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Is there a role for macroeconomic policy in fostering structural reforms? Panel evidence from OECD countries over the past two decades

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Abstract

This paper is an empirical attempt to determine whether macroeconomic policies influence reform patterns in labour and product markets. Multivariate probit and linear econometric analyses of the determinants of structural reforms in labour and product markets are carried out for 21 OECD countries over the period 1985–2003. Robust evidence is found that sound public finances and fiscal expansions help foster reforms. The effect of fiscal expansion may also be greater for countries that pursue fixed exchange-rate regimes.
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1. Introduction

Despite broad recognition that many European countries are in need of structural policy changes, with symptoms ranging from low employment rates to sluggish economic growth, progress towards reform has failed to meet expectations during past two decades. In particular, in the key areas of labour and product markets, European countries – with the exception of a few small ones – have shown no particular ability to carry out important reforms in areas where political resistance is normally strong. Further, in the more specific case of EMU countries, the reform process has if anything slowed down after the formal advent of the euro (Brandt et al., 2005).

This deadlock over major reforms in labour and product markets has inspired a number of insightful theoretical developments in political economy research in recent years (see *e.g.* Saint-Paul, 2000). Still, one overlooked issue in this literature has been the role played by macroeconomic policies. Yet, this issue seems particularly topical now that the monetary and fiscal policy framework across much of Europe is determined by the European Monetary Union (EMU) and the Stability and Growth Pact, respectively.

The main purpose of this paper is to explore whether fiscal and – to a lesser extent – monetary policy settings contribute to shape reform patterns in labour and product markets. In doing so, the paper also helps fill some gap in empirical research on the political economy determinants of reforms. To date, cross-country/time-series analysis has

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remained virtually inexistent, not least due to lack of comparable and comprehensive data on policy reforms (for a recent exception, see IMF, 2004). Here, based on a range of OECD indicators, a unique reform database is constructed, which then allows the use of econometric techniques to study the drivers of policy reforms in labour and product markets.

The remainder of this paper proceeds as follows. Section 2 reviews some of the arguments that have been put forward as to how the state of public finances and the commitment to a fixed exchange rate regime may affect the political economy of structural reform. Section 3 presents multivariate probit econometric analysis of the propensity to undertake reforms in labour and/or product markets for 21 OECD countries over the period 1985–2003. Section 4 turns to linear, dynamic panel data estimates. Section 5 sums up the evidence and concludes.

2. A brief overview of theoretical arguments in favour of macroeconomic policy effects on the propensity to undertake reform

2.1. Fiscal position and structural reforms

There are at least three reasons why a sound fiscal situation should facilitate the implementation of structural reforms.

First, a budgetary cushion provides room for implementing transfer schemes aimed at compensating reform losers. Therefore, it should make it easier to overcome the status quo that typically results from standard pressure group or voting models,[1] especially when there is a number of veto players whose support is critical. For example, the deregulation of air transport in Italy over the 1990s was in a number of cases – *e.g.* in the case of the privatisation of *Aeroporti di Roma* – achieved by explicitly compensating workers for the loss of implicit rents they used to enjoy. Likewise, the gradual privatisation of network industries in France and Germany has been involving compensatory packages such as disembodying special retirement schemes from the privatised companies, with pension provision being fully guaranteed and paid for by the State. Compensatory schemes have also been commonly used in the area of labour markets. For example, the Dutch government reduced real minimum wages and unemployment benefit replacement rates throughout the 1980s and the 1990s, but mitigated their impact of workers' net incomes by cutting taxes and social security contributions paid by employees. Likewise, in the 1990s Denmark traded a reform of its unemployment benefit scheme against higher public expenditures on active labour market policies for the unemployed.

A second argument, put forward for instance by Eichengreen and Wyplosz (1998), is that poor public finances may force governments to spend their political capital on unpopular fiscal adjustment measures, leaving them with less ability and/or willingness to undertake structural reforms later on. Against this background, sound fiscal positions mean less need for fiscal adjustment and thus more room for reforms. On the other hand, as a special case of economic crisis, fiscal crisis may facilitate both fiscal and structural reforms.[2] Overall, one might therefore expect a non-linear relationship between the fiscal position and the propensity to undertake reform, with very sound and very deteriorated public finances both facilitating reforms.

Third, the stronger the initial fiscal position, the greater the room is for fiscal policy to stimulate aggregate demand in the wake of any structural reform that expands potential output but is not necessarily accompanied by a corresponding expansion in aggregate demand. The case for fiscal accommodation is most compelling for those reforms that change an economy's structural rate of employment, since such reforms would improve the cyclically-adjusted budget balance corresponding to a given actual budget balance and employment rate.[3] Put differently, not changing the actual budget balance post-reform and before employment has had time to adjust would imply an effective tightening of fiscal policy.

This "output stabilisation" argument needs to be qualified in a number of ways, however. The basic premise of the argument – that demand does not spontaneously expand in response to added supply as a result of structural reform – is not straightforward. In principle, rational and forward-looking households and firms should respond up-front to the increase in, respectively, permanent income and output. In a similar vein, the argument obviously rests on the assumption that full Ricardian equivalence does not hold. This assumption is less likely to hold in bad (fiscal) times,

[1] See *e.g.* Fernandez and Rodrik (1991).

[2] On the effects of economic crises on the propensity to undertake reforms, see *e.g.* Drazen (2000).

[3] Reforms differ in their impact on budgets. Reforms that boost productivity without raising equilibrium employment will have only limited impacts on the cyclically-adjusted budget balance unless transfer recipients and public-sector employees do not share fully in the real income gains created by higher productivity.

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