Structural Reforms Without Prejudices
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Edited by

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With

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Acknowledgements

The two studies that make up this volume were originally prepared for the sixth European conference of the Fondazione Rodolfo Debenedetti, which was held in Lecce in June 2004. This book draws a good deal on the discussion in Lecce, which involved a qualified audience of academicians, professional economists, representatives of unions and employers associations, industrialists, and policy-makers.

Needless to say, we are very much indebted to all those who attended that conference and contributed actively to the discussion. In particular, we wish to express our gratitude to Giuliano Amato, Vice President of the European Convention, for his insightful opening remarks on the single market and on European institutional integration.

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Part II

HOW TO GAIN POLITICAL SUPPORT FOR REFORMS

Micael Castanheira, Vincenzo Galasso, Stéphane Carcillo, Giuseppe Nicoletti, Enrico Perotti, and Lidia Tsyganok
Introduction

Since the 1980s, when the Thatcher government initiated a programme of massive privatizations and liberalizations, many OECD countries have gone through a large number of structural reforms in crucial sectors of the economy, such as labour and product markets, and the welfare state. This flurry of reforms demonstrates the rise of a new paradigm among economists, often referred to as the “Washington consensus”.¹ Most of these reforms aim at liberalizing the financial and product markets; reducing rigidity in the labour market; retrenching the welfare state; and decreasing the government’s involvement in production, through privatizations. Yet, while some attempts were highly successful and led to structural changes in the economy, other reform plans failed to receive the necessary political support.

Indeed, some deep reform measures leading to the liberalization of relevant markets were initially implemented, but later overturned—casting some doubt on their economic efficiency or rather on the stability of their political support. Here, we refrain from addressing the economic efficiency of the reforms, which has instead been analysed in the Part I for the case of product markets, although we do acknowledge that in a second-best world, some of these reforms may actually fail to be beneficial.

We concentrate on the political feasibility of these reforms, in an attempt to provide some policy advice on how to push forward with structural reforms. Reforms may occur in a variety of economic environments; may have different impacts on economic agents; may take place

¹ A notable example of this consensus is represented by the effort made by the World Bank to set the stage for the reform of pension systems in Latin America (see World Bank, 1994); interestingly, a recent World Bank publication (see World Bank, 1994); interestingly, a recent World Bank Publication (see Holzmann and Hinz, 2005) integrated the previous suggestions with new considerations aimed at emphasizing also the role of public provision in retirement income.
How to Gain Political Support for Reforms

under several political institutions; and may be implemented by policymakers with different political strength. This variety of situations does not allow for a unique, one-fits-all reform strategy. Our analysis is hence based on a case-study approach, which emphasizes the crucial role of economic and political framework conditions. In particular, we consider different reform scenarios. Each scenario identifies some relevant economic aspects, such as the structure of the markets or welfare systems to be reformed, and political elements, such as the relative political strength of the policy-makers. These economic aspects characterize the nature of the opposition to a reform plan. Far-reaching reforms may trigger wide opposition within the population; but narrower reforms that affect less extended yet entrenched interests may also prove equally unpopular, and thus difficult to pass. Some political and institutional (as well as cultural and social) features of the countries instead characterize the relative political strength of the policy-makers—and hence their ability to push forward with reforms—but also how the opposition to reform may materialize—for instance, whether through the threat of electoral backlashes or through lobbying and strikes.

Our case studies include a broad array of economic areas—such as labour and product markets, the welfare state, and privatizations—and of political institutions, ranging from majority systems, such as the UK, to proportional systems and consensus democracies, such as Denmark, to hybrid systems (Italy), and to new democracies (Russia and the Czech Republic). Although this methodological approach may fail to identify universal “laws”, we are confident that the wide range of economic and political framework conditions analysed in our case study will allow us to draw some common lessons on how to design politically feasible reforms. The recipes for reform emerging from this report will hence depend on the overall economic and political scenario, as characterized in particular by the relevant economic and political players and their—often opposing—interests; by the initial structure of the markets to be reformed; by the political institutions in place; by the (electoral) incentives of the policy-makers; and by the existence of external constraints. Table 7.1 provides a classification of our case studies according to a simple economic and political dichotomy: as the relevant economic feature we identify the extent of the interests affected by a reform—whether broad or narrow—while the crucial political feature is represented by the relative political strength of the policy-makers.

2 Economic efficiency clearly plays a role in this discussion by helping to define the size of the opposition.
Our theoretical framework of analysis is deeply rooted in the recent political economy literature of reform (see Chapter 8). Through the analysis of different scenarios, we examine the preferences and interests of economic actors—such as consumers, workers, firms, unions, and retirees—and their key role in shaping the economic response to a reform; the economic rents, which capture the gains from reforming, as well as the intensity of the opposition to these measures; and the political institutions, that is, the rules regulating the economic and political interactions among these different agents.

A common denominator to all the reform processes analysed here is that the policy-makers have to undergo two important stages which determine the success or failure of the reform: a commitment building stage, and a coalition building stage. Interestingly, our case studies show that governments adopted different strategies during these two stages, depending on a set of economic and political framework conditions. For each reform experience, we identify the crucial components that explain why commitment and coalition building were a success or a failure. Our hope is that, by describing a relatively large set of reforms, and by categorizing them along these “strategies”, we can provide some guidance to the “reformers” in different scenarios. The case studies we provide may help them understand how they could use their political strength, the benefits associated with the reform plan (or the information they have about these benefits) to carry out the reform successfully.

Why do policy-makers decide to undertake a reform process and hence to commit their political capital to its implementation? The seminal reasons behind a reform vary widely across reforms, countries, and sectors and, therefore, so do the policy-makers’ initial motivations. Beside the ideological push for reform—coinciding with the Washington

### Introduction

**Table 7.1 A Simple typology of reforms**

<table>
<thead>
<tr>
<th>Economic impact of the reform</th>
<th>Strong policy-maker</th>
<th>Weak policy-maker</th>
</tr>
</thead>
<tbody>
<tr>
<td>Broad</td>
<td>Pensions (UK, Italy, France)</td>
<td>Pension (Italy)</td>
</tr>
<tr>
<td>Privatization (Russia)</td>
<td>Labour market (Denmark)</td>
<td></td>
</tr>
<tr>
<td>Privatization (UK)</td>
<td>Privatization (Eastern Europe)</td>
<td></td>
</tr>
<tr>
<td>Narrow</td>
<td>Telecom (Italy, France)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Labour Market (Spain)</td>
<td></td>
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<td></td>
<td>FDI (various countries)</td>
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Consensus—demands to implement structural reforms in a given market often originate from technical progress and globalization. Substantial reductions in scale economies, the introduction of new technologies, and increased international competition (e.g. in transport and energy industries) create new opportunities to provide services. They reduce barriers to entry, and make users realize that there are costs to keeping some markets highly regulated. Supranational legal constraints—for instance related to trade agreements, to IMF conditionality loans, or to the Maastricht Treaty—have also constituted powerful triggers for structural reforms (see Chapter 8).

Yet, policy-makers often need to build a large political and social consensus around their reform plan. How could they achieve this crucial support, which eventually determines the political success or failure of a reform attempt? Again, the successful strategy depends largely on the economic sector expected to experience the changes, and on the political institutions of the country where the reform is debated. In our case studies, we identify both the common and specific elements of successful reform processes, and we compare these successes to situations that led to failure. For instance, we observe cases in which the choice of an appropriate “strategy” was the essential driver of success. Yet, simply mimicking a strategy that proved successful under a given scenario may easily feed failure under a different set of framework conditions. It is thus important to provide broad-ranging evidence of the different “recipes for reform” that were used under different scenarios. In fact, one of the important lessons of our exercise is that no “one-size-fits-all” policy recommendation can be drawn.

Despite significant diversity in the reform experiences we cover, some lessons can be drawn about the reform strategy to use, given the market to be reformed and the country’s political institutions. For instance, our analysis of the reforms that affect the population at large, such as the labour market and the welfare state, illustrates that clearly defined groups with vested interests—namely, insiders for the labour market, and retirees for the welfare state—emerged in opposing the reform measures. In consensus democracies—such as Denmark, Italy, and, to a lesser extent, Spain—the packaging and the pace of reforms had to be targeted so as to circumvent opposition; to buy approval by the lobbies and unions that represent the interests of these groups. Long transition periods, which effectively sheltered middle-aged workers and retirees from the effects of pension reforms, were engineered in the Italian pension reforms. Gradual, piecemeal, labour market reforms were implemented in Spain, to reduce
their impact on tenured workers. On these occasions, the reform process was rather gradual (and thus slow) but, having built a large public consensus, these governments had secured wide political support for their reforms, and hence reduced the risk of reversal. The experience proved different in the UK, partly due to the existence of a different system of political representation. Under the majoritarian representation rule, governments typically face less resistance—or they can circumvent it more easily. Therefore, reforms can be more sudden and radical, as shown by the Thatcher experience in the UK, which included the 1986 pension reform and the privatization of several major state-owned enterprises. These reform measures clearly hurt some on the fringes of the population but were ultimately used by the Conservative government of Mrs Thatcher to build additional support for the Tories among the upper and upper-middle classes of the population. Yet, the lack of popular consensus, together with genuine questions about the efficiency of these reforms, led to subsequent reversals, as with the case of Blair’s 1999 pension reform.

In the product market, the approach of the government has to be somehow different. In this market, interest groups are less clearly divided along ideological party lines. Vested interests cross the left–right, worker–employer division lines, and develop converging incentives. Workers and employers, blue and white collar, bureaucrats and consumers, tend to join forces in many non-manufacturing industries. In these markets, almost independently of the political strength of the policy-maker, successful reformers appear to have generally followed a “divide and conquer” strategy: targeted changes to existing regulations led to the division of vested interests. However, to achieve these ends, the pace of reform ought to be slow; it must create the conditions for a smooth and continuous reform process rather than appeal to a big-bang reform. Sometimes, this process also calls for reforms in other markets. Our analysis suggests that reforms in one market—for instance, the product market—may well spill over to other markets—such as the labour market—both by creating political momentum and by modifying background economic conditions.

We also cover some reform experiences in transition economies. The contrast between the conditions faced by their governments can be more starkly contrasted, and additional lessons can also be drawn for OECD countries. External constraints played a more prominent role in these countries, since most reforms were inescapable. Moreover, transition countries had to establish simultaneously the role of economic and political governance. We review some of the mass privatization programmes that took place there, and show that many were precisely
designed to target political motives. The role of political governance and external constraints was crucial in the privatization of the main Czech and Ukrainian car makers. Our case studies clearly illustrate that, while the prospect of future EU membership allowed the Czech government to commit to an efficient privatization plan, the excessive freedom of action of the Ukrainian government led to the protection of particular lobby groups and politicians, at the expense of economic efficiency and, ultimately, of the population at large.

The typology of reform experiences analysed here is thus extremely large and varied. Policy-makers must be aware of the wealth of strategies used by their fellow reformers, and take stock of what made some reform attempts successful while others failed. This report highlights the most salient features of several reform processes according to their different economic and political scenarios and discusses some useful “recipes” for reform. Chapter 8 provides broad-brush evidence of the pace of reform over time, across countries and sectors, and reviews some major theoretical elements of the political economics literature of reforms. Then, each of the following chapters investigates a specific scenario and an associated strategy.

In Chapter 9, we concentrate on the reform opportunities that emerge when a government exploits its parliamentary majority. Classical examples of this situation are the privatizations and pension reforms carried out in the UK by the Thatcher government. When backed by a large parliamentary majority, the policy-makers’ only constraint is typically the need to win a future election, which provides ample freedom of action in most cases. Yet, this strategy is not always valuable. The desire to rely exclusively on a parliamentary majority was probably the cause of failure in many other reform attempts—such as Berlusconi’s 1994 pension reform plan in Italy, Juppé’s 1995 labour market reform in France, and Rasmussen’s 2001 labour market reform in Denmark. This mix of successes and failures suggests that other institutional elements are crucial, such as the (lack of) internal cohesion in coalition governments or the existence of strong opposition. A strong parliamentary majority can thus be boldly insufficient to generate sufficient coalition building.

Chapter 10 discusses an alternate strategy that policy-makers tend to use when they do not enjoy sufficiently strong political power, and when they address reforms in broad-reaching sectors that affect a large fraction of the population. In the absence of a large parliamentary majority or in the presence of strong opposition in the economic or social arena, policy-makers widen the political base for their reform, by
resorting to social dialogue and to a more consensual style. The need to gather wider social and political support induces policy-makers to increase the share of winners from the reform, while raising expenses for the losers. Examples of this strategy are the postponed implementation of the measures to future generations in the 1992 and 1995 Italian pension reforms, and the adoption of consensual measures in the Danish labour market.

In Chapter 11, we consider instances in which widening the political base for reform may still be desirable, but is practically unfeasible. This economic scenario typically emerges when the benefits from reform are dispersed among many economic agents, postponed to future generations and perhaps highly uncertain—as, for example, with the liberalization of a “strategic”, traditionally highly regulated market—whereas costs are highly visible and relatively concentrated. Since buying out the opposition of vested interests is too costly or would largely limit the scope for reform, policy-makers must resort to a different strategy. The recipe adopted by successful policy-makers—particularly when liberalizing non-manufacturing industries—is to “divide and conquer”. This strategy aims at disentangling entrenched vested interests by concentrating the costs of the reform on particular groups. Successful adoption of this recipe includes the privatization of Telecom Italia, which had already been corporatized and had offered private contracts to its employees; and can be contrasted with the experience of France Telecom. Often this “divide and conquer” strategy calls for a reform to be initiated gradually, that is, in one particular market or sector to start with. Then, the effects of this first step can trickle-down to other markets over time, as the rents appropriated on these markets are reduced. Examples of such trickle-down effects include the Spanish labour market reform of the 1980s that—by liberalizing temporary contracts—induced a reduction in the relevance of permanent contracts and eventually made the reforms of the 1990s possible.

Chapter 12 takes a different angle on policy-making by recognizing that several successful reforms were actually implemented under the tight pressure of external constraints. Although strong governments may prefer to be free to select their reform options (see Chapter 9), governments facing strong opposition may need to rely on external constraints to increase their bargaining power in the coalition building phase and to limit the opposition of lobby groups. The recipe provided in this chapter is hence to exploit external constraints, such as those imposed by World Trade Organization (WTO) rules, the Stability Pact, or International Monetary Fund (IMF) conditionality rules. Recent economic history
How to Gain Political Support for Reforms

provides several successful examples of how external constraints imposed by EU laws or treaties increased the pace of structural reforms in Europe. Yet, Chapter 12 essentially concentrates on the reform experience of two transition countries—the Czech Republic and Ukraine—and of their major national car producers—Škoda and AvtoZAZ—to highlight the role of commitment to reform provided by a truly external constraint; in this case, the external anchor of the European Union.