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Seizing the European Day

As the financial crisis has mutated into a global recession the attention of policymakers has shifted from the financial sector to fiscal policy as a demand tool. At the European level the Commission has called for coordinated action to stimulate demand and most member countries have by now enacted sizeable fiscal “stimulus” plans.

However, with this exclusive concentration on fiscal policy Europe is missing a great opportunity in the current crisis. These times of “extraordinary politics” should be used to carry out some of the badly needed structural reforms that have kept down the performance of the European economy for so long. The reason why many of these reforms have not been undertaken is clear: most of them meet with fierce political opposition from the start although some also pay in terms of public budgets, but only in the long-run.

Rather than spreading resources across a variety of public expenditure programmes of dubious effectiveness, rather than trying to cheat with the numbers of stimulus packages that will always fail to be as sizeable as the current global recession would require, governments should concentrate their efforts on devising long-ranging reforms and buying consensus around them. This means increasing public deficits in the short run while enhancing the long run structural performance of their economies and improving their position along the intertemporal public budget constraint. Economic research on the political economy of reforms and, above all, the experience accumulated over decades of reforms can be very helpful in finding ways to compensate the short-term losers of these reforms. More spending today should aim at making politically feasible what without compensation and in ordinary times is not.

This effort does not require as much policy co-ordination as the fiscal stimulus packages proposed by the G20, the IMF and other multilateral organisations to counter the global recession. Structural reforms have indeed a national dimension, they vary from country to country and their opponents also differ across nations. Structural reforms are mainly a matter of national governments and constituencies. Yet by pursuing these reform efforts simultaneously, governments would be able to strengthen their positions *vis-à-vis* national vot-

ers and exploit yardstick competition, drawing on the example of the other countries. Experience has shown that European public opinions often react to events occurring in other countries. We had numerous examples of political spillovers in the recent history of the Union, from fiscal discipline and social pacts associated with the convergence to euro, to the tightening of migration policies, to the increasing popularity of flexicurity arrangements. Sometimes these spillovers have worked in undesirable directions (as in the case of migration policies after the enlargement). Now it is time to have them playing in favour of long-term growth.

European institutional “rigidities” – those barriers that keep markets from operating effectively – exist because, somewhere, there is a group benefiting from them and lobbying for their preservation. What is more, such barriers rarely operate in isolation; a regulation in one area calls for regulations in another area. That is why the countries with the most restrictive labour markets usually have the most tightly regulated product markets.

Removing these rigidities is proving extremely difficult, and not because governments do not wish to carry out reforms. The fact of the matter is that measures such as these usually encounter strong political opposition; they are initially unpopular while they pay in the long run. Governments with short horizons do not want to pay the political costs of these reforms; they are concerned that, by carrying them out, they may not be re-elected. As stated by the European veteran, Jean Claude Juncker, “They know what to do, but do not know how to be re-elected afterwards”. However, the current recession is creating a TINA type situation: There Is No Alternative to carrying out reforms. Governments will not be blamed for the unavoidable recession, but for the way in which they prepared their countries for the aftermath of the crisis.

A key element in many reforms concerns the labour market and associated social legislation. Rigidities in these areas are widely perceived to be the key to improving the economic performance of Europe. The Fondazione Rodolfo De Benedetti has now established an inventory of labour market and social policy reforms carried out in EU member countries during the 1986-2006 period. Reforms are categorised as either popular or unpopular, marginal or radical. This analysis revealed that – contrary to common wisdom – many

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Table 1
Labour and Social Policy Reforms and the Macroeconomic Environment

(1986-2006, EU15 less Luxembourg)

		Politically Difficult Reforms				Politically Popular Reforms			
		GDP growth				GDP growth			
		Downturns		Upturns		Downturns		Upturns	
		of which	of which	of which	of which	of which	of which	of which	of which
		recessions	strong growth	recessions	strong growth	recessions	strong growth	recessions	strong growth
Employment Protection Legislation	marginal	6	2	43	25	6	1	54	47
	structural	2	2	10	8	2	2	7	6
Non-Employment Benefits	marginal	26	8	221	160	6	1	53	45
	structural	5	1	15	11	1		3	1
Public Pensions	marginal	16	5	85	57	9	5	58	48
	structural	3	1	13	11			1	1
Total per column		58	19	387	272	24	9	176	148
Of which structural (%)		17%	21%	10%	11%	13%	22%	6%	5%
Number of country-years		26	21	247	187	26	21	247	187
Reforms per country-years		2.23	0.90	1.57	1.45	0.92	0.43	0.71	0.79
Structural reforms per country-years		0.38	0.19	0.15	0.16	0.12	0.10	0.04	0.04

Notes: GDP growth: downturns imply $g < 1$, Upturns $g > 1$, strong growth $g \geq 2$. In brackets, average number of reforms per year and country (Ex: 19 politically difficult reforms in periods of recession / 21 country-years of recession).

reforms have, in fact, been carried out over the past two decades. We counted almost 650 reforms, that is, about 2.2 per year and country. However the changes have often been marginal: 583 out of 645 reforms, that is roughly 90 per cent of the regulatory changes were not structural reforms. This means that these regulatory changes were not comprehensive reforms, addressing the broader design of existing systems rather than their minor features.

In particular, a structural reform of the employment protection legislation is one that does affect all types of contracts (e.g. it should also concern workers under permanent contracts and not only those with fixed-term contracts). A reform of non-employment benefits is structural insofar as it affects the entire population at risk, that is, the population of working age. Finally, a reform of the public pension system is structural if it is going to affect, sooner or later, all future cohorts of pensioners.

Moreover, reforms can be split between those that are unpopular, as they reduce the generosity of public pensions or non-employment benefits or make employment protection less strict (445 out of 645, that is, about 70 per cent) and those moving in the opposite direction. We find frequently reforms undoing one another over a few years. These inconsistencies and the marginal nature of most reforms have significantly increased the complexity of the European institutional landscape.

In the field of employment protection, for instance, we have assisted a multiplication of contractual types, with a number of fixed-term and unstable jobs going

hand in hand with permanent and still heavily protected positions. Pension rules are getting different from cohort to cohort. And there is a huge number of different soft landing schemes to retirement. All this has increased the dualism of European labour markets, making them more segmented not only between insiders and outsiders but also among various types of outsiders. This overrepresentation of marginal reforms among the unpopular regulatory changes is a clear indication of the fierce political opposition that these reforms face.

Thus, the message has so far been mixed: many reforms have been undertaken, but few resulted in lasting structural improvement. Can Europe do better now that a deep recession is unavoidable? An important message of this inventory (see also Table 1) is that during recessions or at times of economic stagnation it is actually easier to carry out these "politically difficult" reforms than proceeding the other way round. In particular, when GDP was growing at more than 2 per cent per year, there were 272 politically difficult reforms, but also 148 reforms doing the popular job of increasing generosity, adding more employment protection and reducing rewards from participation. There is a higher probability of carrying out the key reforms, those that are politically difficult and structural, during downturns than during upturns. And these reforms are more likely under a recession (19 per cent of country-year observations) than during periods of strong growth (16 per cent).

Thus, the view that negative or slow growth prevents difficult reforms does not find support from this

dataset. It is true that radical and unpopular reforms are difficult when unemployment rises and there is a strong demand for protection, but it is precisely under these conditions that one can find support for such difficult things as reforming public pensions and reducing the dualism of labour markets. A tentative explanation for this rather surprising result is that there may be a stronger perception of emergency when macroeconomic conditions are less favourable – recessions are often times of “extraordinary politics” – than during upturns when lobbies are at work to appropriate a larger share of the economic “pie”.

Overall, recent European history suggests that it is precisely now that European governments should

act. It is mainly a matter of national decision-making. European supranational authorities can support this process by increasing yardstick competition. They can also reward those countries that carry out structural reforms through the allocation of the globalisation fund. Given the limited size of this fund, it will be a rather minor economic reward, but may involve a significant political dividend for the beneficiary. The largest economic rewards from carrying out structural reforms will come, in any event, from the reduced costs of servicing the public debt of governments who succeed in convincing markets that they have indeed improved the long-term growth prospects of their economy.