

## **Joint IMF-OECD Conference on Structural Reform in Europe**

Remarks by Michael Deppler

This afternoon, we shift our focus to the issue of how best to move reforms forward. This is not just an economic question, but also—and perhaps more so—a political one.

In introducing the discussion, I will mention first the lessons that I and several colleagues at the IMF have drawn from past cases of successful reforms; relate those findings to the situation that seems to obtain today; and close with a question on how to best approach the fomenting of reform today.

### **A few lessons from past cases of successful reform**

Denmark, Ireland, the Netherlands and the UK stand out as cases of successful long-term reform. In each case:

- The reforms were instigated by a visible weakness in macroeconomic performance—typically low growth and high unemployment, but also unsustainable fiscal or external positions.
- The reforms were broad and deep and, partly as a result, sustained.
  - The reforms were broad, sweeping, and sustained—the Wassenaar agreement that launched the Dutch reforms, for instance. As a result, the reforms had a visible impact on performance and perceptions, which together with their perceived fairness, helped build ongoing support and acceptance. This is critical since benefits tend to be slow in coming.
  - The role of fiscal policy was complementary rather than cushioning. That is, it typically was focused on consolidation, but within a framework that also buttressed the supply side incentives required by the strategy. As a result, virtuous circles of growth and tax cuts were initiated and made the reform process sustainable. An important aspect was tax cuts to sustain pay of those whose wages were facing downward pressure. Fiscal adjustment that is excessively based on revenues can undercut support for reforms and kindle wage pressure. This may have contributed to the difficulties that Denmark encountered during its reform drive in the first half of the 1980s.
  - The reforms deliberately sought to leverage complementarities between structural reforms (as well as between structural reforms and macroeconomic adjustment). They sought to lower tax wedges and liberalize product markets. Research confirms that comprehensive approaches tend to be more successful, in part because product and labor market reforms reinforce each other's

benefits. We have found that labor-market reforms bring larger and faster rewards if product markets are relatively free and flexible. In a competitive environment, firms can take advantage of increased labor supply and flexibility to expand their activities, resulting in higher employment and productivity. Likewise, product-market reforms are likely to have greater effect in an environment of labor-market flexibility.

- The countries had diverse political arrangements. Some had coalition governments, others a single party majority government.

### **The reform context today**

Economists generally agree that economic performance in Europe remains well short of what it could be. It is perhaps most evident in the disappointing performance of productivity in the services sector, the higher but still low levels of labor participation, and the implications of the looming problems of aging for future growth.

The short falls in performance today are, however, less visible than they were in the 80s and 90s. In good part because of past reform policies, employment has been robust, unemployment has fallen to less unacceptable levels, fiscal imbalances have reduced, and external positions have been unproblematic.

Moreover, the problems today are more diffuse and intangible. The rigidities in services markets—and the “rents” they protect—are manifold and widely spread throughout the economy. As a result, few of them taken individually are macro economically significant even though they amount to a very large drag on the economic system taken together. Moreover, some of the problems are less about today than about addressing today problems which will become quite large in the distant future (pensions).

Structural reforms thus remain at least as politically difficult as in the past. Reforms require immediate sacrifices by a few for the sake of small, diffuse and sometimes remote benefits for the many. The links to jobs and real take home pay, something the population cares about, are harder to make. The resulting imbalance in the political forces for reform is reinforced by widespread impulses toward solidarity—to the notion that sacrifices need to be equitably shared.

The result is that the hurdles to getting agreement on reforms that have sufficient punch to generate lift off and garner ongoing support to ensure sustainability has become more difficult.

### **Need for a comprehensive and sustained approach**

Combining the lessons of past successes with the realities of today’s problems, successful reforms today would seem to argue for comprehensive reform strategies, but strategies

comprising a host of rigidity-reducing actions that dovetail in ways that offer the promise of tangible overall benefits. A broad and comprehensive reform proposal could also help to build political support by making it clear that both the burdens and benefits of reform will be widespread across society, rather than concentrated on specific groups, industries, or professions.

And political support will be important, not least because reform efforts need to be sustained if success is to be assured. This is because structural reforms, especially comprehensive ones, take time to design and implement, and also because history shows that fundamental reforms take time to bear fruit.

### **Approaches to reform**

Turning to process, countries have been successful in pursuing reforms using different approaches. To begin this afternoon's discussion, let me enumerate four such models, and briefly discuss their pros and cons.

- Outside pressure. An obvious example is international competition, which, in Europe, has resulted in world-class traded-goods industries. Another obvious example is the European Union and the single-market project, which is the subject of our first session this afternoon. It has helped to dismantle barriers to trade within Europe and to promote reforms within member countries. This process has, once again, been most far-reaching in manufacturing, but is being extended to service sectors, including financial services. A difficulty with outside pressure, however, is it tends to lack domestic political legitimacy and is therefore frequently resisted.
- Social compacts or tri-partite agreements. These were used, with notable success, in Ireland and the Netherlands to greatly improve labor-market performance while reducing tax rates and stabilizing public finances. A risk of this approach, however, is that such agreements can be inconsistent with fiscal needs, undermining their effectiveness.
- Commissions and other consensus-building devices. These have been used successfully to promote reform, including pension reform in France, by bringing expertise to bear in a public way. However, they tend to be best suited to specific reforms, rather than broad reform programs, and in many cases this approach has taken a long time to come to fruition.
- Government-led reform. Governments clearly have to show leadership, and there have been examples of successful reform even in the absence of broad social agreements or consensus building. One example is Agenda 2010 in Germany, which labor unions have opposed. This approach is, however, a risky strategy, not least because such reforms, not having broad prior support, can be more easily reversed.

## **Conclusion**

PM Juncker once said something to the effect that we know how to reform; what we do not know is how to get re-elected. This is largely true, but not entirely so. The governments of the successful reformers I mentioned earlier were re-elected. How much of this was due to their economic reforms, I will not venture to speculate. However, the basis of their economic successes—notably the emphasis on comprehensiveness and a structure of reforms that consistently leverages the complementarities needed to achieve maximum results—would seem to be worth emulating. The reform process became self-sustaining and cumulatively successful.

My advice to the political class is thus not to give up on structural reform but to pressure us economists to come up with convincing compacts that consider the political economy of reform. And it will be incumbent on us economists to improve our understanding of the interrelationships between reforms, their relations with the specific institutional structures of countries, and the political economy dynamics that they can set off.

With these thoughts, I turn the floor over to this afternoon's panelists, all of whom are experts in the political economy of reform, and look forward to hearing their views.