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Understanding the Political Economy of Reforms
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By Theo Aphecetche, Erik Canton, Maria Garrone and Alexandr Hobza

Abstract

This Economic Brief identifies the main political economy conditions facilitating or hindering the implementation of reforms. It analyses and draws lessons from some of the most significant reform efforts by EU countries over the past decade. First, reform implementation is easier when the government has a strong political mandate. Second, providing a strong evidence base for the reform helps to build support. Finally, reform design needs to consider adequate compensatory measures, and an effective communication and consultation process. The note concludes by indicating how the design of the Recovery and Resilience Facility addresses some of these political economy factors.

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Introduction

The EU is recovering stronger than expected[1], but the level of uncertainty and risks surrounding the growth outlook is still high. There is nonetheless a broad consensus that the COVID-19 crisis will have long-lasting effects on macro-economic fundamentals, economic resilience and potential output.[2]

Moreover, the economic impact of the pandemic comes on top of the subdued potential growth that the European economies have been experiencing over the last decades.[3] Reforms and investments promoting inclusive and sustainable growth are thus needed more than ever.

However, implementation of such reforms is notoriously difficult. Addressing the obstacles to fundamental drivers of growth and productivity often comes with economic and social costs in the short-term, typically falling on specific groups, while benefits are diffused across the economy and may only arise over time. Reforms may produce winners and losers, and the opposition of potential losers makes them difficult to implement. Moreover, the distribution of gains from a reform may in some cases be perceived as unfair by the population at large. The resulting lack of domestic reform ownership and commitment becomes a serious hurdle for planning, adopting and implementing complex reforms.

Progressing with structural policies that promote inclusive and sustainable growth is particularly important for the euro area. In the absence of a flexible exchange rate and in the presence of strong spillover effects, euro area countries need to find adequate adjustment mechanisms to absorb shocks. Implementing approriate reforms is therefore crucial for addressing macroeconomic imbalances. Enhancing Member States' reform efforts to address underlying social and economic weaknesses that could lead to increased divergences in the event of shocks, and potentially disturb the good functioning of the Economic and Monetary Union, is all the more important.

The COVID-19 crisis is both a daunting challenge and a stark reminder for policymakers to generate momentum behind ambitious reform agendas. The decisive role of governments in times of emergency came more to the fore during the crisis. The pandemic and the drop in economic activity that has followed have highlighted the key role of governments in not only responding to the alarming health situation but also in supporting the economy. Financial support programmes for businesses and deferral of interest and tax payments, as well as the activation of short-time work schemes, have contributed to limiting the economic damage. In addition, the forceful response at EU level has confirmed Member States' capacity to coordinate within the Union. Experience suggests that it will be a challenge to maintain momentum in the policy actions following a crisis. Indeed, the strong impact that the crisis has on people's lives could erode popular support for further action. Governments will need to pay particular attention to the design of their recovery strategy to make reforms perennial, through generating economic growth and living-up to citizens' expectations. The need to sustain the recovery and ensure that the policy action supports the longer-term challenges, such as the green and digital transition, makes it clear that reform fatigue or reform reversals need to be avoided.

The role of the EU in supporting structural reforms is also evolving. Traditionally, the European Semester has supported structural reforms at national level through benchmarking, the development of best practices and guidance in the form of Country-Specific Recommendations. Long-term investment has *inter alia* been supported by the Structural Funds. In recent years, technical assistance through DG REFORM (formerly known as the Structural Reform Support Service) has provided a new tool to support reforms.

The policy focus is gradually moving from emergency support to policies to sustain the recovery and structural changes. In this context, the Recovery and Resilience Facility (RRF) offers a new and powerful temporary instrument for the EU to support reform efforts at Member State level, combined in coherent packages of investments and reforms in policy areas where there are pronounced barriers to growth. By linking direct financial support to the implementation of investment and reforms, the RRF provides positive incentives for Member States to make their economies more resilient, sustainable and better prepared for the future.

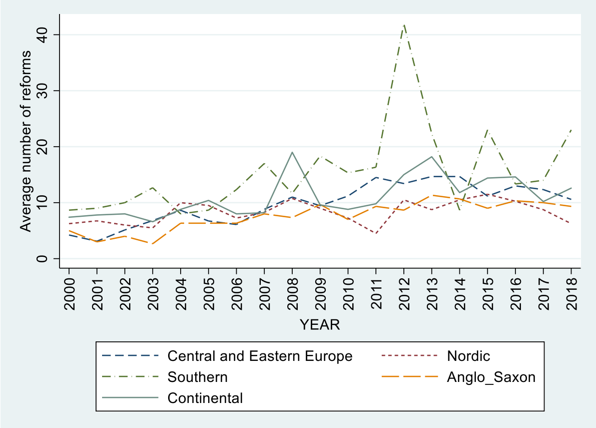
The focus of this brief is on how political economy factors can affect reform implementation.[4] It draws on a non-exhaustive list of reform episodes observed across the EU Member States[5] over the past decade, before the COVID-19 crisis. The analysis provides insight into factors that have facilitated implementation of reforms, as well as reforms that were not implemented as planned due to various political economy constraints. Such lessons are important to keep the reform momentum and promote a strong and inclusive recovery. It concludes by indicating how the design of the RRF aims to address some of these lessons.

Reform intensity in the EU

The EU and euro area countries made significant reform efforts in the years following the 2008-2009 financial crisis. Reform efforts were rather broad in the aftermath of the crisis, and went well beyond measures to fight the impact of the recession or strengthening of the EMU architecture (see for example Turrini et al., 2015).

However, intensity and trends varied across countries and policy areas. Member States with higher reform needs typically showed higher reform intensity, and this was also the case for Member States that were not subject to the conditionality associated with macroeconomic support programmes (see reform intensity in product and labour markets in D'Adamo et al., 2019). For instance, in the labour market. Southern countries exhibit higher reform intensity with a remarkable peak in 2012 (Graph 1). At the same time convergence is observed in the product market, which suggest that countries with the strictest regulations have implemented the biggest reforms (OECD, 2014). A decreasing trend in the standard deviation of the economy-wide PMR indicator and its three components[6] - most prominently as regards the barriers to trade and investment and State Control - is reported between 1998 and 2013 (Graph 2). Moreover, as regards the ease of doing business, World Bank data show that the world ranking position of most EU countries has improved, suggesting they have made reform efforts in this area (Graph 3).

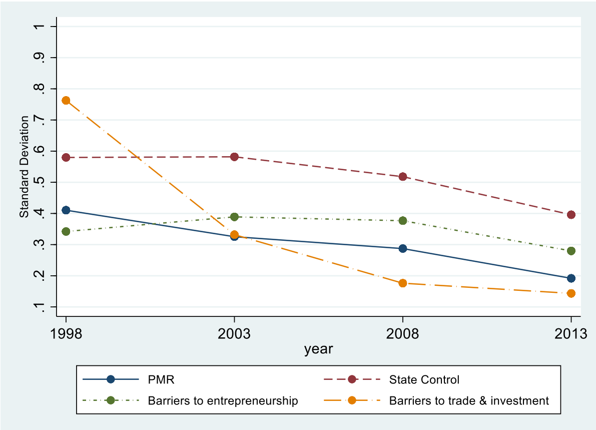
Graph 1: **Average number of labour market reforms adopted by EU countries, 2000-2018**



Note: the reforms cover a wide range of labour market policies, such as Active labour market policies, Early withdrawal schemes, Labour mobility and migration policies, Job protection, Labour taxation, Unemployment benefits, Other welfare-related benefits, Wage Setting and Working Time. The country taxonomy comes from Turrini et al. (2015). Croatia is classified in the group Central and Eastern Europe.

Source: Authors' elaboration from LABREF – Labour Market Reform Database, DG EMPL.

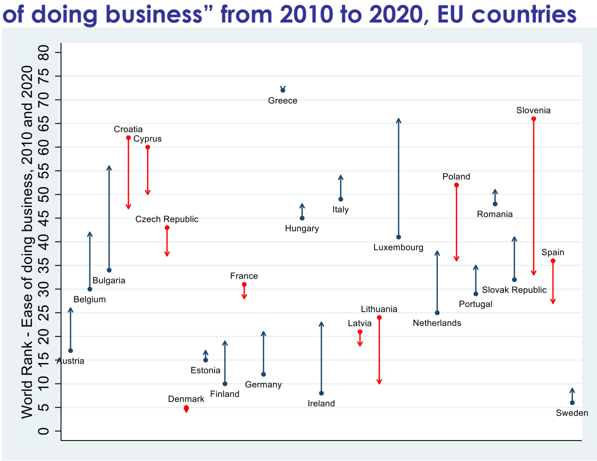
Graph 2: **Standard deviation of the economy-wide PMR and its components, EU countries 1998-2013**



Note: Several EU27 countries are not included due to lack of PMR data in some years (Bulgaria, Croatia, Cyprus, Estonia, Luxembourg, Latvia, Lithuania, Malta, Slovak Republic, Slovenia and Romania). The 2018 data for the PMR cannot be used, due to a change in methodology.

Source: Authors' elaboration from the OECD PMR database.

Graph 3: Change in World rank position on "Ease of doing business" from 2010 to 2020, EU countries

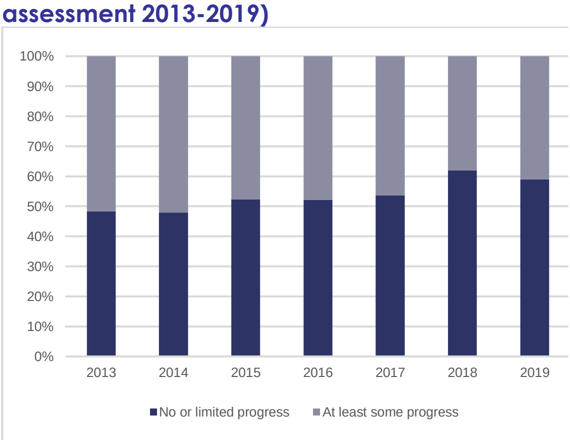


Note: the head arrow refers to the rating of the ease of doing business indicator in 2020. The solid dot at the start of the arrow refers to the rating of ease of doing business in 2010. Data for Malta are missing.

Source: authors' elaboration from World Bank ease of doing business.

However, "reform fatigue" may have affected a large number of Member States when the economy emerged from the financial crisis, as can also be seen from the implementation record of the country-specific recommendations issued as part of the European Semester.[7] Since 2013 the share of country-specific recommendations (CSRs) that have been implemented with "at least some progress" has declined by around 10 percentage points, whereas there has been a corresponding increase in the share of CSRs "with no or limited progress" (see Graph 4).[8]

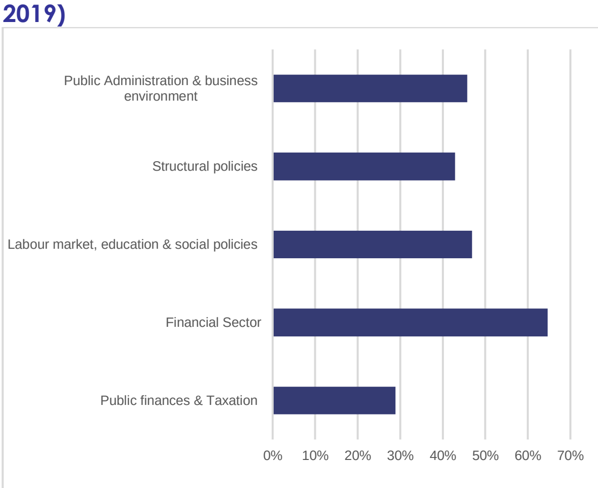
Graph 4: Implementation progress of CSRs (annual assessment 2013-2019)



Source: authors' own elaboration from ECFIN CeSaR data.

The implementation of reforms has been advancing unevenly across policy areas. Graph 5 indicates that compliance with recommendations seems to be higher in the financial sector. The number of CSRs with at least "*some progress*" accounts for almost 65% of the overall CSRs in that policy area. On the contrary, a possible phenomenon of reform fatigue seems to be present in the area of public finance and taxation, where less than 30% of the CSRs achieved at least "*some progress*".

Graph 5: Share of CSRs with "at least some progress" by policy area (annual assessment 2013-2019)



Note: for the classification of policy areas, see Annex 2. The progress made is evaluated using five categories: "no progress", "limited progress", "some progress", "substantial progress" and "full implementation". The share of CSRs with at least some progress includes CSRs with some progress and above, i.e. substantial progress and full implementation.

Source: authors' own elaboration from CeSaR, ECFIN.

A closer look at structural reform experiences in the EU

This section builds on past reform experiences of EU countries over the past decade, but preceeding the COVID-19 crisis. It refers to specific reform episodes in different countries. However, these examples are meant to demonstrate specific political economy lessons and should not be seen as assessments of the specific measures. Evidence was collected through a consultation of DG ECFIN's geographical desks in collaboration with the European Semester Officers (ESOs). This was complemented by insights from recent literature on political economy of reforms. Furthermore to build our policy-framework, we relied on an extensive set of literature.[9] The examples are necessarily very selective and non-exhaustive.

Strong political and electoral mandate fosters reform adoption

The experiences of EU countries over the past decade suggest that the overall democratic support plays a decisive role in the capacity to pass reform proposals. Governments with strong support from the parliament are more likely to be successful in implementing reform measures.[10] For example, reforming the regulated professions is always a challenging task. Governments typically face strong opposition from incumbents with vested interests. An example of how a strong commitment of the Polish government in combination with a well-rounded design strategy can be instrumental in the success of a reform is the reform of professional service access started in 2013 and completed in 2015. This reform was high on the campaign agenda of one of the parties of the coalition government. Following the elections, the government set this reform as a high priority and was ready to take ownership. On the other hand, it is difficult for a government to generate reform momentum in case of an unstable and fragmented political landscape.

Timing matters

Reforms are more likely to be implemented when perceived to be urgent.[11] Such sense of urgency shortens the decision horizon for policymakers, but also contributes to legitimacy of the policy action in the eyes of the general public. In such windows of opportunity, the cost of reform is more easily tolerated in order to reap what is hoped will be sizable benefits down the line.[12] The awareness of the costs of the *status quo* helps alleviate or fully remove resistance to reform. Cyprus, for instance, was severely hit by the economic crisis that reached its peak in 2013, with the country entering a three-year economic adjustment programme. Unemployment reached around 16% in 2013, compared with a historic average of 4-5%. The poverty and social exclusion rate peaked at almost 30% in 2015. This forged a consensus among the political forces on the need to adopt the guaranteed minimum income scheme, which was perceived as a key factor for improving social conditions in Cyprus.

Another example is the 2014 reform of the mortgage interest tax deductability system in the Netherlands.[13] The reform aimed to limit the growth of household debt, and was put on the agenda in the aftermath of the financial crisis when declining house prices underscored the financial vulnerabilities linked to high household debt. This induced a sense of urgency to implement the reform.

Next to macroeconomic conditions, the election cycle aslo matters and can affect reform momentum.[14] With general elections approaching, governments may refrain from implementing reforms bearing short-term costs, whereas newly-elected governments tend to be more open to reforms whose benefits will materialise over a longer time-span. This is particularly the case for newly elected governments.[15] For example, Belgium managed to implement a substantial “tax-shift” reform at the dawn of the new government coalition that entered in power in 2014.

Reform design may facilitate implementation

The design of a reform can make a significant difference to its successful implementation. It is crucial for the governments to understand well the nature of the challenges, the potential effects of alternative policy choices and involved trade-offs, and typically also to adopt a comprehensive approach to refoms. In particular, it is important to take into account also the distributional impact of the reform. Certain policies are win-win in terms of reinforcing growth and reducing inequality, but others may involve trade-offs. In this respect, understanding who the winners and losers of a reform are, is crucial to build reform support. Reforms targeting a well-defined group are more likely to generate tensions and resistance than reforms involving large groups with a blurred frontier between winners and losers. For example, an increase of the statutory retirement age reduces leisure time of the current workers who have to work longer. This inter-generational redistribution of costs and benefits is a central point in the policy discussions on pension reforms (and potential backtracking from these reforms). Moreover, those who potentially lose out from the reform are more likely to mobilise in order to maintain the *status quo* than those who might benefit from the reform.[16] One possible reason for this is that reform benefits are typically spread across the population, whereas the costs are usually borne by a well-defined group with vested interests, more capable of lobbying against or opposing reform efforts.

An effective consultation with stakeholders and constructive negotiation with opposition parties can help build support and long-term sustainability of reforms. Including a consultation process in its policy-design can contribute to building consensus for reforms, by helping to set out clearly the long-term objectives and allowing sufficient time for discussion of various policy options available. It can contribute to strengthening trust and making stakeholders, social partners or opposition parties more willing to arrive at a compromise. In Denmark, for instance, the minority government invited the opposition to discuss its major welfare reform in 2006. It then stepped back on some initial measures related to student grants and unemployment benefits, which were perceived as unfair. This negotiation was important to create broad political support and safeguard the core of the welfare reform, i.e. linking the retirement age to life expectancy. In some cases, however, concertation may also bear the risk of excessively limiting the scope and impact of reforms if the multitude of (opposing) interests of different groups are difficult to be properly reconciled. For example, in Italy the government's resistance to lobbying pressures against the competition reform in 2015 was weaked by the fact that the parties forming the coalition had very different constituencies in terms of economic interests.

Some form of compensation or measures (temporarily) limiting the impact on those who may lose out from a reform may help gain reform acceptability. Such compensation can be financial, or take form of a combination of different elements in the reform package compensating for potential adverse effects (e.g. losers from one reform can benefit from another one). As compensation measures can come with budgetary costs, the scope to use them also depends on a country's fiscal situation.

"Grandfathering"[17] granted rights and gradual phasing-in of reforms through longer transition periods are alternative compensation strategies. They can help soften opposition and reduce the risk of reform reversals. For example, in Portugal, grandfathering minimised resistance and limited the social impact of labour market reforms under the adjustment programme, in particular for the severance payments system and unemployment insurance (see Turrini (2017) and European Commission (2016(b)). At the same time, compensatory measures can water down the objectives of reforms[18] and generate concerns about fairness, for example if incumbents continue benefitting from generous arrangements at the expense of new entrants.[19]

Reforms that are part of a larger package tend to meet less resistance, and may also be more effective as together they form a coherent set of mutually reinforcing measures. For instance, Italy managed to adopt and implement a comprehensive labour market reform package in 2014-2015, which combined an effective relaxation of employment protection legislation, an increased duration and coverage of unemployment benefits, and efforts to enhance the effectiveness of active labour market policies. Another example of a comprehensive package of reforms is the French law on economic activity, growth and equal opportunities, the so-called "Macron law", introduced in 2015. The aim of this law was to improve the French business environment at large, notably by promoting the functioning of product markets. The reform resulted from an intensive preparation and interaction with stakeholders, seeking to simultaneously lift barriers to activities in a wide array of sectors, including transport, professional services and retail, as well as contributing to improve the functioning of the labour market.

Appropriate sequencing within a reform also play a role. Adopting an incremental approach by dividing reform in sub-sets of measures is often crucial in order to make reforms work.[20] The sequenced approach for reforming the tax revenue administration chosen by Portugal is a good example. This reform (conducted between 2011 and

2014) was a package comprising the reform of the tax revenue administration and measures to prevent tax fraud, evasion and assessment errors. The reform started by laying the foundations of a single revamped tax administration that set the stage for subsequent policy actions, including enhanced IT services and actions that supported tax compliance. Besides, a swift adoption of reforms can ease their implementation by limiting the room for manoeuvre for diluting the reform. As discussed above, policymakers should nonetheless grant an appropriate time for debating the reform in order to ensure ownership.

International pressure can reveal the unsustainability of existing policies and help raise citizens' and politicians' awareness of the need for action. Peer pressure could also help governments to better explain the necessity of the envisaged changes in policies and expected results. The fiscal framework reform in Latvia that took place between 2009 and 2013 is an example of how international pressure can influence the type and the scope of a reform. Following the onset of the financial and economic crisis, Latvian society at large acknowledged that the pro-cyclical fiscal stance prior to the crisis was a policy mistake. Such understanding seems to have been reflected, for instance, in the election of a new government that took office during the midst of a crisis and adopted austerity measures. The international pressure came into play by reinforcing this dynamic, in the form of a financial assistance programme and Latvia's commitment to join the euro area. In the midst of the crisis, the government set ambitious targets to join the euro area and meet the convergence criteria. This allowed the government to implement larger fiscal adjustments than the fiscal rules would have required, elevating people's expectations. The government thus managed to implement this reform at no or limited political cost.

However, the potential of international pressure to enforce reforms is severely limited in the absence of ownership by national governments. For example, as part of the economic adjustment programme of Portugal, a framework law on the liberalisation of the professional associations was adopted in 2013. But as soon as the programme ended and the international pressure was weakened, the bylaws for most of the professional associations were never amended. Instead, some further restrictions were adopted.

Effective communication backed-up by objective and evidence-based policy design can foster acceptance of reforms and facilitate its overall implementation. The quality of the preparatory and implementation process can have a positive effect on reform readiness. A culture of *ex-ante* and *ex-post* policy assessment increases transparency, contributes to the effectiveness and efficiency of reforms, and helps to build trust in the decision-making process. Sufficient technical capacity should be made available to support evidence-based policy and to ensure effective implementation.[21] It is also crucial to communicate on the good results achieved. Estonia's work ability reform (2016-2017) is an example of combining good communication with high-quality evidence-based analysis carried out by respected institutions, such as the Bank of Estonia. Moreover, the reform benefitted from the initial trigger of international policy exchanges and peer-reviews, such as the analyses in the European Semester. Both *ex ante* and *ex post* communication is important to foster reform acceptance and avoid reform fatigue.

How the Recovery and Resilience Facility can support reform implementation

The RRF provides significant loans and grants available to support reforms and investments undertaken by Member States. The aim is to mitigate the economic and social impact of the coronavirus pandemic and make European economies and societies more sustainable, resilient and better prepared for the green and digital transitions. The dialogue between the European Commission and the Member States supported the construction of the national Recovery and Resilience Plans (RRP) consisting of a coherent set of key investments and complementary reforms.

The design of the RRF takes into account several political economy factors of reform implementation presented in this brief. A key feature of the RRF framework is the strong link between the multilateral context and the domestic ownership of the decision making process. Each RRP should effectively address challenges identified in the country-specific recommendations. It should also advance the green and digital transitions and make Member States more resilient. The country-specific recommendations are tailored to individual Member States, discussed in a multilateral context and adopted by the Council, while leaving the full control of the policy-making process to achieve commonly agreed objectives to the Member States. The Member States then decide how they would like to address these specific recommendations in their plans, ensuring therefore ownership. In its assessment of RRPs, the Commission evaluates how each Member State addresses the country-specific recommendations, and how its plan contributes to the green and digital transitions through the green and digital tagging of investments. The assessment of the plan is then discussed in the Council and adopted by the Council in a Council Implementing Decision. Moreover, the RRF framework strongly encourages Member States to ensure broad consultation on their national plans. Member States must explain what consultation process took place and how the consultation input was reflected in their RRP. Also, much emphasis is given to ensure effective communication on the measures. In particular, the RRF financing agreement has several provisions on communication. Finally, the installments will depend on the completion of a set of milestones and targets until the full implementation of reforms and investments. This approach ensures that Member States adopt a comprehensive approach that balances reforms and investments in different policy areas. Such a comprehensive approach allows to take into account packaging and spillover effects of measures, including the design of compensatory measures when necessary. As outlined in this brief, these design elements could broaden the support for the recovery reform agendas. Milestones and targets are expected to be fulfilled at a specific time of each year covered by the RFF, stressing the importance of pace and sequencing of reform agendas.

The RRF thus provides promising conditions for the launch of the recovery efforts in Europe. However, as past experiences have shown, the hard part about structural reforms is not only to agree on them, but to implement them on the ground. The additional lessons provided in this brief on how a combination of political economy factors can affect reform implementation could prove useful as Member States are now engaging in the design and implementation of the reforms agreed in the plans.

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[1] See European Commission, European Economic Forecast, Autum 2021, Institutional Paper 160, (2021)

[2] See for instance and Jollès and Meyermans (2021).

[3] The reasons behind slower potential economic growth were analysed in a background note "Drivers of the low interest rate environment" presented by the Commission to the Economic and Financial Committee in March 2020.

[4] The primary objective of this brief is to identify the main political economy conditions and determinants that facilitate or impede the implementation of structural reforms in Member States over the last decade. It does not discuss any ex-post analysis of their economic and social impact.

[5] The analysis was carried out based on both literature and a standarsided survey conducted among DG ECFIN's geographical desks in collaboration with the European Semester Officers (ESOs) for all 27 Member States.

[6] The OECD economy-wide Product Market Regulation (PMR) indicators measure how competition-friendly a country's regulatory framework is. A higher value of the Product Market Regulation indicator means more stringent product market regulation.

[7] The slowdown in reform adoption in recent years is not only the case for the EU but also for other advanced and emerging market economies, as highlighted by the OECD in its latest "Going for growth" publication. At the same time, the importance of structural reforms to enhance the growth potential as well as having an inclusive approach to growth has also been reiterated in international fora like the G20.

[8] While this trend can give an indication of the extent of reform fatigue, it should be also considered that the degree of progress may vary based on the focus of the CSRs themselves. For example, some earlier CSRs were addressing more pressing reforms, which contributed to a better implementation record. On the other hand, some of the reforms may take time to progress, which can negatively affect the implementation record.

[9] See OECD (2018), Høj et al. (2006), Tompson (2009) and Grüner (2013). Further empirical insights have also been drawn from studies related to reform episodes or macroeconomic support programmes in Europe, for example Turrini (2017), European Commission (2016b) and Pinelli et al. (2017).

[10] See for instance OECD(2010) and OECD (2019).

[11] For instance, there is a vast political economy literature suggesting the crisis and ensuing recession as one the political and economic factors that induces reforms. Crisis can act as catalyst for popular support to reforms (See, among the others, Tommasi and Velasco (1996), Drazen and Grill (1993), OECD (2012). However, crisis may have different effects depending on the type of crisis and regulation, see e.g. IMF, 2019 and Cimelli et al 2019.

[12] See Rodrick (2016).

[13] Further legislation was adopted in 2018 to accelerate the reduction of the maximum deduction rate.

[14] European Commission (2016a) analyses the implementation of the Macroeconomic Imbalance Procedure five years after its introduction. The study shows a significantly lower CRS compliance if an election is forthcoming. However, the actual impact of undertaking reforms on re-election probability is not obvious (see Buti, Turrini and van den Noord (2014)).

[15] However, the opposite can also occur. When government is facing the end of its term, it might push for measures with very short term benefits that could translate into greater electoral support (in literature, this refers to " electoral gift"). For an interesting review of the theoretical literature on the stimulation of the economy related to political business cycle, see e.g. Dubois (2015).

[16] See also Tompson (2009).

[17] A grandfathering clause is a provision creating an exemption in which an old rule continues to apply to the existing situations while a new rule will apply to all future cases.

[18] For more details, see Tompson (2009).

[19] Some literature has also emphasised potential distortions of grandfathering measures from a fairness perspective. Grandfathering might lead to a new form of group segmentation, as incumbents continue benefitting from generous arrangements at the expense of new entrants, who are bearing the costs of adjustment (creating for instance the risk of dual labour markets or inter-generational inequalities of pension systems). For more details, see Pinelli, et al. (2017).

[20] There is also substantial literature focusing on sequencing and complementarities across reform areas. One stream of this literature, for instance, suggests that product market reforms should go before labour market reforms, as this will raise competitive pressures on companies and indirectly on their employees (Blanchard and Giavazzi, 1993). Other literature claimes that complementarities between more popular and controversial reforms help build constituencies and political support for the implementation of the latter (see e.g., Dewatripont and Roland (1995)).

[21] If the specific expertise is not available in-house, governments could resort to external expertise and can get EU technical assistance to support the implementation of national reforms. The Structural Reform Support Program (SRSP) facilitated the implementation of important reforms in different Member States. Through the SRSP, the Commission has since 2017 provided technical support to all 27 Member States with more than 1000 projects in a broad range of policy areas. Building upon the success of the Structural Reform Support Program, the Commission has now introduced the Technical Support Instrument, as part of the Multiannual Financial Framework (MFF) 2021-2027 and of the Recovery Plan for Europe. With this instrument the Commission can continue to provide tailor-made expertise on the ground, so that the Member States have the necessary institutional and administrative capacity to develop and implement growth-enhancing reforms.

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