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**Structural Reforms in the European Union after the Global
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Structural Reforms in the European Union after the Global Crisis: Problems and Prospects

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Abstract

In the perspective of a successful exit from the recent global crisis, the debate on the long-term programmes of structural reforms in the EU countries has gradually revived. However, similarly to the pre-crisis experience, the path of structural reforms continues to appear fraught with difficulties. On the basis of the extensive literature grounded on the political economy and public choice approaches, this paper analyses why the decision-making process of structural reforms is usually very difficult even though they lead to a more efficient allocation of resources and boost long-run growth. Finally, the paper points out how the progress of a country's structural reforms may be strongly influenced by political, institutional and economic factors contributing to define the framework in which policy makers interact with the national community in its various forms, the lobbies and more in general the organized special interest groups.

Keywords: Financial crises, Growth, Political economics, Structural reforms

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1. Introduction

A broad and soul-searching debate has developed, notably since the 1990s, on the causes of the European Union (EU)'s scant economic dynamism in recent decades and the most appropriate measures to improve the outlook for the area's growth. In this period, as is well known, the EU has recorded a significant slowdown in growth not only with respect to the past but also in comparison with the other advanced countries, especially the United States.

According to the prevailing interpretations, the poor performance of the European economy is largely due to widespread structural shortcomings. Consistently with this line of interpretation, the various member countries have been encouraged to undertake and have undertaken, with great difficulty and varying degrees of success, wide-ranging reform programmes aimed at removing these shortcomings and thereby improve such variables as production, employment and productivity. In many cases, at both Community and national level, the corrective structural measures were set within the framework of the so-called Lisbon Strategy, which was launched in 2000 and, after an extremely disappointing start, re-launched in 2005.

The major financial and economic crisis that in 2008 hit Europe and in particular the euro area gave rise, as in most of the Organization for Economic Cooperation and Development (OECD) countries, to a rapid and large fall in economic activity in the area. In such circumstances to stabilize the financial markets and at the same time to support production and employment were the priority of EU governments, compared with the longer term objective of overcoming the structural weaknesses that continued to characterize member countries and diminish the outlook for

growth. The anti-crisis programmes put in place often accompanied highly expansive monetary and fiscal policy measures with robust support for the banking system in the form of government injections of capital and guarantees of various kinds (European Commission, 2012, in particular pp. 27-42). Substantial State aid was also granted, in various forms, to other economic sectors.

In the second half of 2009 and the first half of 2010 there were some encouraging signs that pointed to an inversion of the economic cycle. In a forecasting scenario that subsequently proved over-optimistic about the imminent exit from the crisis, there was a gradual revival of interest within the EU in longer-term problems. Both the European Commission and the main international economic organizations repeatedly stressed the need for Europe to re-embark without delay on the arduous path of structural reforms, which, as a consequence of the emergencies deriving from the unfavourable cyclical phase, had suffered a slowdown, if not come to a complete halt. An important pointer to the guidelines formulated by the European Commission for overcoming the crisis and reviving growth is provided by the document “Europe 2020” published in 2010. Among other things it contains some interesting solutions for overcoming the serious weaknesses that emerged in the implementation of the Lisbon Strategy, although there are important elements of continuity with this document (Sestito and Torrini, 2012, pp. 18-21).¹

However, as in the pre-crisis experience, the path of structural reforms continues to appear fraught with difficulties also in relation to the post-crisis scenario. This paper focuses on the origins of such difficulties. The next section analyses the factors

¹ On the limits and difficulties encountered in applying the Lisbon Strategy, especially in the initial phase, see Tabellini and Wyplosz (2004) and ECB (2005).

that – in the light of a firmly established literature – are often likely to be stubborn obstacles to the political feasibility of the structural measures needed to stimulate Europe’s long-run growth potential. The third section shows how the incentive for policy makers to persist with reforms and their ability to overcome the resistance of interest groups are influenced by a whole range of variables, mostly unalterable in the short term, that define the political, institutional and economic reference setting. The last section concludes. The last section concludes.

2. The Obstacles to the Political Feasibility of Structural Measures: A Review

Although academics, economic agents and policy makers recognize the potential benefits, in terms of efficiency and economic growth, that could come from rapid and incisive measures to eliminate the structural weaknesses still widespread within the EU, the implementation of such measures continues to be fraught with problems. An extensive, firmly established literature grounded in the political economy and public choice approaches has illuminated several recurring causes of a general nature that help to explain the powerful resistance that often arises within policy-making processes, impeding or delaying the implementation of structural reforms even when they are advantageous from the perspective of social welfare. A thorough knowledge of these causes is a pre-requisite for the shaping of the strategies best able to enhance the chances of success of policies aimed at boosting potential economic growth in Europe.

Among the factors delaying the implementation of structural policies, uncertainty about what their substance should be in practice is often cited. In fact, even when

there is a very broad consensus on the need for public action in certain areas of the economy in order to improve its growth prospects, incomplete understanding of the workings of the economy and thus imperfect knowledge of the foreseeable effects of the various types of measures can make it very difficult for policy makers to agree on the necessary package of specific measures (Sachs, 1994; Rodrik, 1996; Drazen, 1998; Freytag and Renaud, 2007). In this context, a major obstacle can be disagreement between those who adhere to theoretical approaches that give the public authorities vast discretion in using both direct and indirect instruments to steer the economy in the desired direction and those who advocate setting strict limits on the battery of tools available to the government and on the way they can be used, whose greatest fear is that the negative consequences of regulatory action will do excessive harm to the market mechanisms.

Another well-known and particularly important obstacle to the political feasibility of structural reforms stems from the fact that their benefits are mostly deferred whereas their costs are concentrated in the short term.² This is the case, for example, of some product- and labour-market reforms whose positive effects on a country's growth rate tend to materialize mainly in the long run but which in the short run can adversely affect both production and employment (IMF, 2004, pp.124-128). The more deferred are the benefits, the more a community, which discounts the future at high rates, will tend to disregard them, refusing to give political support to the adoption of a reform whose short-term costs are, instead, fully perceptible by its members. Temporal mismatching of the benefits and costs of structural measures can

² Situations in which the difference between the distribution over time of the costs and benefits of a reform results in the former initially outweighing the latter, which more than offset them in the longer run, can be depicted by a 'J curve' (Pinëra, 1994, pp. 227-228).

therefore set a stringent constraint on policy makers' room for manoeuvre, determining a status quo unfavourable to reforms. Added to this, policy makers tend to behave in ways intended more to serve their personal self-interest than to maximize some social welfare function. Opportunistic choices, aimed at increasing their chances of re-election, result in their preferring a short time horizon for evaluating the costs and benefits of economic policy actions and putting off reforms whose positive impact on social welfare ripens too late for them to benefit in terms of electoral support. This is borne out by empirical evidence showing that governments usually introduce structural reforms soon after being voted into office (OECD, 2007, pp. 171-172; OECD, 2009b, pp. 36-37). This argument is especially valid for countries whose electoral cycles are characterized by pronounced instability and short-lived governments.

Obstinate resistance can also arise when the benefits and costs of reforms are unevenly distributed among the different components of a national community. Specifically, in addition to being deferred, the benefits in terms of overall efficiency are usually spread among large swathes of the population but are modest for the single individual, whereas the costs often fall on a fairly small number of persons, with a considerable burden for each of them. An example is offered by policies to open protected markets to competition, where a large group of potential winners, consumers, contrasts with a small number of potential losers, the producers that operate in those markets, who see their rent positions threatened. Since the structural measures entail costs borne by a limited number of persons, the latter have a strong incentive to unite, forming pressure groups to fight their passage. Not infrequently, the action of these groups defending particular interests leads to opportunistic

choices on the part of policy makers, to the detriment of the goals of efficiency and growth. On the other hand, the high degree of dispersion of the benefits, together with the transaction costs connected with the activity of organizing, which tends to grow for more numerous interest groups, reduces the individual incentive for the many potential beneficiaries to unite in support of the implementation of the measures (Olson, 1965). In this asymmetry between interest groups composed of a modest number of members and numerically larger ones in terms of their ability to organize on behalf of a common objective, we have another factor that contributes to the status quo prevailing at the expense of structural reforms.³

An orientation in favour of the status quo, one that penalizes reforms, can be reinforced when public opinion is poorly informed about the actual size of the net benefits and their distribution over time. In particular, the benefits of structural reforms are less visible and amenable to assessment than are their costs, since they are often indirect, materialize mainly in the longer-term and are spread over large sectors of society, with a modest impact on each of its members. This contributes to voters underestimating the benefits of reforms.⁴ An effort by the governmental authorities to make the public better informed about the social costs of the status quo and the actual net benefits of a reform can help to create a pro-reform consensus (OECD, 2009b, pp. 9 and 49-51).

A political and social climate hostile to a programme of reforms can also arise as a consequence of pervasive uncertainty not so much about the size of the benefits

³ For a detailed analysis of a set of situations in which the action of pressure groups defending a shared interest of a limited number of persons leads to inefficient policy choices that penalize the growth rate of a country, see Olson (1983, particularly pp. 16-24).

⁴“Most often it is mismatch ... between the real or perceived costs and benefits of reforms that generates opposition to them” (OECD, 2007, p. 171).

and costs but as to the identity of those who will ultimately be helped or harmed. As Fernandez and Rodrik (1991) have shown, in such circumstances an electorate composed of rational individuals may be induced to reject a reform process even if it is well aware that reform would be advantageous for the economy as a whole and that the majority of voters would get a net benefit. A situation of this kind can arise when, alongside those who think they know with certainty whether or not they will be among the beneficiaries, there is a sufficiently large percentage of individuals who are not in a position to predict whether they will be losers or winners. It is worth stressing that Fernandez and Rodrik develop their analysis assuming risk-neutral individuals. Their conclusions would be strengthened, however, under the assumption of risk-averse individuals. As Rodrik (1996, p. 38) underlines, situations where the lack of consensus in favour of a reform that would nevertheless benefit the majority of individuals stems from the difficulty of identifying in advance, with certainty, the position of winners or losers of an appreciable portion of the electorate can explain the survival of structural measures originally introduced by authoritarian regimes, against the prevailing will of public opinion, even after the return to democracy.

From what has been said so far, it follows that structural measures aimed at eliminating inefficiencies and improving a country's growth prospects in the longer run are almost never distributionally neutral. This is often the root of the strong resistance to them within society. In theory, a way to counter this resistance is to eliminate the distributional obstacle by devising adequate mechanisms to compensate for the losses of those who will be hurt by the implementation of the proposed reforms. In practice, however, the 'compensation principle' encounters

appreciable limitations: the compensating measures, for example, may be very costly and thus impracticable, especially for countries wrestling with budget adjustment and excessive public debt. Such measures, moreover, may be hard to manage and promise uncertain results, owing to the difficulty of identifying the losers and quantifying the loss to be indemnified (IMF, 2004, p. 109; OECD, 2009b, pp.54-60).⁵ And the payment of compensation can be complicated by opportunistic behaviour on the part of the potential recipients. In certain circumstances, the efficacy of the ‘compensation principle’ as an instrument for weakening the resistance of organized pressure groups and gaining the consent of the electorate can be vitiated by time-inconsistency and credibility problems with regard to governments’ commitment to delivering compensation once the reform is in place (Rodrik, 1996, p. 38).

It should be pointed out that the ‘compensation principle’ does not necessarily entail financial transfers to the “losers” but can take other forms, including the joint adoption of a set of reforms: those harmed by a structural measure in one sector can be compensated in whole or in part with the benefits accruing to them from the simultaneous adoption of another measure in a different sector. An example is a package of measures based on the principles of flexicurity, where the disadvantages for workers deriving from the introduction of more flexible contracts are coupled

⁵ On the unfeasibility of strictly applying the ‘compensation principle’ and the advisability of resorting to pragmatic solutions, Olson (1983, p. 46) writes: “This method is more difficult, even impossible, to apply when the losers or the sizes of their losses aren’t readily calculable, and it is accordingly impossible in practice to compensate every one of the losers fully, so unanimity cannot be obtained. Yet as a practical matter, existing democratic governments require little more than majority approval rather than unanimity to make changes, so imaginative if rough-and-ready proposals that buy off the main groups that would lose from reform can often pass despite scattered opposition”.

with and counterbalanced by measures to provide more support for unemployment and more effective active labour policies.⁶

With reference to the joint implementation of two or more reforms, the sequencing of such reforms may be important. For example, it has been shown that the short-term impact of certain reforms on the labour market – which is likely to be negative, if they are introduced in isolation – may be mitigated if they are preceded by reforms that liberalize the markets for goods, by lowering the barriers to new firms' entry and, more generally, guaranteeing more competition (Blanchard and Giavazzi, 2003; Estevão, 2005).

The political sustainability of a reform process can also be facilitated by phasing in the programme of structural interventions gradually, over a transitional period long enough to allow their negative impact on the group of potential losers to be circumscribed. Strategies for the at least partial compensation of potential losers based on reforms that provide for long phase-in periods and/or exemption of certain groups have been implemented in various European countries in the social security sector and the labour market. Nevertheless, it should be pointed out that a strategy of this kind is exposed to various risks (OECD, 2009b, pp. 56-58).

3. The influence of the Political, Institutional and Economic Context on the Progress of Structural Reforms

In the preceding pages it has been shown that the progress of structural reforms within a country is determined by the interaction between policy makers and the

⁶ On the trade-off in the labour market between protecting jobs and providing support for unemployment and on the consequent scope for policy makers to take joint measures in these two fields as part of a strategy of compensation, see Boeri, Conde-Ruiz and Galasso (2012).

national community in its various expressions, lobbies and more in general organized special interest groups. At this point it should be emphasized that a government's determination and ability to overcome the various kinds of opposition to the structural measures necessary for growth are powerfully influenced by the specific institutional, political and economic context in which it must act. In many cases this explains the different pace and effectiveness of reform policies in the individual European countries in recent years. Many of the variables defining that context are not within the power of national policy makers to control and thus to modify, at least in the short term.

Among the political and institutional variables able to influence reform programmes' likelihood of success, the literature has often focused on whether the system of government is presidential or parliamentary and the electoral system proportional or majoritarian. Another important variable identified is the electoral cycle. As noted earlier, elected officials usually have a greater incentive to adopt reforms in the early part of their term of office. Also, governments' commitment to reforms tends to diminish in a setting of acute political instability and short-lived administrations.

As to the economic variables that can influence the ability of governments to undertake reform policies and carry them to completion, various empirical studies have shown that situations of prolonged low or negative growth can increase political support for structural adjustment programmes. One possible explanation is that the protraction of an economic crisis makes society more conscious of the costs of not embarking on reforms and at the same time weakens the opposition of interest

groups.⁷ Another important economic variable that can assist the progress of structural reforms is the sustainability of the public finances in the longer term. With reference to the positive correlation often found between the soundness of countries' public finances and their ability to implement structural reforms, it has been noted that although weak public finances and international constraints on the budgetary measures are likely to exert pressure in favour of reforms, they may also make them more difficult to implement owing to the costs those reforms impose in the immediate (OECD, 2009b, pp. 40-42). In other words, when the public accounts are in order, governments have more scope to undertake growth policies that put a burden on the budget in the short term.⁸

Evaluating the influence exerted by international rather than domestic factors on the dynamics of structural reforms in a country is an especially complex matter. They can work their influence through various channels (IMF, 2003, pp. 102-104; IMF, 2004, pp. 112-113 and pp. 130-132; OECD, 2007, p. 175). A first channel consists in the economy's external openness. Lags with respect to the "rest of the world" in adopting the structural interventions needed to stimulate productivity and efficiency gains adversely affect a country's international competitiveness and hence its ability to export goods and attract foreign direct investment, with negative effects on its domestic economic performance. The hope of avoiding these costs, whose

⁷ However, there are also examples of opposite sign with regard to the relationship between economic crises and the political sustainability of structural reforms. On this issue, see Rodrik (1996, pp. 26-29, and the references cited therein), IMF (2004, p. 113-114), OECD (2007, p. 171), OECD (2009a, p. 38) and OECD (2009b, p. 40).

⁸ Helpful observations on the relationship between the state of the public finances and structural reforms are published in Buti, Röger and Turrini (2009). In this work, which contains three decades of empirical data on fifteen EU countries, it is suggested that the time horizon of policy makers' choices may be an important factor in causing policies oriented towards fiscal rigorousness and structural reforms to be linked by a relationship of complementarity or substitutability.

impact is considerable in a setting of closely integrated economies, gives policy makers a stronger incentive to accelerate the pace of structural reforms in their own country by resisting the pressure of special interest groups that fear they stand to lose from an abandonment of the status quo.

Public opinion can be swayed in favour of structural corrective measures not only by fear of a loss of international competitiveness but also by the success, in terms of economic growth and employment, enjoyed by other countries that took similar initiatives earlier. This ‘imitation effect’ can be considerable in countries belonging to the same regional area and having highly interdependent domestic economies.

International agreements are another important channel through which the external environment can influence the propensity of a country to proceed with reforms. One can cite a large number of instances of governments adopting structural measures, above all regarding the goods and financial markets, because of the need to honour commitments made within international organizations at regional level, e.g. the EU and the North American Free Trade Area (NAFTA), or at global level, e.g. the IMF and the World Trade Organization (WTO).⁹ The strategy of “tying one’s hands” by adhering to a programme of structural interventions under an international agreement may be a way for a country’s policy makers to overcome problems of credibility and time inconsistency. In particular, stakeholders’ awareness that infringement of the international agreement would expose the country to costly economic sanctions helps to render the government’s commitment to

⁹ A much-discussed issue in this field is the relationship between international aid and the dynamics of structural reforms in a country. With specific reference to the IMF’s activity of providing financial assistance, a highly controversial question concerns the effectiveness of so-called structural conditionality, usually associated with the granting of loans, as a means of bringing pressure to bear on the governments of beneficiary countries to promote the reforms necessary to launch lasting processes of economic growth and poverty reduction.

reform credible, with the result, among other things, of discouraging the activity of lobbies opposed to the reforms.

4. Conclusions

In the wait of a successful exit from the recent crisis, an extensive debate concerning the long-term programmes of structural reforms in the EU countries has gradually revived. However, similarly to the pre-crisis experience, the path of structural reforms is still fraught with difficulties. A thorough knowledge of such difficulties is a pre-requisite for the shaping of the strategies best able to enhance the chances of success of policies aimed at boosting potential economic growth in Europe.

Drawing on a considerable body of literature largely based on the political economy and public choice approaches, this paper has surveyed the chief general causes of the strong resistance to structural reforms that quite often arises within the political decision-making process and impedes or delays their implementation even when they are beneficial for social welfare.

The final part of the paper pointed out how the progress of structural reforms in a country can be strongly influenced by a constellation of political, institutional and economic factors that determine the framework in which policy makers interact with the national community in its various expressions, lobbies and more in general organized special interest groups. Many of the variables defining that context are beyond the reach of national policy makers and thus hardly modifiable, at least in the short term.

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