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STRUCTURAL REFORMS IN THE EUROPEAN UNION: WHAT IS NEW AFTER THE CRISIS?*

Abstract

This study analyses how individual countries in the European Union have to react to the recent global crisis by significantly changing their policy priorities, in different ways and to a different extent, in order to implement a plan of structural reforms aiming at effectively relaunching their process of economic growth in the new post-crisis scenario. The paper argues that three factors turn out to be particularly relevant: (i) vulnerabilities in public finance, especially in a number of Eurozone countries; (ii) the tendency towards widespread and growing income inequalities threatening social cohesion and negatively affecting long-term economic growth; (iii) the persisting cyclical weakness of certain important areas of the European Union.

Keywords: Financial Crisis, Growth, Europe, Structural Reforms
JEL Classification: G01, O40, O52, P11

Riassunto

Le riforme strutturali nell'Unione europea: cosa è cambiato dopo la crisi?

Questo studio analizza come i singoli paesi dell'Unione europea debbano rispondere alla recente crisi globale attraverso modifiche significative nelle loro priorità di politica, con modalità diverse da caso a caso, in relazione all'obiettivo di un'efficace strategia di riforme strutturali che rilanci il processo di crescita nel nuovo scenario post-crisi. L'articolo individua tre fattori come particolarmente rilevanti: la vulnerabilità della finanza pubblica, soprattutto in alcuni paesi dell'Eurozona; la prolungata e diffusa tendenza all'aumento delle disuguaglianze nella distribuzione del reddito la quale minaccia la coesione sociale ed incide negativamente sulla crescita economica di lungo termine; la persistente debolezza ciclica di alcune importanti aree dell'Unione europea.

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1. Introduction

According to the prevailing interpretations, the European Union (EU)'s scant economic dynamism in recent decades is largely due to widespread structural shortcomings. In coherence 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.

Just as this delicate and complex implementation of structural reforms was in full swing, Europe was hit by the financial crisis that broke out in the United States in the second half of 2007 and then spread to the entire world economy. The financial crisis was associated with the longest and deepest recession that the EU countries as a whole have had to cope with since the end of World War II. Inevitably policy makers' interest, at both Community level and in individual member countries, rapidly shifted from policies to revive growth in the longer term to those meeting the immediate need to counter the repercussions of the global crisis on economic activity and employment.

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. Gross domestic product (GDP) began to grow again, although the pace was modest and varied considerably from country to country, not only in Europe but in other important areas as well. In particular, the macroeconomic environment remained particularly weak within the euro area for some heavily indebted countries severely hit by the sovereign debt crisis. In a forecasted scenario that subsequently proved over-optimistic about the imminent exit from the crisis, the European Commission hoped that Europe would rapidly lengthen its horizon beyond the short term and supplement the strategy for overcoming the crisis with effective measures in the two following directions: the introduction of suitable corrections to their domestic financial systems in order to realize more effective prevention against the risk of a recurrence of crises like the one just experienced; and the revival of programmes of structural reforms needed to overcome the bottlenecks of various kinds that in recent decades have hindered the strengthening of the European economy's potential growth in the medium and long term. This paper addresses the second of these two aspects.

Section 2 examines the brake applied to structural reform programmes by the global crisis, when

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stabilizing the financial markets and, at the same time, supporting production and employment became the top priority of European governments. Section 3 analyses how the crisis may have altered individual countries' priorities in the selection of pro-growth structural policies to be adopted in the near future. Section 4 draws attention to several caveats to which the arguments developed in the paper are subject. Section 5 offers some concluding remarks.

2. Structural reforms, macroeconomic stability and sustainability of the public finances in the years of the global crisis

In recent decades the EU as a whole has seen a significant slowdown in its growth. In this respect the performance of the European economy has also been very disappointing compared with those of the other advanced countries, above all the United States. Over the years it has been increasingly recognized that Europe's persistently low growth is only partially the product of strictly conjunctural factors. In the specific case of euro area countries, the phenomenon – according to this view – cannot be interpreted simply as the result of a prolonged contraction of aggregate demand due to circumstances such as the introduction of the single currency, the monetary policies pursued by the European Central Bank (ECB) and the constraints on fiscal policy imposed by the Maastricht Treaty and the Stability and Growth Pact. In reality, structural and institutional weaknesses played a significant role in holding back Europe's growth potential in the medium and long term. Accordingly, the urgent need for structural reforms on a major scale has been forcefully asserted, taking due account, among other things, of the drastic changes that have occurred over the years in the international economic setting. The areas identified as needing effective corrective measures, to a varying extent depending on the country, have involved: markets for goods and services, the financial market, the labour market, the tax regime, the education system, infrastructure, the level and composition of public expenditure, and the quality of public institutions.

At the summit held in Lisbon in March 2000 the European Council adopted an ambitious plan – known as the Lisbon Strategy – with the declared aim of stimulating the growth potential of member countries. If the overall structural situation in Europe can be said to have improved in the years following this initiative, it is also true that the speed with which the reforms were implemented and their effectiveness differed widely from country to country and from sector to sector.

The major financial and economic crisis that in 2008 hit Europe and in particular the euro area gave rise to a rapid and large fall in economic activity in the area. In these 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. 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). Substantial state aid was also granted, in various forms, to other economic sectors.

Taken together, the fall in tax revenue caused by the contraction in economic activity, the working of built-in stabilizers, the discretionary countercyclical policies adopted and the sectoral measures to support the economy referred to above had a powerful adverse effect on the public finances of European countries. In the period considered here the ratio of the budget deficit to GDP rose sharply and the public debt ratio mounted. The sharp deterioration in public finances, that occurred in conjunction with the crisis, made it a priority for many countries – notwithstanding the persistently unfavourable cyclical situation – to adopt prudent adjustment policies to safeguard the longer-term sustainability of their public finances.

With an exit from the crisis in mind, as early as 2010 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 difficult path of structural reforms, which, as a consequence of the emergencies deriving from the unfavourable cyclical phase, had suffered a slowdown. 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. This document sets five targets for the EU to be achieved by 2020 concerning employment, research and development, climate change and energy, education, poverty (European Commission 2010). Among other things 'Europe 2020' contains some interesting solutions for overcoming several 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).

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Resuming the structural reform process revealed to be particularly difficult within the euro area. In fact, following the financial crisis of 2008-09 and the ensuing recession, several countries were severely hit by the sovereign debt crisis. The sovereign debt tensions, initially involving Greece, Ireland and Portugal, later spread to larger countries of the euro area periphery, especially Italy and Spain. In this context, euro area member countries faced the difficult task of reconciling the implementation of the structural reform plans needed to restore growth and competitiveness with the following two additional targets: firstly to pursue fiscal consolidation, in order to reduce sovereign risks and restore long-run sustainability of their public finances; secondly to provide effective support to aggregate demand and employment in the near term, after a prolonged period of stagnation. Within such a complex economic and financial environment, an intense and controversial debate has developed on the right package of measures to ensure the simultaneous achievement of the above mentioned three key targets. In the light of this debate, assessing the links between fiscal consolidation policies, public debt reduction and economic growth recovery has become a very challenging issue[1].

3. The crisis may have altered individual countries' new reform priorities

The serious consequences of the financial and economic crisis on the public finances and real economy of the EU have altered, to a varying degree, the individual national governments' priorities in the selection of the reforms to implement in the near future from among those potentially suitable for reviving still sluggish growth. This is an important aspect that a consistent and effective post-crisis structural reform strategy shouldn't ignore. In this respect, three factors appear to be particularly important: i) weaknesses and vulnerabilities in public finance; ii) rising inequality and poverty; iii) weak recovery in a number of EU countries.

3.1 Weaknesses and Vulnerabilities in Public Finance

Owing to the severe weaknesses and vulnerabilities in the public finances of many EU countries resulting from the financial crisis and the ensuing recession, priority should be given to measures that are likely to stimulate productivity growth and/or employment without putting a heavy burden on the budget. This is especially true for euro-member countries exposed to the

[1] In particular, many criticisms have been moved to the austerity programs implemented in a number of Eurozone countries in the hope of bringing public finances back to a sustainable path (Auerbach and Gorodnichenko, 2012; Blanchard and Leigh, 2013; De Grauwe and Ji, 2014, 2015; Acocella, 2020).

risk of a sovereign debt crisis, which have an especially great need to reconcile the objective of reviving growth with that of fiscal consolidation and sustainability of public finances in the longer term. Examples of measures consistent with the simultaneous pursuit of these objectives may be seen in a set of reforms of the public administration aimed at increasing its efficiency, reforms of the welfare state, a reorganization of the tax system to make it more growth-oriented, and measures to strengthen competition in the markets for goods and services (OECD, 2012). There is no lack of reforms potentially able to foster growth that, at the same time, have a positive effect on the State budget by increasing the revenue and/or reducing the expenditure associated with them (Boeri and Garibaldi, 2011). It should be pointed out, however, that the presence of organized pressure groups defending their rent positions may represent a serious obstacle to the political feasibility of reforms even when, implying a negligible cost, they do not interfere with fiscal consolidation processes and/or in the case of Eurozone countries, they do not violate fiscal rules and financial assistance conditions imposed by the so-called Troika.

With reference to the often found positive correlation between the soundness of countries' public finances and their ability to implement structural reforms, it should be noted that, although weak public finances and international constraints on the budgetary measures that can be adopted are likely to exert pressure in favour of reforms, they may also make them more difficult to implement owing to the costs they impose in the immediate (OECD, 2009). In other words, when public accounts are in order, governments have more scope to undertake growth policies that put a burden on the budget in the short run[2].

3.2 Rising Income Inequality and Poverty

Again with a view to redetermining the priorities for programming the optimal timing of structural reforms, a second important factor is the dynamics of income distribution. Over the last few decades, in fact, the welfare of a sizeable number of EU countries has been hurt not only by the problems deriving from prolonged low growth but also by a persistent and widespread tendency for inequality in the domestic distribution of income to increase and by the emergence of new areas of poverty. This trend is observable also in the case where disposable income (i.e.,

[2] Helpful observations on the relationship between the state of the public finances and structural reforms are published in Buti *et al.* (2009). In this work, which contains three decades of empirical data on 15 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.

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income after taxes and transfers) is used to measure inequality. The long-term trend of rising income inequality and the marked rise in income poverty have affected the majority of developed countries, albeit to an extent that differs from country to country (OECD, 2011; UNCTAD, 2012; Bourguignon, 2018). This phenomenon has three main origins: growing international economic integration, above all with the developing countries (Furceri and Loungani, 2015; Ostry *et al.*, 2018); skill-biased technological change, which has increased the skill premium to the benefit of better educated workers and consequently widened the earnings differential between these and less skilled workers; and institutional reforms as well as economic and social policies pursued domestically by each country. As for the relative importance of each of these causes, the empirical evidence is often contradictory and difficult to interpret.

In many cases, the trend towards increasing income inequality was not reversed even after the global financial and economic crisis of 2008-09. During the crisis, often the rise in income inequality was mainly due to the fall in employment rather than to changes in wage dispersion (OECD, 2015a). In various EU countries from 2008 onwards the pronounced economic contraction has further accentuated the costs and social tensions of the wide differences between *per capita* incomes, threatening social cohesion and political stability. This is particularly the case within the euro area for countries undertaking fiscal austerity programmes. In fact, solid empirical evidence suggests that fiscal consolidation usually leads to a significant increase in income inequality through various channels. In particular, it appears that not only the size of the manoeuvre, but also its composition (spending versus taxes-based adjustments) may be important for the distributional impact of fiscal consolidation. Moreover, these distributional effects tend to be long-lasting (Ball *et al.*, 2013, also the literature quoted therein)[3]. Within this context, it is all the more urgent to favour redistribution policies to the advantage of the more vulnerable members of society[4].

Concern for growing inequality within countries is noticeably reinforced from the findings of a wide and recent empirical literature suggesting that, besides its adverse impact on social

[3] The study by Ball *et al.* (2013) analyses 173 episodes of fiscal consolidation measures for a sample of 17 OECD countries over the period 1978-2009. An analysis of the distributional consequences of fiscal consolidation measures adopted in 8 EU countries after the financial crisis of the late 2000s and the ensuing economic downturn has been provided by Paulus *et al.* (2017).
[4] With reference to a large group of OECD countries, both the effects of the global crisis on income inequality and on relative poverty and the redistributive action taken by national governments through income taxes and social benefits are assessed for the 2007-10 period in OECD (2013a).

cohesion, high inequality might also negatively affect long-term growth (Cingano, 2014; Ostry *et al.*, 2014; OECD, 2015a; Berg *et al.*, 2018). It should be stressed in this respect that the various reforms potentially suitable to correct the structural weaknesses of the European economy are almost never neutral, but they may have repercussions of various kinds, at least in the short term, on the domestic distribution of income. In fact, as suggested by an extensive, firmly established literature grounded in the political economy and public choice approaches, the involved distributional implications are often at the root of the strong resistance to structural reforms within society[5]. Under this aspect, there are structural measures that point to a complementarity relationship between the objectives of growth and equity, in the sense that they strengthen growth while simultaneously reducing inequality. Others, by contrast, give rise to a trade-off between the two objectives: to the extent that they are successful in accelerating growth, they accentuate inequality. Certain pro-growth reforms, besides increasing income inequality, can also entail a trade-off with household-level income stability (Cournède *et al.*, 2015a, 2015b). In this second case it should be taken into account that the potential growth-gains from structural reforms can be in some measure offset by the negative effect on growth from higher levels of inequality brought about by the reform themselves (Ostry *et al.*, 2018). Lastly, there are reforms that appear to be neutral as regards distribution, or whose effects are uncertain. OECD (2015b: Chapter 2) and Causa *et al.* (2016) provide evidence on the effects of a set of pro-growth structural reforms on income inequality with reference to OECD countries[6].

The importance taken on in the present European economic and social situation by the objective of a fairer distribution of income, together with that of faster growth of its economy, means that policy makers should give priority to the structural reforms belonging to the first of the three categories just described. Among the policies that not only have a positive effect on a country's growth potential but are also effective in attenuating its internal inequalities there are, for example, measures to raise the average level of the population's education and, at the same time, to guarantee equal educational opportunities for all individuals regardless of their initial socio-economic conditions. The objectives of growth and a reduction of inequality can also be pursued simultaneously by means of reforms designed to reduce the various forms of dualism and, more generally, discrimination present in the labour market. Among these reforms can be included

[5] For a survey of this literature, see, among others, Milone (2017).
[6] For a recent empirical analysis of the relationship among reforms, growth, and inequality covering advanced, emerging-market and low-income countries see also Ostry *et al.* (2018).

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those aiming to harmonize employment protection legislation for regular and temporary workers and those which fight gender discrimination (OECD, 2012: Chapter 5; OECD, 2013b: Chapter 2)[7].

More in general, these two objectives may be reconciled by the adoption of a policy package strategy where the potential negative impact on income inequality of growth-enhancing reforms is compensated by the joint adoption of one or more other measures which are effective in promoting equality; for instance, by means of appropriate tax and transfer measures. In the current European scenario of high and growing inequality, single structural reforms, introduced in isolation and potentially increasing the gap between rich and poor, would hardly achieve the political and social consensus required for their implementation, although they might improve a country's growth prospects in the longer run. It should be stressed that in the absence of simultaneity in the implementation of the various measures forming the reform package, the strategy of removing or weakening the distributional obstacle by devising complementary measures for compensating those who would be subsequently hurt by the proposed reforms could result hard to manage and promise uncertain results. In particular, when the compensating measures are delayed compared to pro-growth reforms, the efficacy of the 'compensation principle', as an instrument for weakening the resistance of pressure groups and gaining the consensus of the electorate, can be vitiated by time-inconsistency and credibility problems with regard to the governments' commitment to delivering compensation once the pro-growth reform exacerbating income inequality is in place (Rodrik, 1996). In some cases, the political viability of a reform process can also be facilitated by phasing in the program of structural interventions gradually, over a transitional period long enough to allow their short-term distributional impact on the group of potential losers to be circumscribed. Strategies for 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 in the labour market. Nevertheless, it should be pointed out that a strategy of this kind is exposed to various risks (OECD, 2009).

With specific attention to the labour market, an application of the 'compensation principle' taking the form of the simultaneous adoption of a set of reforms in different sectors is provided

[7] With reference to pre-crisis experience, labour market reforms played a role in strengthening dualism in some European countries (Cheptea *et al.*, 2014).

by the 'flexicurity approach' where the disadvantages for workers deriving from the introduction of more flexible contracts are coupled with and counterbalanced by measures aimed at providing more support for unemployment and more effective active labour policies[8]. Nevertheless, it should be noted that various studies have provided evidence on a number of severe shortcomings and difficulties in existing flexicurity arrangements hindering their successful implementation during the years of a crisis on the scale of the recent one (Tangian, 2010; Heyes, 2013). The main lesson that seems to emerge from these studies is the need to proceed to a substantial revision of the current flexicurity systems, before promoting them within the set of labour-market reforms.

3.3 Persistent Weak Recovery in Many EU Countries

The prolonged weak recovery and the related high level of unemployment still characterizing various European countries, especially within the euro area, after the 2008-09 financial crisis are a third important factor in identifying the structural reforms to be given priority in the immediate future. In this respect, it is worth noting that an extensive literature analysing cost-benefit dynamics of reforms has tracked down various cases of long-term growth-enhancing policies which, however, can entail negative effects on output and unemployment in the short term. This may be the case, for instance, of certain labour market reforms, such as reforms on employment protection and unemployment benefit systems. In fact, labour market reforms, as well as product market reforms, can contribute to strengthening potential output in the long term. However – differently from product market reforms – their short term impact on aggregate demand is deeply conditioned by the overall economic environment. In particular, employment protection legislation and unemployment benefit reforms can have an expansionary impact in the short term when introduced in the upper post of the cycle. Vice versa, such reforms can give rise to a contractionary effect during economic crises (Cacciatore *et al.*, 2012; IMF 2016: Chapter 3; Banerji *et al.*, 2017). In this latter circumstance, the uneven intertemporal distribution of their costs and benefits may constitute a severe obstacle to the political feasibility of these reforms. As suggested by the extensive literature on the political economy of reforms, temporal mismatching of the benefits and costs of structural measures can

[8] 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 *et al.* (2012).

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set a stringent constraint on policy makers' room for manoeuvre, determining a status quo unfavourable to reforms. The more the benefits materialize in the long-term, whereas the costs are concentrated in the short term, the higher the difficulty for policy makers to obtain the community's support for the implementation of a reform programme. In this context, policy makers, concerned about their chances of re-election, are induced to favour a short time horizon for evaluating the costs and benefits of their initiatives, tending to exclude reforms whose positive impact on social welfare mature too late for them to benefit in terms of electoral support. This is in line with empirical evidence which reveals that governments usually implement structural reforms soon after being voted into office (IMF, 2004, and references cited therein; OECD, 2009).

Against this background, a good strategy could be to adopt the so-called 'two-handed approach': that is, to combine structural reforms improving the outlook for potential growth in output in the long term, but implying a contractionary effect in the short term, with the temporary stimulus of macro policies supporting aggregate demand (Blanchard *et al.*, 1985; Draghi, 2014; Banerji *et al.*, 2017). This approach, however, may be hardly feasible for those European countries with limited manoeuvre margins for stimulating the economy through standard macroeconomic policies. This is mostly true for the euro area countries where available fiscal space is restricted by problems of budget consolidation requirements and where monetary policy effectiveness is constrained by their participation in a monetary union as well as by the persisting zero lower bound on interest rates. In such a scenario, policy makers should focus on those structural reforms that, in addition to boosting long-term job creation and productivity, also provide expansionary short-term effects. Among the reforms that may also boost demand in the near term, besides increasing productivity and improving labour utilization in the long term, there are policies aimed at restructuring government expenditure for strengthening and modernizing public infrastructure in sectors such as telecommunications and transport systems, electricity distribution and water supply networks. The impact of these policies on employment is reinforced by the fact that investment in these sectors often involves substantial use of labour. Moreover, as is well known, investments in infrastructure may also improve a country's outlook for growth in the long term through the externalities they generate, which contribute to improving firms' productivity. This manoeuvre of government expenditure restructuring should take place without increasing the global level of public expenditure.

During periods of slack, priority should also be given to a range of reforms aimed at liberalizing product markets which, by rising firms' expectations and strengthening confidence, stimulate aggregate demand in the short term[9]. Employment and aggregate demand can also be stimulated in the short term by reforms that reduce the taxation of labour incomes and transfer the tax burden on to other revenue items of the budget. Again, short-term effects in terms of job recovery can originate from the adoption of active labour market policies that – through training, employment incentives and other types of intervention – aim at facilitating job search for the unemployed, thereby helping to counter long-term unemployment and the exit of discouraged workers from the labour market (OECD, 2012: Chapter 4; IMF, 2016: Chapter 3).

Going back to the case of the labour market reforms previously mentioned in this section – that is, those whose short-term effects on employment and output are likely to be negligible or even negative when they are introduced in isolation, in periods of weak economic juncture – various studies have shown that their impact may be more favourable if they are adopted in combination with other structural reforms. In particular, it has been argued that reforms in job protection legislation and unemployment benefit systems aimed at encouraging wage moderation and flexibility may produce short-term costs in terms of real wages and employment which tend to be higher if the competitiveness of the markets for products is limited and they are marked by rent-seeking behaviour by firms (Blanchard and Giavazzi, 2003; Estevão, 2005; Cacciatore *et al.*, 2012; IMF, 2016: Chapter 3). By contrast, these transitional effects are less penalizing if the wage moderation policies are coupled with reforms that liberalize the product markets, by lowering the barriers to new firms' entry and, more generally, guaranteeing more competition. Some of these studies suggest that product market reforms should precede labour market reforms. This reform sequencing may be crucial for the growth and employment effects of a policy package strategy combining product and labour market reforms. A fruitful analysis of the benefits deriving from reform strategies that take account of the complementarity relationships existing between reforms in these two markets has been provided, among others, also by Nicoletti and Scarpetta (2005), OECD (2007: 174-175), Everaert and Schule (2008), Barkbu *et al.* (2012), and Fiori *et al.* (2012).

[9] However – as argued by Eggertsson *et al.* (2014) – during a deep crisis, when the monetary policy is constrained by a zero lower bound, reforms increasing product and labour market competition may entail contractionary rather than expansionary short-run effects. In particular, during a recession these reforms may induce price deflation which increases real interest rate and depresses aggregate demand in countries with nominal interest rate at its lower bound.

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4. Some caveats

The analysis developed so far is subject to a number of caveats. The following three deserve particular attention. The first concerns the real effectiveness of structural reforms in accelerating the dynamics of potential growth in Europe. As properly stressed by Gros (2016: 6),

"European policy makers should be careful not to promise too much for structural reforms".

With reference to a number of major EU reform initiatives since 1992, Gros points out that their recorded growth impact over time has usually been lower than officially expected. Various factors may contribute to an understanding of this systematic divergence. A possible explanation is that official forecasts have underestimated the constraints on the relationship between Europe's overall growth performance and structural reforms due to the macroeconomic environment and the quality of political institutions and their credibility. Another aspect deserving attention is possible complementarity among reforms in that there may be potential gains in terms of growth arising from implementing reforms in different policy areas simultaneously. A wrong assessment on how reforms interact in their effects on growth may lead to over-optimistic expectations about the links between economic performance and structural reforms. The role played by anti-reform interest groups may be a further factor deserving attention in analysing why the EU output growth has been significantly below the expected level. In fact, the success of a reform, defined as its ability to reach a desirable goal, may be reduced by the action of interest groups which, failing to block a proposed reform at the moment of its adoption, succeed in limiting its effects at the moment of implementation. An incomplete or a not well calibrated reform may imply a negative outcome (Cheptea *et al.*, 2014). In sum, evaluating how effectively reforms are enforced remains a very challenging task and a full understanding of the reasons why the European growth path associated with undertaken reforms has been so embarrassing is still needed.

A second caveat deals with the political feasibility of the suggestions made here on the best structural reform strategy to strengthen Europe's long-run growth in the post-crisis predicament. In fact, such suggestions remain thoroughly abstract because they tend to ignore the specific constraints within which individual national governments operate. However, as largely emphasized by the political economy literature, the ability and, at the same time, the incentive of a country's policy makers to undertake reform initiatives in line with the goal of

maximizing social welfare depend crucially on a broad set of factors. More specifically, the actual pace and effectiveness of structural reforms within a country is determined by the interaction between policy makers and the national community in its various expressions, lobbies and organized interest groups in general. Moreover, a government's commitment and ability to overcome the various kinds of obstacles to structural reforms required for boosting long-run growth are powerfully constrained by the country-specific institutional, political and economic context in which that government happens to act. Many of the domestic factors as well as international factors defining that context are not within the power of national policy makers to control and, thus, they are hardly modifiable, at least in the short term. Differences among EU countries in relation to these factors will continue to play a decisive role in determining differences in terms of the timing, sequencing and drawing of reforms in the near future. With specific reference to the post 2008-09 financial crisis scenario, a very controversial and complex issue is the role played by the crisis in facilitating or in hindering the reform process. Theoretical analysis as well as empirical studies have often supported the view that crises can facilitate structural adjustment programmes. A well-known explanation is that prolonged weak economic conditions increase society's perception of the need for reforms and, at the same time, weaken the resistance of interest groups sustaining the *status quo* – that is, the so called 'back against the wall hypothesis' (Rodrik, 1996). Conversely, empirical findings also show many examples where crises have hindered reforms, rather than fostered their implementation. In particular, the literature reveals that the various types of crisis – for example, economic recessions, currency crises, inflation crises, debt crises, fiscal imbalances – play a role in influencing the ability of governments to undertake and implement reforms which may be different for the specific reform policy areas. (Drazen and Easterly, 2001; Lora and Oliveira, 2004; OECD, 2009; Galasso, 2014; Agnello *et al.*, 2015 and the references cited therein). This evidence induces one to conclude that the interaction between crises and reforms may vary substantially across countries, markets and the content of policy measures. Going back to the experience of the 2008-09 crisis and the subsequent recession, empirical evidence seems to suggest that such events actually played a significant role in spurring the reform process in a number of highly indebted Eurozone countries. For some countries however, namely Greece, Ireland and Portugal, the nature of the reforms implemented largely reflected the external conditionality linked to the financial assistance activity granted by the EU and the IMF, rather than being due to an autonomous domestic decision-making process (OECD, 2012: 25-29; Featherstone, 2015).

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Another caveat is that in this paper the analysis has been developed under the implicit assumption of a given country individually implementing growth-enhancing reforms. However, for a full understanding of the economic impact of structural reforms within the EU it is important to distinguish between the case of a single country acting alone and the case of cross-country coordination of reforms. This is particularly true for the European Monetary Union (EMU), which is characterized by a common currency, highly interdependent economies and large cross-country spillovers. Various studies have estimated, through the use of multi-country dynamic general equilibrium models, both short- and long-term macroeconomic effects for the euro area countries in the two cases. Particular emphasis has been given to labour and product market reforms. This literature tends to conclude that in general there are benefits for a country implementing structural reforms unilaterally, while spillovers to other countries belonging to the euro area depend on the size of the country undertaking such reforms; cross-country coordination of reforms implies potentially larger gains for each country of the Eurozone vis-à-vis the case of unilateral implementation of reforms; simultaneous implementation of reforms by euro area countries may result in a long-term positive, although often marginal, impact on the rest of the world (Everaert and Schule, 2008; Gomes *et al.*, 2013; Anderson *et al.*, 2014).

The final caveat has to do with an issue which, although not explicitly raised in this paper, is crucial if one wants to design a coherent and effective structural reform strategy aiming at accelerating the growth process in the post-crisis scenario of the euro area, namely the relationship between structural reforms and current account imbalances within the EMU. Since its start, the EMU has been characterized by the presence of large and persistent intra-area current account imbalances, reflecting, at least partly, differences in the price competitiveness of member countries. Within a currency union, such as the euro area, where a devaluation of the nominal exchange rate is not possible, changes in relative prices between member countries to restore competitiveness may be achieved through the so-called ‘internal devaluation’; that is, via a country’s nominal wage and domestic price reductions or, more generally, via lower nominal wage and domestic price increases relative to other euro-area trading partners. However, this adjustment process of external imbalances entails for the countries involved short-term costs as for employment and output which tend to be higher, the higher the rigidity of domestic wages and prices. A number of theoretical and empirical studies have examined the potential role of structural reforms as a way to facilitate the adjustment process of intra-euro area current account imbalances. According to this literature, structural reforms – specifically labour market

reforms such as unemployment benefit systems, employment protection and active labour market policies – may mitigate short term losses of output and employment associated with the internal devaluation by enhancing wage and price flexibility. Even product market reforms fostering competition and liberalizing economic activity can contribute to accelerating the adjustment process by reducing the degree of price stickiness. In addition to fostering wage moderation and flexibility, structural reforms might improve a country's price level competitiveness through measures aimed at ensuring higher productivity growth rates relative to other members of the Eurozone (Zemanek *et al.*, 2010; Alcidi *et al.*, 2016; Belke and Gros, 2017)[10]. In the context of a cross-country approach, estimating the impact of an internal devaluation on output and employment, both on the country undertaking this measure and on the euro area as a whole, constitutes a very difficult and controversial task. Recent literature has highlighted a wide range of factors that contribute to determining size and sign of these effects. Among the most important of these factors are the number of member countries simultaneously aiming at recovering their external competitiveness within the euro area, the nature of structural reforms as well as the kind of macroeconomic policies enacted by these countries in conjunction with internal devaluation and the ECB monetary policy. In relation to the specific case of a monetary policy bounded by the ZLB on nominal interest rates, it has been argued that an internal devaluation pursued through a policy of wage moderation, while producing an expansionary effect on output of countries adopting this measure, is likely to cause negative spillovers on the remaining euro area countries and an output contraction of the euro area as a whole (Decressin *et al.*, 2015 and references cited therein).

5. CONCLUSIONS

The EU is made up of very disparate realities at national level so that the reforms required for putting member countries on a more favourable long-term growth path than the pre-crisis one are likely to differ even substantially from country to country. Therefore, a single reform strategy that would fit all the European countries cannot be hypothesized. Nonetheless, this paper argues that, regardless of the differing national realities, a consistent and effective action implies recognition that the recent global crisis has altered, to a varying degree, individual EU

[10] It is still an open question whether and to what extent the behaviour of a member country of a currency union which increases its intra-area current account surplus through price competitiveness gains due to labour market reforms may be viewed as a beggar-thy-neighbour policy (Baas and Belke, 2014).

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countries' priorities in the choice of structural policies for the near future from those potentially likely to boost growth. Among the factors explaining this phenomenon is the sharp deterioration in the public finances of a number of countries in concomitance with the crisis. For these countries, mainly in the Eurozone, faced with the need to reconcile the objective of reviving growth with that of carrying on with the policies of fiscal consolidation and safeguarding the sustainability of the public finances, measures that can stimulate increases in productivity and the employment rate without significant additional costs for the budget have priority. From the perspective of the revision of priorities, a second important factor is the dynamics of income distribution. In recent years the social welfare of the EU countries has been penalized not only by low growth but also by a persistent, widespread increase in distributive inequality. The recession following the 2008-09 financial crisis exacerbated the social costs and tensions of the high and increasing disparities in per capita income. Moreover, a wide literature stresses that rising inequality may hinder long-term growth. Against this economic and social backdrop, the pre-eminence taken on by the objective of a more equitable distribution of income, together with that of faster growth, implies that policy makers should carefully analyse the distributional impact of structural reforms giving priority to those measures which combine the objectives of growth and equity by strengthening growth while reducing inequality. A third important factor, in the choice of structural reforms to be given priority in the short term, consists in the prolonged sluggish recovery and the associated high unemployment still characterizing various EU countries. In these circumstances immediate priority should go to structural measures that not only improve the prospects of potential output growth in the long term but also give, directly and indirectly, effective support to aggregate demand and employment in the short term. This is mostly true for those Eurozone countries with limited margins for stimulating the economy through standard macroeconomic policies.

The suggestions presented here, in relation to the task of identifying a successful reform strategy for a steeper growth path in the European post-crisis scenario, are subject to some caveats. Two of them deserve special attention. First, the analysis has been developed by abstracting from the country-specific institutional, political and economic constraints within which the initiatives of individual national governments should be taken. In reality, as in the pre-crisis context, differing national realities in relation to these aspects will continue to play a significant role in determining differences among EU countries in the drawing up, sequencing and timing of reforms also in the near future. A further caveat is that this study has focused the discussion

exclusively on the domestic impact of growth enhancing reforms undertaken by a single country acting alone. However, a full understanding of the effects of any reform initiatives pursued by its members on the growth process of the EU as a whole requires that both their domestic impact as well as their external spillovers on other European economies are properly taken into account. This is particularly true within the Eurozone area.

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