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ECONOMIC REFORMS IN THE EURO AREA: IS THERE A COMMON AGENDA?

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Economic reforms in the euro area: Is there a common agenda?[1]
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Despite the recent growth revival, the state of the euro area economy remains vexingly disappointing. What is taking place is too little, too late and the very fact that output growth only started to pick up in the fourth year of the global recovery suggests that something must be wrong. Against this background, the overriding priority remains to design and implement policy packages aiming at:

(i) Increasing potential output through higher employment, higher labour participation, and higher productivity;
(ii) Ensuring that actual output does not lag behind gains in potential output.

While several items on the reform agenda remain a matter for discussion, the *overall direction* and a large part of the concrete prescriptions increasingly command consensus among euro-area policymakers[2]. It is also widely recognised that this agenda leaves room for social choices that may differ from one country to another or from one political camp to another — say, as regards the respective roles of public and private initiatives or the balance between individual and collective responsibility.

Yet the devil is in the detail, and there is much less consensus on the *strategy* for reform, that is, on whether reforms should be bundled into comprehensive packages or introduced step by step, on how to deal with their distributional effects, and on the methods governments should rely on to overcome political economy constraints. This would be less of a problem if the political momentum for reforms was strong enough to overcome those constraints. But opponents are loud and proponents are almost apologising for trying to get things right.

The result is damning: reforms in the euro area tend to be piecemeal and lack coherence. In other words, many governments tend to waste scarce political capital in low-return reforms and they find themselves unable to build on first gains to sustain the effort and achieve significant results. In the worst case — but not the least frequent one — the choice of a reform agenda is primarily determined by the amount of political capital a government finds itself able to venture on a particular project — absent any consideration of expected return. This is *reform by stealth*, and it does not work.

This note intends to be a somewhat subjective contribution to the emerging discussion on reform strategies in the euro area. It is not based on original research and does not constitute a survey but draws selectively on our reading of the evidence and the literature to ask questions we regard as relevant in the present European context. We concentrate on four issues:

1. What is special about reforms in Europe and the euro area?
2. What do we know about reforming in good times?
3. Should governments try to find the right reform sequencing or to exploit robust complementarities (across policies or over time)?
4. To what degree should reforms be coordinated?

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[1] An earlier version of this note was presented in October 2006 to the Eurogroup Working Group of the Economic Policy Committee of the EU.
[2] Aghion (2006) summarises the essential components of a package of policies aimed at innovation-based growth.

1. Why is Europe special?

In several countries including important ones such as Germany, France and Italy the need for, and nature of reforms are frequently a matter of political and social controversy. Why?

Popular aversion to structural reforms is rooted in three main causes:

- *Uncertainty,* Structural reforms are by nature complex (their purpose is to change economic agents' behaviour and/or the outcome of their interactions on markets), and it is difficult for policymakers to predict and explain their economic effects;
- *Risk aversion.* Individuals are also uncertain about whether they will benefit from the reforms, or actually lose out from them as economic rents are destroyed or reshuffled, and the perception of economic risks is affected[3];
- *Distribution.* Market-oriented reforms tend to reduce rents and/or to redistribute them, creating losers and winners. While losers are clearly identified, the beneficiaries are more widespread and their individual gains are more likely to be small in comparison to the individual costs for the losers.

It is not always clear why those factors seem to play a greater role in some countries than in others. Uncertainty should concern all countries and policymakers in the world. Yet it is a stronger source of concern in countries where disagreements on the likely effects of reforms (and therefore on their desirability) are widespread. As discussed by Ravi Kanbur (2001), there can indeed be several reasons why rational people disagree on the effects of reforms, and this has relevance for Europe[4].

Risk aversion may differ across countries and it is frequently assessed that it is especially high in continental Europe. That said, one should not forget that people also ask for protection because they objectively face a greater risk. For instance, a rigid labour market does a poor job at reallocating jobs across sectors, which means that unemployment shocks are persistent. This can give rise to a reform standstill because lack of reform increases the perceived cost of it.

Societies also differ in the degree to which they value equity. In societies with stronger sense of equality, anti-reforms coalitions tend to be easy to form even if the group of losers is small and not well-connected politically. The same argument prevails for reforms that strengthen the link between individual income and productivity, such as labour or product market reforms.

Those three types of motivations often combine to strengthen opposition to reform. Indeed, if it is clear the uncertainty about the distributional effects of reforms is a key source of status quo (or anti-reform) bias (Fernandez and Rodrik, 1991), greater risk aversion and equity concerns work together to magnify such bias.

If resistance to reforms in the major euro area countries is actually motivated by these factors or a combination thereof, what consequences should we draw from this situation? It is often argued that only deep crises can help break such deadlocks, as illustrated by the experience of several EU countries (the United Kingdom, Denmark, the Netherlands and Ireland in the 1980s, Finland and Sweden in the 1990s[5]). Furthermore, the aggregate evidence seems to be disappointing for Europe. For instance, Debrun and Annett (2004) find evidence that while Anglo-Saxon OECD countries tend to implement reforms in good times, continental European countries rather do it in bad times. Yet a

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[3] For instance, greater labour market flexibility simultaneously increases the risk of losing one's job and the odds to find a new job quickly, making risk-averse employees worse-off (and the unemployed better-off).

[4] Kanbur emphasizes three sources of disagreement: different time horizons (the reformers focus on the medium term and overlook the transition costs, their opponents on the short term); different preferences for equity (the reformers emphasize efficiency, their opponent distributional effects) and different assumptions on how markets work (reformer assume they are competitive, their opponents are alarmed by market power).

[5] See for example Annett (2006).

consequence of the euro is that at least the risk of exchange crises has been removed and that the overall probability of crises has diminished. Furthermore, the only question with practical relevance in the current conditions is how to reform in the context of an improving economic environment. This should lead policymakers to design reform strategies for good times which address all three dimensions of opposition to reform.

2. Reforming in good times

The problem with good times is, of course, that the need for reforms is less apparent when the economy is doing well than otherwise. But this should not distract policymakers from the fact that in good times, incomes grow faster, and that in the same way as inflation blurs relative price signals, reform-induced changes in income distribution are less visible and the corresponding resistance less pronounced. Losers can also be more easily compensated when budgetary resources are less scarce. Transition costs themselves are reduced because labour can be more easily reallocated across sectors, which reduces the risk of creating persistent unemployment, especially if gross labour flows into (and out of) employment remain limited. Finally, a key argument that is often underexploited by policymakers is that reforms that increase potential output would help prolong the upper phase of the cycle and delay the downturn. Well-thought reforms would therefore encourage monetary authorities to be more patient before entering a tightening cycle.

To summarize, while governments that reform in good times cannot rely on the "There is No Alternative" (TINA) argument and need to buy support for reform — at a cost for public finances, good macroeconomic conditions simultaneously reduce the fiscal price tag of reforms and provide more tax money to pay for it.

Good times should therefore be regarded as opportunities that policymakers should take full advantage of. It should also be recognised that the corresponding packages are bound to differ from those implemented in bad times and that there is more need for addressing the main concerns directly (mainly through a smart use of fiscal policy). Specifically:

- *The EU has a role to play to help reduce uncertainty* about the consequences of reforms. Careful evaluation of experiences with successful reforms in other, similar countries can help reduce resistance primarily motivated by uncertainty;
- In response to risk aversion*, measures that have the potential of reducing risk and increasing opportunities should be both an important element of the package and an important argument* when "selling" reforms. For example, reformers in more risk-averse societies need to think harder on ways to insure against potential downsides of reforms, and to substitute for the insurance function associated with some market "rigidities.". The flex-security model in Denmark is a perfect illustration of that argument;
- *In response to distributional concerns, the efficient policy response is to compensate losers through explicit transfers* (up to the net present value of the costs). Whether those transfers are justified on equity grounds or simply result from political recognition that there is a price to pay to buy off rents is immaterial here. What matters is that, although the amount of the compensation can be smaller, the demand for compensating losers is likely to be more pressing when macroeconomic conditions are better. To the extent that the gains will be spread over time, it seems legitimate to finance such costs (at least in part) with higher public debt.

The upshot is that in contrast to reform in bad times, reform in good times is more likely to conflict with fiscal consolidation (which is also easier and expected to be more ambitious in good times) and that reformers need to decide where they wish to allocate political capital[6]. This suggests that the

[6] Debrun and Annett (2004) find suggestive evidence that, in EU countries, reduced room for fiscal maneuver tends to discourage reforms in the labour market. However, they also find that, all other things equal, accelerations in consolidation efforts (which in Europe tends to happen in bad times) went along with more labour reforms, in line with the tendency to make tough choices in bad times.

budgetary dimension of reform packages [7]— even those with little direct and traceable budgetary implications[8] — should be taken seriously and addressed explicitly in the implementation of the revamped SGP.

A practical conclusion is that countries contemplating ambitious reform programmes should be allowed to initiate a comprehensive discussion on the budgetary aspects of their plans. This discussion could take place within the Eurogroup in anticipation of the examination of the country's stability programme.

3. Comprehensive vs. step-by-step reforms

Which are the priority reforms? Too often, would-be reformers adopt what Ricardo Hausmann, Dani Rodrik and Andrés Velasco (2005) call a "laundry-list approach to reform" that "implicitly relies on the notions that (i) any reform is good; (ii) the more areas reformed, the better; and (iii) the deeper the reform in any area, the better". Hausmann, Rodrik and Velasco rightly claim that such a strategy can be a waste of political capital and even that in the presence of significant distortions, it is not guaranteed that such a strategy will improve welfare.

But what should a strategy be? There are two views. The first one draws on the complementarities across sector reforms to advocate implementing a comprehensive package of mutually reinforcing measures covering a broad scope. Policy complementarities, the argument goes, are strong enough to make the return on individual reforms small (Coe and Snower, 1997). In contrast, a well-designed package can exploit complementarities to ensure a significantly higher return. This does not need to imply implementing all reforms to their full extent at once, but suggests that policymakers need to select priorities while taking into account robust complementarities and implement reforms according to a "radial" strategy involving simultaneous and proportional progress on several fronts (Braga de Macedo and Oliveira-Martins, 2006).

The other approach does not start from economic complementarities but from political constraints. It advocates starting with reforms that have the potential of building constituencies for, and reducing opposition to, future, more ambitious reforms, even if this is at the cost of lower immediate efficiency (Dewatripont and Roland, 1992). This approach suggests beginning with reforms that are less costly (for example in the financial sector) but can increase the benefits from future reforms (for example of products and labour market reforms). In the same vein, it advocates reforms that have the potential of eroding rents and therefore to facilitating future reforms, as argued by Blanchard and Giavazzi (2002) for European product markets.

The controversy is by no means new. There was a fierce discussion in the 1990s between the partisans of the Polish Big Bang and the advocates of Chinese gradualism, and while the context was different, the arguments were essentially the same. Both approaches have their pros and cons and the choice between them cannot be made *in abstracto.*

What can be said, however, is that they cannot be treated symmetrically in the current euro area context. First, there are probably few low-hanging fruits left in the euro area because many low-cost reforms have already been implemented or attempted. Second, to the extent some reforms are meant to undermine opposition to future ones, those social groups who could suffer are likely to anticipate the next steps in the game and oppose reforms from the start. The controversy over the services directive was in this respect a vivid illustration as though the project was affecting product markets, it was mainly opposed on the ground that it would have had undesirable labour market consequences. Third and most importantly, a gradualist strategy that takes into account political constraints can only be

[7] Furthermore, comprehensive packages that simultaneously erode rents throughout the economy may reduce the need for compensating losers because at the limit, everybody simultaneously loses and gains from reform.
[8] This would be the case for compensatory transfer schemes. Unfortunately, the formulation of the new SGP makes it difficult to give credit for reforms outside second-pillar pension reforms (Beetsma and Debrun, 2006).

designed on a case-by-case basis, while the identification of robust complementarities — which involve both national and EU policies - is a matter for common discussion and decision.

This suggest identifying of a core set of complementary measures for the euro area that are considered as having the potential of increasing potential output and should be given priority in reform programmes. Those measures should logically involve both national policies (especially as regards education, labour markets, land markets and some services regulations) and EU-wide policies (especially as regards financial markets and product markets).

The broader issue is whether some explicit coordination of structural reforms should be undertaken at the euro area level, and if so, how this could be done.

4. The scope for coordination

The standard case for international policy coordination rests on two motives for it: spillovers (i.e. national policies affect performance abroad) and economies of scale (i.e. certain policies give more bang for the buck when decided and implemented at a supranational level). The mainstream argument against coordination (Tabellini and Wyplosz, 2004) is that the design and implementation of structural reforms should be left in the hands of national authorities for two main reasons: first, because the content of the reform agenda is by essence country-specific as it largely depends on existing institutions and on political-economy constraints (including electoral cycles), which vary greatly across countries; second, because the spillover effects of supply-side policies are thought to be small, and possibly negative. For example, a country that improves its competitiveness through supply-friendly reforms is likely to gain market shares at the expense of its partners. In a non-cooperative setting, those countries would thus be encouraged to alleviate competitiveness losses through structural measures of their own. Such a competition for reform is healthy to the extent that the speed of reforms is deemed too slow. By contrast, coordination may end up building a coalition of reform-wary governments, which is likely to reduce the reform effort instead of encouraging it.

Those are powerful arguments which command a wide consensus in the academic and policy communities. Therefore, any attempt at coordination should be weighted against them. There are, however, counter-arguments for a cooperative approach:

1. *A case can be made for a soft Lisbon-type coordination at the EU level,* namely for setting targets, exchanging information, discussing the results of reform measures, and comparing performances. One argument is that coordination, through a permanent exchange of information, fosters *learning* from the experiences of others on what works and what does not work. It therefore helps reduce uncertainty on the effects of reforms. Another argument relies on *complementarities* between, on the one hand, product and financial market reforms (the responsibility for which frequently belongs to the EU) and, on the other hand, labour market reforms (which belong to the remit of the member states).[9] Here, coordination should boost the returns on reforms. Finally, there may be *political economies of scale* by acting together on the reform front ("we do it because we don't want to be left behind" or "we do it although our governments belong to different political families, therefore this is not a partisan agenda").

2. *Positive policy spillovers, and the corresponding case for coordination, are arguably stronger in the euro area.* This is because a country which implements a reform whose effect is to reduce inflationary pressures exerts an effect on its neighbours through the reaction of the common monetary policy. Therefore, only coordinated reforms in the euro area (or in a significant part of it) will ease the task of the ECB in managing the risks to price stability and

[9] For example, a combination of product market regulations that aim at favouring entry, and of labour market regulations that aim at preserving existing jobs (or vice-versa), is a recipe for ineffectiveness because it will only increase adjustment costs for existing firms.

elicit a response from it. Coordination between governments would open the possibility for monetary policy to accommodate an expected increase in the area's potential output. It could serve as a basis for a dialogue with the ECB. By the same token, a coordinated approach to reforms and the associated response of the ECB could alleviate the pressure on fiscal policies to be more supportive of reforms, which is important given the sorry state of public finances in many countries.

3. *Euro-area-specific policy conflicts may also be avoided with greater coordination.* For instance, some structural reforms (slashing subsidies, raising administered prices) may temporarily conflict with macroeconomic objectives. In the absence of vertical coordination (or, rather, dialogue) with the ECB, there would be a case for a staggering of reforms across countries rather than joint actions.[10] Alternatively, horizontal coordination on such reform could facilitate some form of vertical coordination with the ECB (and wage-setters) to pre-empt an adverse monetary response. Such reforms should thus be treated separately, and explicitly discussed with ECB and wage-setters.

How should such coordination be organised? The proliferation of procedures and the corresponding fatigue leads to caution against creating another general procedure. Rather, action should be targeted at situations where there is a demonstrable case for joint intervention. Specifically:

- *The Commission and the ECB could be invited to outline what they regard as priority areas for structural reform in the euro area* and member countries should respond by indicating what actions they intend to take within a given time frame. A potential area for such action is the response to EU initiatives on product or financial markets. The resulting action plans could serve as a basis for drawing up a euro area reform programme.
- *The Eurogroup discussions should identify potentially large spillovers from certain national reforms (or the absence thereof) and discuss possible responses on a case-by-case basis*. In response to potentially harmful performance divergence in a euro area country, the President of the Eurogroup and the ECFIN Commissioner should be given a mandate to initiate discussions with the country's authorities. In the current context, it could for example be given the mandate to discuss competitiveness with Italy and the property market with Spain. Country examinations should serve as a basis for deciding on such a mandate.

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[10] Non-synchronized electoral cycles complicate such horizontal coordination on reforms, unless it carries significant benefits on the macro policy side.

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