THE DIFFICULT PATH OF STRUCTURAL REFORMS IN THE EUROPEAN UNION

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In the expectation of a successful and definitive exit from the recent global crisis, the debate on the long-term programmes of structural reforms in the European Union has gradually revived. It is a widely shared view that the scant economic dynamism characterising a number of member countries in recent decades is largely due to widespread structural weaknesses. 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 political economy and public choice approaches, this paper analyses why the decision-making process of structural reforms is usually very difficult even though, at least potentially, they lead to a more efficient allocation of resources and boost long-run growth. Finally, the paper points out how the path of a country's structural reforms may be strongly influenced by political, institutional, and economic factors contributing to the definition of a framework in which policy makers interact with the national community in its various forms, lobbies and, more generally, organised special interest groups.

Nell'attesa di una definitiva uscita dalla recente crisi globale, il dibattito sui programmi di lungo termine in tema di riforme strutturali nell'area dei Paesi dell'Unione europea ha progressivamente ripreso vigore. È ampiamente condivisa l'opinione secondo la quale l'insoddisfacente *performance* economica di vari Paesi membri nel corso degli ultimi decenni rifletta in larga misura la diffusa presenza di carenze strutturali al proprio interno. Tuttavia, analogamente a quanto si è verificato nell'esperienza del periodo precedente la crisi, il sentiero delle riforme strutturali continua a prospettarsi denso di difficoltà. Sulla base di un'ampia e consolidata letteratura riconducibile agli indirizzi teorici della *public choice* e della *political economy*, il presente articolo analizza le principali ragioni per le quali i processi decisionali in merito alle riforme strutturali risultano di norma assai travagliati anche quando, almeno potenzialmente, essi conducano a una più efficiente allocazione delle risorse e a una accelerazione della crescita economica. Si pone inoltre in evidenza come la dinamica delle riforme strutturali di un Paese possa essere condizionata in modo significativo da un insieme di fattori politici, istituzionali ed economici che contribuiscono a definire il contesto all'interno del quale i *policy makers* interagiscono con la comunità nazionale nelle sue varie espressioni, le *lobbies* e, più in generale, i gruppi di pressione organizzati a difesa di interessi particolari.

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

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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 to the other advanced countries, especially the USA.

It is a widely shared view that this poor performance of the European economy was largely due to widespread structural weaknesses. Consistently with this view, at the summit held in Lisbon in March 2000 the European Council adopted a plan – the so-called "Lisbon Strategy" – with the aim of strengthening the growth potential of member countries through wide-ranging reform programmes. After a rather disappointing start, the Lisbon Strategy was re-launched in 2005, with results that differed widely from country to country and from sector to sector.

As a consequence of the major financial and economic crisis that hit Europe in 2008, and in particular the euro area, stabilising the financial markets and at the same time supporting production and employment became the top priority of EU governments, compared with the longer-term objective of correcting structural shortcomings that continued to penalise the growth rates of member countries.

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. The expectation of an imminent exit from the crisis, which subsequently proved to be over-optimistic, contributed to encouraging a gradual revival of interest within the EU in longer-term problems. This renewed interest of the European Commission for re-embarking without delay on the arduous path of structural reforms, after the slowdown imposed by the crisis, found its expression in the document "Europe 2020" published in 2010. This document, which formulates a strategy for overcoming the crisis and reviving growth, sets five targets for the EU to be achieved by 2020 concerning employments, research and development, climate change and energy, education, and poverty.

Nevertheless, the sharp deterioration in public finances that occurred in many European countries, as a consequence of the financial crisis of 2008-2009 and the ensuing recession, made the task of resuming the structural reform process very challenging. This was particularly true for several Eurozone countries exposed to the risk of a sovereign debt crisis, needing to reconcile the objective of reviving growth with that of fiscal consolidation and the sustainability of public finances in the longer term.

As a matter of fact, as in the pre-crisis experience, the path of structural reforms has continued to appear fraught with difficulties also in relation to the post-crisis scenario. This paper focuses on some of the major political economy factors that are at the origin of such difficulties. The next section analyses these factors, which - 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.

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

Although academics, economic agents, and policy makers recognise 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. The areas identified as needing effective structural reforms have involved, to a varying extent depending on the country, the markets of goods and services, the labour market, the financial market, the tax regime, the educational system, infrastructure, the level and composition of public expenditure, and the quality of public institutions. 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 policies (Sachs, 1994; Rodrik, 1996; Drazen, 1998; Freytag, Renaud, 2007). In this context, a major obstacle can be disagreement between those who adhere to theoretical approaches that give 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.

An orientation in favour of the status quo, one that penalises 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, materialise 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. 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).

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 often concentrated in the short term[1]. This is the case, for example, of some product- and labour-market reforms whose expected positive effects on a country's growth rate tend to materialise mainly in the long run but which in the short run can adversely affect both production and employment (IMF, 2004, pp. 124-8). The more deferred 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

[1] Situations in which the difference between the distribution over time of the benefits and costs of a reform results in the latter initially outweighing the former, which more than offset the costs in the longer run, can be depicted by a 'J curve' (Pinẽra, 1994, pp. 227-8).

are, instead, fully perceptible by its members. Temporal mismatching of the benefits and costs of structural measures can 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 maximise some social welfare function. Opportunistic choices, aimed at increasing their chances of re-election, lead to a preference for short time horizons 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. 171-2, 2009b, pp. 36-7). This argument is especially valid for countries whose electoral cycles are characterised 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 which open protected markets to competition, where a large group of potential winners, i.e. consumers, contrasts with a small number of potential losers, i.e. the producers that operate in those markets, who see their rent positions threatened. Since 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. In contrast, the high degree of dispersion of the benefits, together with the transaction costs connected with the activity of organising, which tend 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 organise themselves on behalf of a common objective, we have another factor that contributes to the status quo prevailing at the expense of structural reforms[2].

With reference to the analysis of the distributional conflict among interest groups as an explanation of why structural reforms are often not enacted or are long-delayed even when they would benefit everyone, an interesting contribution is represented by the 'war of attrition' model of Alesina and Drazen (1991)[3]. The model assumes that the costs of a given reform are known. Moreover, each socio-economic group is informed of the net benefit it would receive from the adoption of that policy change "under a given distribution of costs", while it is uncertain "about the net benefits other groups will enjoy and hence about their willingness to pay for the reform" (Drazen, 1998, p. 40). Although different

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

[3] The model of 'war of attrition' was originally applied by Alesina and Drazen to explain why a macroeconomic stabilisation programme requiring a change in fiscal policy can be long-delayed owing to its significant distributional implications. This model, however, as underlined by the authors, may be usefully extended to various cases of structural reforms implying a distributional conflict among interest groups (Alesina, Drazen, 1991, p. 1182; Alesina, Ardagna, Trebbi, 2006, pp. 25-6).

socio-economic groups agree that this welfare increasing reform would benefit everyone and that it would have to be adopted eventually, they may disagree on the distribution of the costs of implementing that reform. In this context, it may be rational for each interest group to try to delay the reform programme with the aim of inducing other groups to bear a larger share of its costs. This finds an explanation in the hypothesis that the reform has a public good connotation[4]. The war of attrition ends and the reform is adopted when the interest groups blocking this policy measure realise that the expected benefits coming from further delays are lower than the expected costs. At this point, these groups would agree on the reform programme, accepting that they would have to bear a larger quota of the burden of its implementation. The literature has indicated a number of factors in the political and economic scenario that may affect the agents' behaviour during the war of attrition. Among them the most relevant are: i) electoral outcomes changing the relative political power of various interest groups; ii) the government's strength; iii) the nature of political institutions; and iv) the occurrence of a crisis.

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 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 the 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. Situations where the lack of consensus in favour of a reform that would 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 (Rodrik, 1996, p. 38)[5].

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

[4] As Drazen (1998, p. 42) points out: "The conflict-over-distribution approach has as its basis the notion that reform is a public good, so that people may be in favor of reform, but want someone else to bear the cost".

[5] In his comment on differences between the war-of-attrition approach of Alesina and Drazen and the Fernandez-Rodrik approach, Drazen (1998, p. 57) writes: "[W]hile in the war-of-attrition model an individual who agrees to bear the cost of a reform program knows what his net benefit will be, central to Fernandez-Rodrik approach is uncertainty about the net benefits an individual will receive from a reform program".

the loss to be indemnified (IMF, 2004, p. 109; OECD, 2009b, pp. 54-60).[6] What is more, 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 organised 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 pro-growth 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 with and counterbalanced by measures to provide more support for unemployment and more effective active labour policies[7].

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 liberalise the markets for goods, by lowering the barriers to new firm entries and, more generally, guaranteeing more competition (Blanchard, 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. 56-8).

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 national community in its various expressions, lobbies and, more generally, organised special interest groups.

[6] 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".

[7] 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).

At this point, it should be emphasised 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 the likelihood of a successful outcome of the reform programmes, 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. In addition, 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, a number of empirical studies have shown that economic and financial crises as well as situations of prolonged low or negative growth can increase political support for structural adjustment programmes. One possible explanation is that the protraction of unfavourable conditions, involving severe macroeconomic deterioration, makes society more conscious of the costs of not embarking on reforms and at the same time weakens the opposition of interest groups[8]. This is the so-called 'back against the wall' hypothesis according to which the widespread perception that the status quo is no longer viable increases the political consensus for major structural reforms (Rodrik, 1996, pp. 26-32; IMF, 2004, pp. 113-4). However, empirical evidence concerning the relationship between weak economic conditions and reforms is mixed. The literature in the field is rich with examples where crises did not play a 'catalytic role' for structural reforms, but, vice versa, they hampered their implementation. There are also circumstances where crises appeared to play only a marginal role, or no role at all, in stimulating reforms. To conclude, the relationship between crises and the political sustainability of structural reforms may vary substantially across countries, markets, and reform areas (OECD, 2009a, p. 38, 2009b, p. 40; Drazen, Easterly, 2001; Galasso, 2014 and references cited therein).

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 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 future (OECD, 2009b, pp. 40-2). 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[9].

[8] On the role of the financial crisis of 2008-2009 and the ensuing recession in promoting structural reforms in a number of highly indebted Eurozone countries, see OECD (2012, pp. 25-9).

[9] Helpful observations on the relationship between the state of public finances and structural reforms are published in Buti, Röger and Turrini (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 poli-

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. 102-4, 2004, pp. 112-3 and pp. 130-2; 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 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 organisations at a regional level, e.g. the EU, the European Monetary Union (EMU), and the North American Free Trade Area (NAFTA), or at a global level, e.g. the International Monetary Fund (IMF) and the World Trade Organization (WTO)[10]. 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 reform credible, with the result, among other things, of discouraging the activity of lobbies opposed to the reforms[11].

4. Conclusions

In the expectation of a definitive 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. Thorough knowledge of such difficulties is a pre-

cies oriented towards fiscal rigorousness and structural reforms to be linked by a relationship of complementarity or substitutability.

[10] 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.

[11] As regards countries joining an international trade agreement to solve credibility and time-inconsistency problems, see, for instance, Matsuyama (1990) and Maggi and Rodriguez-Clare (1998).

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 has 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 organised 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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