

**Speech by Marco Buti**

**HIGH-LEVEL SEMINAR ON  
THE POLITICAL ECONOMY  
OF CRISIS-INDUCED  
REFORMS**

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## **Reforms and re-elections: Lunch talk**

- The financial crisis caused an unprecedented drop in demand for size and abruptness. After a successful co-ordinated fiscal stimulus to contain financial sector risks and second round effects, **most western economies now find themselves with weak prospects for recovery in demand and with no bullets left in terms of room for further fiscal expansions.**
- After a relatively widespread global slump, the outlook now varies greatly across world regions. **Demand remains weak especially in those world regions where net savings are adjusting in such a way to rebalance external deficits.** Against this background, the EU and the euro area itself cannot be considered as homogenous areas because some countries (“the center”) record external surpluses and a strong recovery while the periphery is generally characterized by external deficits, deteriorated fiscal positions, and weak or negative growth rates.
- The current context appears particularly problematic for policy. **Although output gaps and unemployment rates for the euro-area aggregate are below those recorded in other world regions,** and notably the US, **some countries are still struggling with a deep recession** and are facing very serious unemployment problems. The euro area finds itself in the textbook case of a monetary union which has been hit by **shocks with highly idiosyncratic effects.** In such a

case, monetary policy is hardly sufficient to deal with such a constellation of shocks. Moreover, **fiscal policy is not only constrained by fiscal stability concerns, but in many cases fiscal expansions would hamper rather than favour the inevitable adjustment of external imbalances.**

- Such a situation, if not adequately managed via timely policy action, may turn out very costly. **Some countries will have to undergo a painful process of adjustment in relative prices** to recover competitiveness, which will permit, over time, to adjust external imbalances and restore growth at the same time. During the process, however, income growth will have to stay below that in partner countries to ensure gains in terms of relative production costs.
- Just after the financial crisis, EU countries were invited to carry out a co-ordinated approach to stimulate demand via fiscal policies. **In the current juncture, the priority should instead be on supply-side measures.** A co-ordinated structural reform effort would at the same time contribute to ease adjustment and re-launch potential growth, with positive effects on confidence and investment.
- Usually, structural reforms pertain to the medium to long term. That's why they often fall out of the political limelight. No longer. With the financial crisis, **markets are paying new attention to structural reforms.** Credit rating agencies have downgraded sovereign debt on the basis of poor medium term growth projections.
- Compared to other policies, the problem with **structural reforms** is that, by touching the interests of well-identified groups in the society, they **may find strong resistance and may be perceived as politically costly** [Olson, 1971]. This explains the well-known problem of "reform inertia": even when the need for reform is widely acknowledged, progress may be slow, discontinuous, or lacking altogether.
- A key question arises: are reforms likely at the current juncture? **A simple reading of the literature dealing with the political economy of reforms would suggest that this is *not* a moment where one can expect strong reform activism.** On the one hand,

the financial crisis shock may be at our back, and the momentum for major emergency action is probably over [Drazen, 2000, and Drazen and Easterly, 2001, inter-alii, argue that economic crises, by making reforms more urgent, increase their likelihood. This is consistent with empirical findings, e.g., IMF, 2004; Duval and Elmeskov 2005]. On the other hand, the political capital available to governments to carry out unpopular reforms is low in many countries, because output is largely below potential while the room for stimulating growth through fiscal policy is very narrow [e.g., Bean, 1998].

- Most probably, a larger number of factors play a role in determining the willingness to carry out reforms. Ultimately, **what is crucial from the viewpoint of policy makers is the perception of the electoral costs and benefits associated with reforms.**
  
- **A series of papers of mine and coauthors** [Buti et al., 2009b and 2010] **focus exactly on this question. *Is it true that reformist governments are less likely to be elected?*** We were motivated in our analysis by the incomplete progress towards the reform objectives of the Lisbon strategy and by the famous statement by Jean Claude Juncker that the true problem for policy authorities is not that of doing the reforms but that of being re-elected afterwards. We have dubbed it the "Juncker Curse". It turns out that many of the results we obtained in these papers are of great interest for the current situation.
  
- As in previous analyses [e.g., Brender and Drazen, 2005 and 2008], **we found that** across OECD countries, starting from the seventies, **governments were more likely to be re-elected if in the years before elections growth accelerated with respect to past trends**, while not significant effect is played by the stance of fiscal policy.
  
- **Analysing the relation between elections and reforms is not obvious from an empirical viewpoint**, which may explain why the issue remained under-investigated for long. There are difficulties from the viewpoint of measurement (how to measure whether a government was a reformist one?... ) and because of the risk of spurious relations (governments that feel strong and expect to be re-elected may take a bolder reformist stance) and selection bias (truly unpopular reforms are simply aborted and not observed).

- In spite of the above difficulties we **were able to show a quite robust “non result”, namely that reformist governments were neither more nor less likely to be re-elected.** Reforms as such do not seem to have a significant impact on the probability of being re-elected. The result could be explained by the fact that a-priori there are reasons for a negative impact of reforms (reforms could be highly unpopular among those groups that are negatively affected) but there are also positive ones, if reform benefits are sufficiently visible already in the short-to medium term. Alternatively, the result could be explained by the fact that the electoral impact of reforms could be highly specific to the type of reform considered and may depend on a series of concomitant factors.
  
- Our next step was therefore to analyse:
  - Whether there are reforms that are more or less costly in electoral terms
  - Which factors affect the electoral impact of reforms.
  
- Regarding the first point, **we found that while there are reforms that have a significant negative impact on re-elections, other appear to be helpful.** For instance, pension reforms reducing the generosity of the system and reducing EPL restrictions appear to be costly, while pro-competitive reform concerning the tax wedge and unemployment benefits have a positive impact on re-elections.
  
- Regarding which factors affect the electoral impact of reforms,
  - **We did not find a significant role for the fiscal stance.** The often claimed trade-off between fiscal discipline and reforms due to limited political capital of governments do not appear to be confirmed empirically;
  - we found that **well-functioning financial markets reduce the electoral cost of reforms.** This result suggests that financial markets are effective in bringing forward the benefits of reforms and in providing insurance to those groups that may be negatively affected;
  - we found that **initial structural conditions matter: reforms appear less costly in electoral terms if countries have already product and labour markets that are not excessively regulated.** This finding has an important

implication: countries could remain trapped in situations where markets are rigid, the interests of the protected insiders in favour of the status-quo are strong, and the likelihood of reforms low because the perceived political cost is high.

- finally, we find that **a strong mandate for reforms increases the likelihood of re-election** of a government chief executive that carried out major reforms .
  
- What are the main lessons from the above results for tackling the major challenges ahead? I see **three main lessons**:
  - **First, some of the reforms that will have to be carried out in EU countries are likely to be perceived to be politically costly and could find resistance.** Just think to structural fiscal reforms to reduce the cost of the welfare state on a permanent basis or reforms in labour market to permit higher flexibility of wages and employment. In some cases, packaging these unpopular reforms together with other reforms that are more favourably seen by the electorate might be necessary for their acceptance.
  - **Second, in absence of a strong reform mandate by incumbent governments, resistance could be strong especially in those countries where the need for reforms is the strongest.** Our results suggest this.
  - **Third, repairing financial markets**, including ensuring an adequate level of capitalisation, **could be key not only to foster investment, but also to create the conditions for the acceptance of growth-enhancing reforms.** At the same time, our results warn on the possible implications of putting in place over-restrictive regulations for financial markets, which may rather increase the electoral cost of reforming labour and product markets.
  
- Translating the above lessons in concrete implications for policy, I do believe that ***electorally costly reforms are needed, especially in those countries where these reforms may find stronger resistance.***

- The presence of hard fiscal constraints are undoubtedly posing trade-offs to policy makers. Nonetheless, **I would like to stress some elements of optimism that should not be neglected**
  - **First, some countries may find themselves in a situation where the fundamental need for reform may prevail on short-term electoral considerations.** For some countries, simply *There Is No Alternative*. Just think of countries that must create the conditions for macroeconomic stability for euro adoption or for higher growth to ensure fiscal solvency. Does it mean that governments making such painful choices are bound not to be re-elected? No. Take for instance the Latvia government which carried out a very harsh adjustment within the EU-IMF programme. It has been re-elected with an increased majority.
  - **Second, even for those countries where, in light of harsh economic conditions that erode their consensus, myopic considerations may prevail, an active reformist stance should not be excluded.** In a paper of mine [Buti et al., 2009a] I showed theoretically and empirically that fiscal discipline and structural reforms are more likely to become complementary exactly for more myopic governments, i.e. for governments that perceive a short time horizon in front of themselves. **The reason is simple: these governments cannot rely on an accommodating fiscal stance to improve their consensus in the short term**, so that they will have count on a smart reform package.
  
- **Most importantly, to win resistance to reforms, peer pressure and support by partner countries could play a relevant role.** In this respect, what matters is not the Juncker's curse but what can be named the "Monti's curse", after Professor **Mario Monti** who **stressed the need to overcome the excessive "politeness" which often characterises discussions within the Eurogroup**, with ministers avoiding to criticise each other even in the event of blatant misbehaviour. Now, that the financial crisis has shown that interdependence and spillovers are so strong within the euro area and the EU that countries had to put money on the table to redress the situation, we are more hopeful that the Monti's curse can be defeated.
  
- **In the above respect, the new framework for EU policy coordination is well equipped. Surveillance is now broadened and**

**more integrated**, with a stronger inter-connection between the processes for macro-fiscal (SGP) and macro-structural policies (EU2020). Reforms to enhance the adjustment capacity of countries are now subject to enhanced surveillance within the new framework to address the risk of excessive imbalances in the EU and the euro area.

- Moreover, since in the current juncture getting the timing right is key, the implementation of the EU2020 country surveillance was focused on the identification of major bottlenecks in the various countries and on the need to make fast progress (“frontload reforms”) in the identified key areas.
- **All in all, we will have difficult years ahead**, where major reforms will have to be carried out in a context of fiscal austerity. **At mid 1990s, the situation was not too dissimilar.** EU governments had to make progress both in terms of sound public finances and structural conditions in compliance with the single market and the process of monetary unification. **Many governments were not re-elected, but since they were successful in both respects, they left a very important legacy.** The hope is that also now, as in the years leading to Maastricht, long-term considerations could prevail over short termism.

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