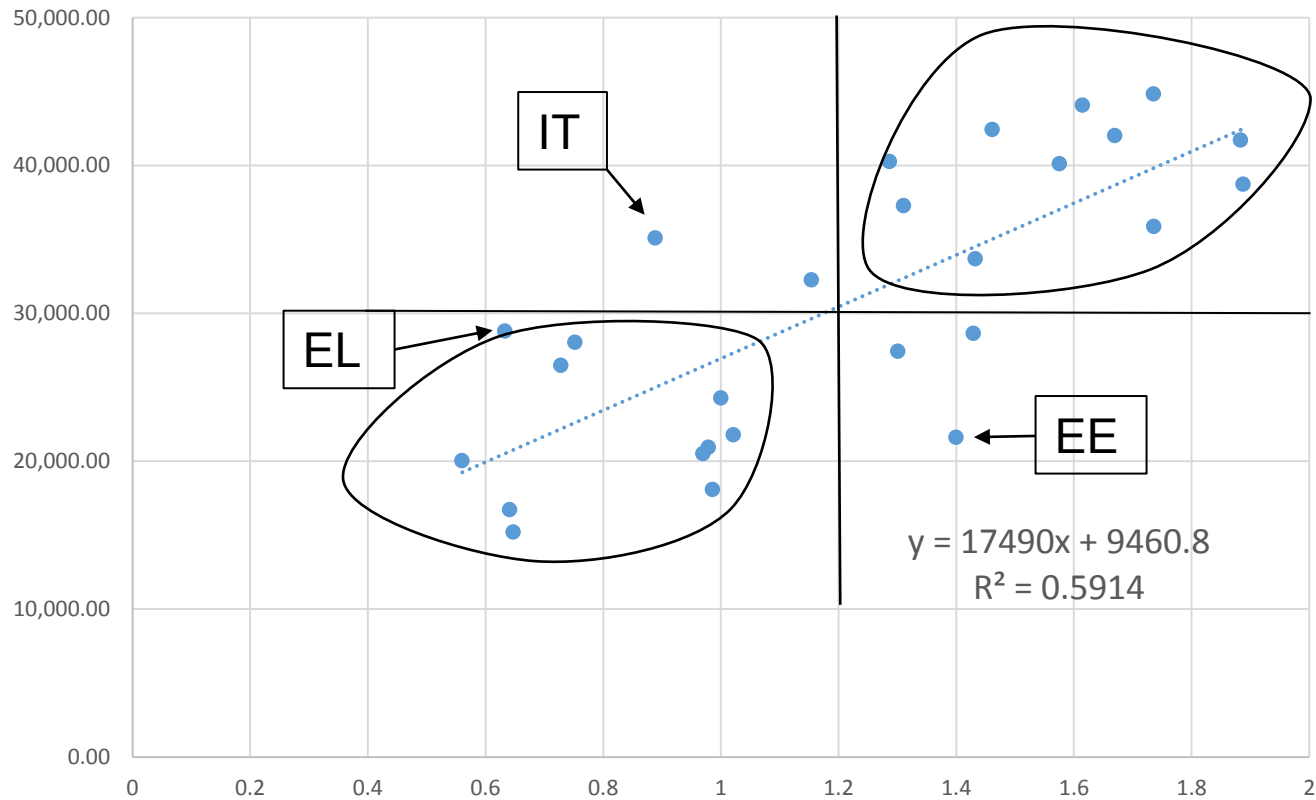
(EU28, excl. Lux, PPP\$, 2010)



# GDP per capita strongly correlates with regulatory quality

## EU28 (excl. Lux)

GDP per capita, 2010



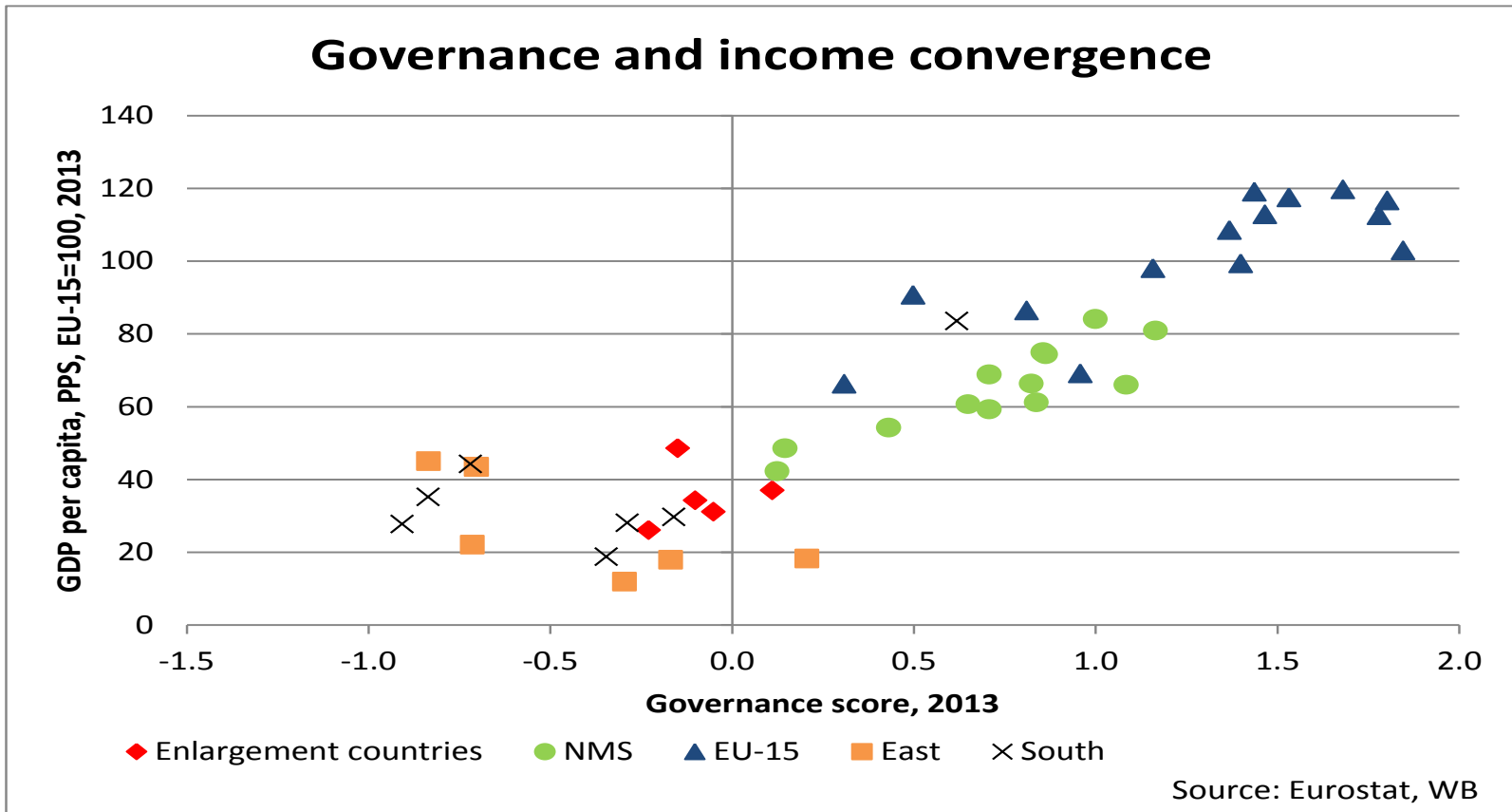
Correlation coefficient  
= 0.77

Regulatory quality, 2010



# Same result with WB governance indicator

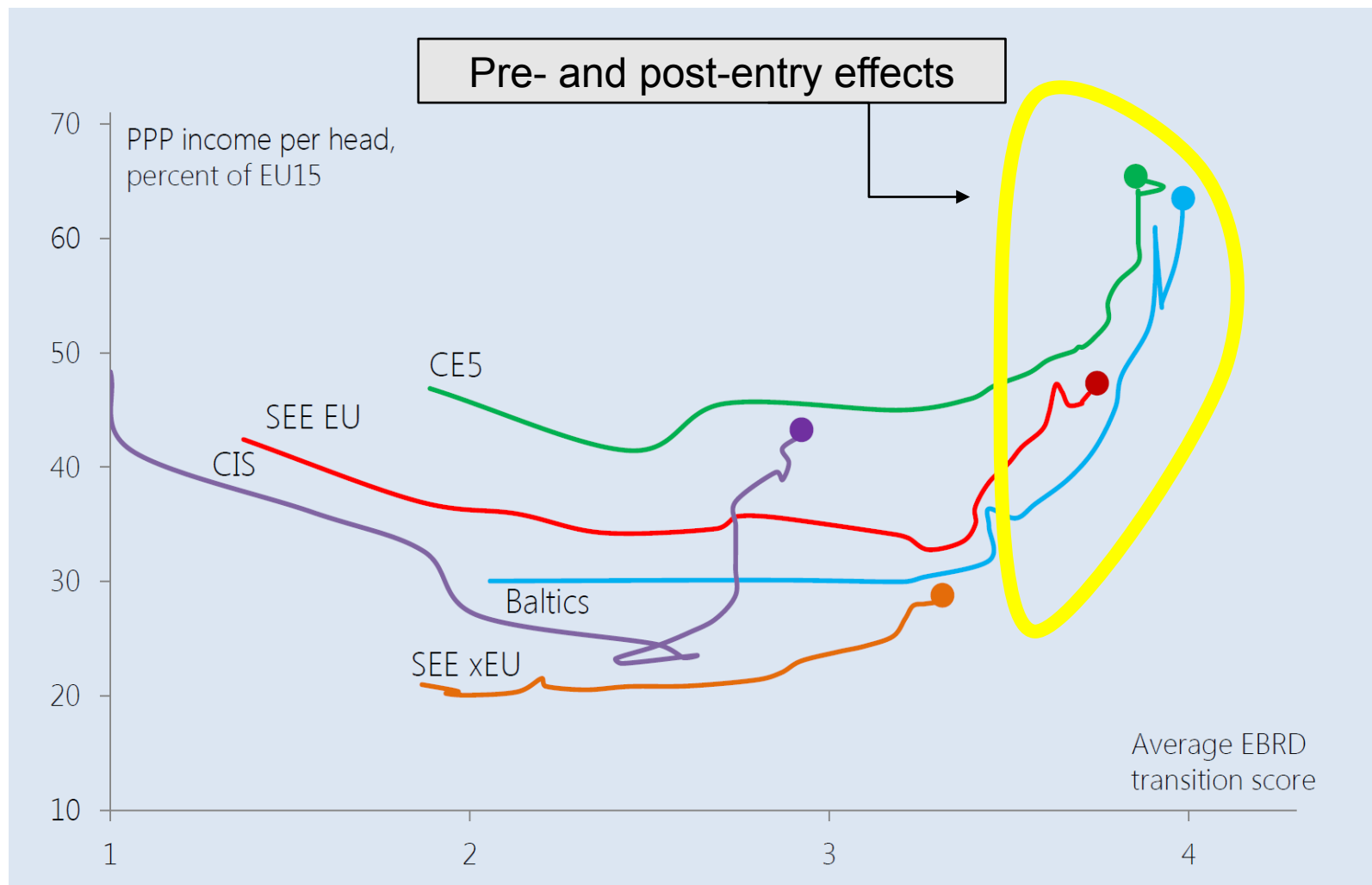
## EU27 plus neighbours



## Reform process: EU and national levels

- EU level reform process worked very well **before EU entry** and delivered strong results in terms of convergence **after EU entry**

# Reform and convergence in Europe's transition countries



Source: IMF presentation on 25 years of transition

# Reform process: EU and national levels

- EU level reform process has been more difficult **otherwise**
  - » League tables and peer pressure are helpful, but...
  - » EU Country specific recommendations (similar to OECD's Going for Growth and IMF's Article IV recommendations) also helpful, but...
  - » Typically more effective in small than in large countries, and in more than less open economies
  - » SEE OVERVIEW TABLE OF 2015 CSR

# Overview of 2015 country specific recommendations

	Public finances and welfare systems				Financial sector		Labour market			Product and service markets		Education	Social inclusion	Administration	
	Public finances	Taxation	Pension system	Healthcare system	Banking and access to finance	Housing and private debt	Labour market	Labour taxation	Wage-setting	Services and network industries	Innovation and business environment	Education and skills	Poverty and social inclusion	Administrative modernisation and rule of law	
AT															AT
BE															BE
BG															BG
CZ															CZ
DE															DE
DK															DK
EE															EE
ES															ES
FI															FI
FR															FR
HR															HR
HU															HU
IE															IE
IT															IT
LT															LT
LU															LU
LV															LV
MT															MT
NL															NL
PL															PL
PT															PT
RO															RO
SE															SE
SI															SI
SK															SK
UK															UK
Euro area															Euro area

**21**   **18**   14   10   11   6   **21**   8   11   13   5   13   6   **19**

# Reform process: EU and national levels

- Ultimately the EU level reform process can only act as a facilitator
- Responsibility for politically painful reforms rests with national policymakers accountable to their national public opinions

# How to make reform happen - OECD's Going for Growth

- Government **leadership** and **cohesion**, based on a strong **democratic mandate**
- Policy design backed by solid **research and analysis**, and effective communication by government
- Successful structural reforms take **time** and require **persistence**

## **Bold reforms also require a sense of national urgency that the status quo is not viable**

- EU accession acted as a successful anchor for needed reforms
  - » Southern accession: Greece, Portugal, Spain in the 1980s
  - » Eastern accession: 11 CEECs since 2004
  
- In other situations, reform followed crises, e.g.
  - » NL's 1980s "Polder Model" reforms to deal with "Dutch disease"
  - » IE's late 1980s "Tallaght Strategy" to deal with deep crisis
  - » SE's mid-1990s reforms during a severe financial and fiscal crisis
  - » DE's 2003-5 Hartz reforms to deal with high unemployment
  - » FR: no bold reform so far...
  
- Sovereign debt crises have led to important reforms, e.g.
  - » Greece, Ireland, Italy, Portugal, Spain



# Labour market reforms are politically the most difficult

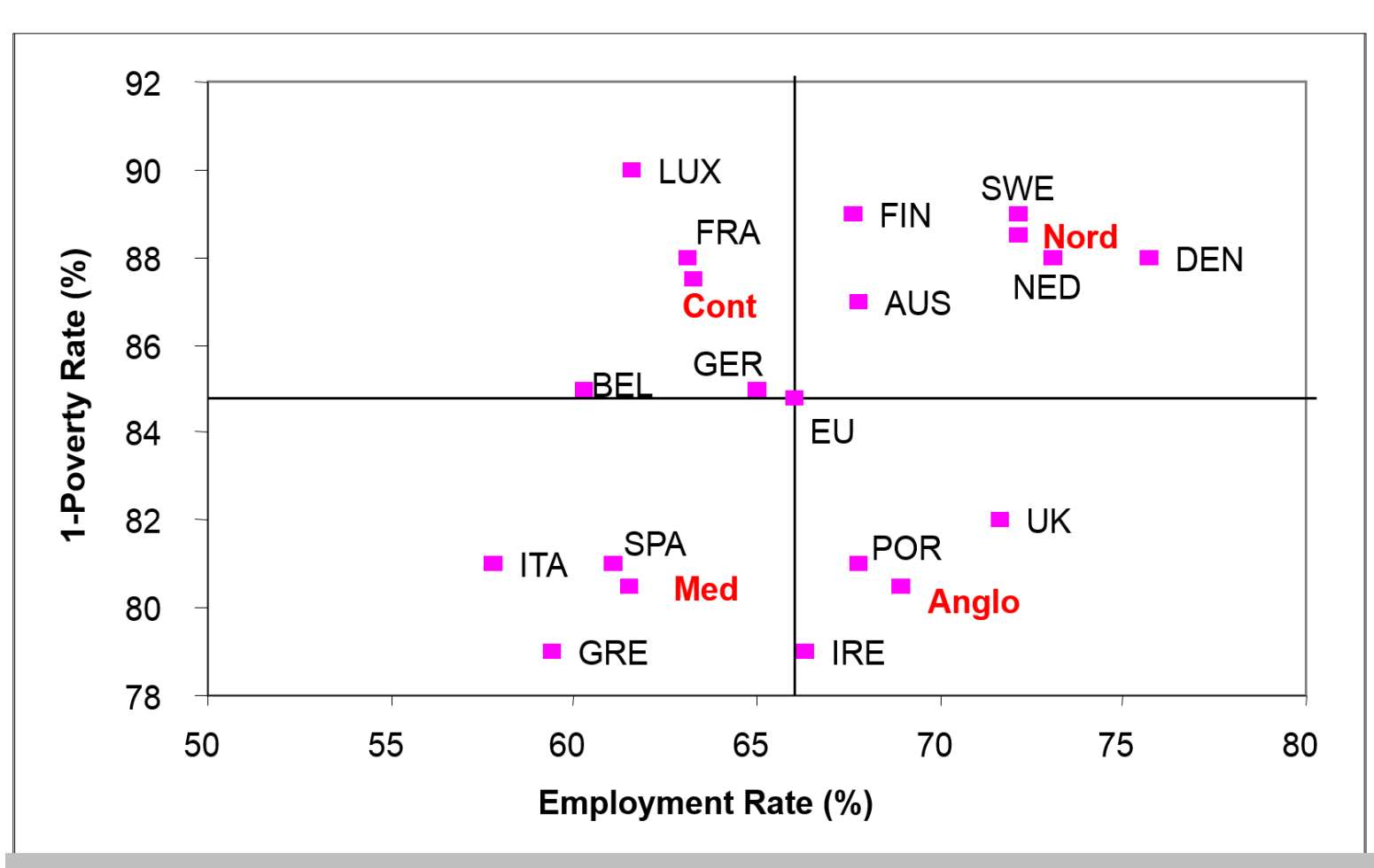
## But they are key in EU15: Going for Growth priorities

(In percent of the total number of policy priorities of the geographic area, 2015)

	EU OECD	Non-EU OECD
<b>Labour utilisation</b>	<b>49</b>	<b>22</b>
Tax system (emphasis on the level of labour tax wedges)	11	0
Social benefits and active labour market policies	21	9
Policy barriers to full-time female participation	4	6
Labour market regulation, collective wage agreements	10	6
Housing and planning policies, barriers to labour mobility	4	0
<b>Productivity</b>	<b>51</b>	<b>78</b>
Human capital	15	17
R&D and innovation policies	5	8
PMR, trade and FDI	20	23
Agriculture and energy subsidies	1	11
Tax system (structure and efficiency)	2	11
Efficiency of public spending	3	6
Public infrastructure	3	2
Legal infrastructure and rule of law	0	2
Financial markets regulation	0	0
Housing and planning policies, barriers to labour mobility	2	0

# Big diversity of labour market & social models, 2004

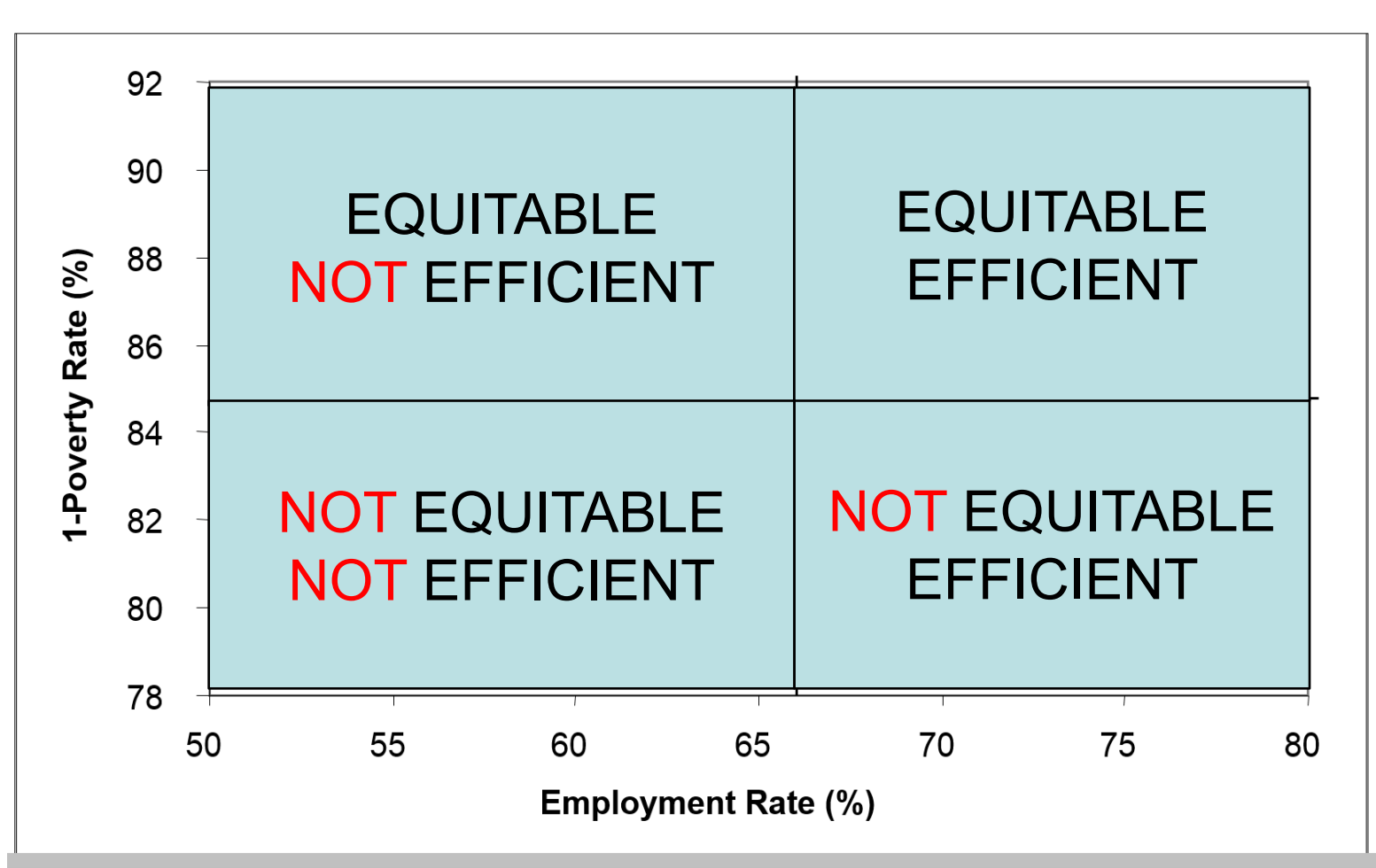
EU15



- Persons at risk of poverty is after social transfers
- EU is the simple average of EU15 countries

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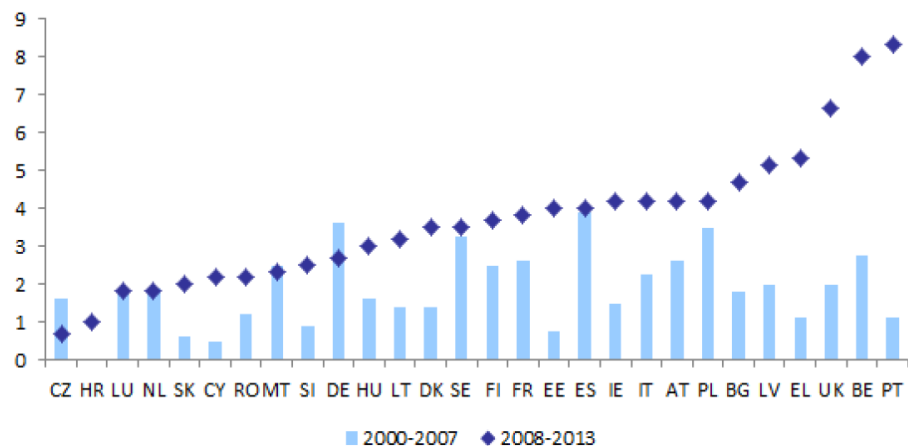
# EU countries need to modernize their LM&S models

- To deal with the “Great Transformation”
  - » Globalization of activity – shift from advanced to emerging economies
  - » Technological change – digitization
  - » Ageing of the population
  
- Flexibility is key, but security is also very important
  
- Social models should be seen as comprising two components:
  - » Employment and social policy
  - » Education/training policy

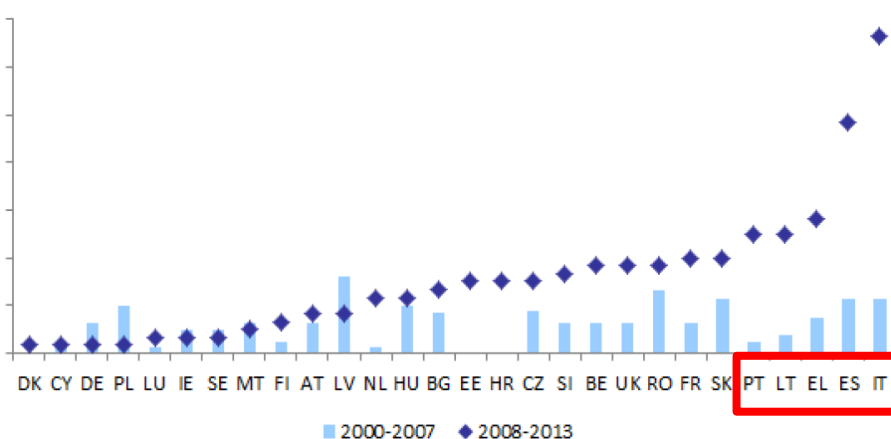
# Lots of labour reforms, especially in crisis countries

2000-07 and 2008-13

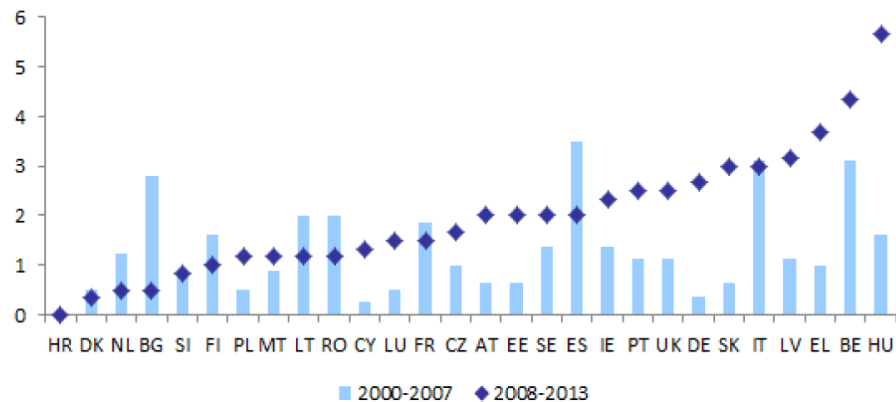
## Active labour market policies



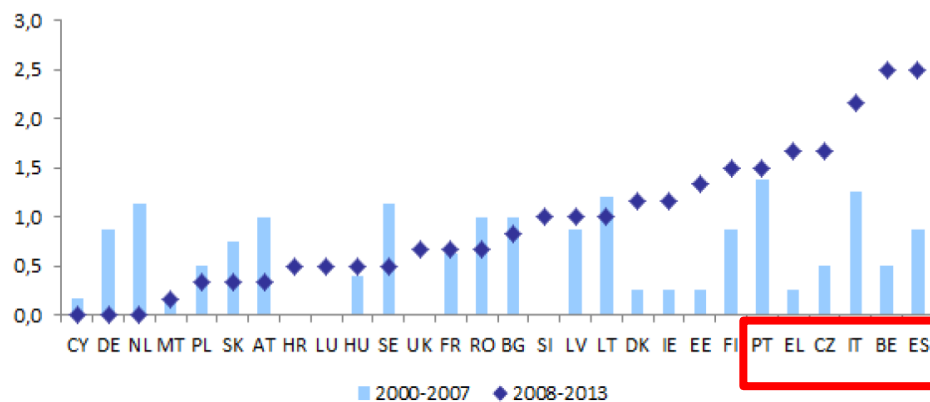
## Employment protection legislation



## Labour taxation

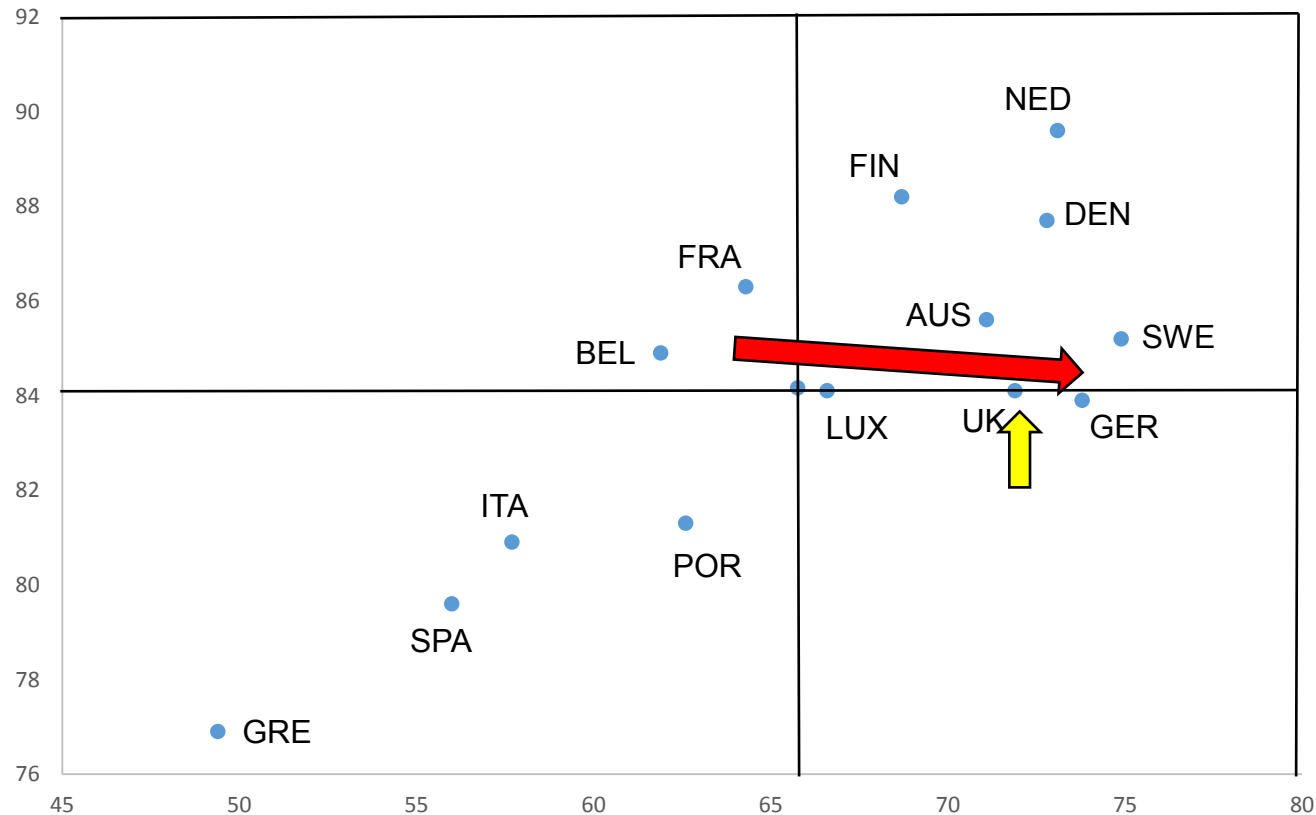


## Unemployment benefits



# Some changes in LM&S, 2014 vs. 2004

## EU15



- The Nordics are still Nordics
- The Meds are still Meds BUT...
- Changes of category: 2/4 Continentals; 3/3 Anglo-Saxons (IRE n.a.)

## Some final remarks

- The EU can only act as a facilitator, but in some dimensions (Single Market) and some instances (accession) it can be crucial
  
- “Reform is ultimately a domestic political business where trade offs are being made between economic efficiency, social goals and the way power and income are distributed in a society” (Fatas, 2015)
  
- Timing and design of reforms are key
  - » Reform fatigue sets in fast, esp. if communication/leadership weak
  - » Although macroeconomic crises may/often trigger reform (see Agnello et al., 2015) the right macroeconomic policies are important to ensure that reforms succeed

# Readings

- Agnello, Luca, Vitor Castro, João Tovar Jalles and Ricardo M. Sousa (2015). “What determines the likelihood of structural reforms?”, *European Journal of Political Economy*, Vol. 37, 129–145.
- Fatas, Antonio (2015). “The agenda for structural reform in Europe”, CEPR Discussion Paper No. 10723. London: CEPR.
- Felipe, Jesus (2012). “Tracking the Middle-Income Trap: What is It, Who is in It, and Why?” ADB Economics Working Paper No. 306, Asian Development Bank
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- OECD (2015b). *Economic policy reforms 2015: going for growth*. Paris: OECD.