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The Political Economy of Structural Reform and Fiscal Consolidation Revisited

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Abstract

Europe is going through an unprecedented period of fiscal consolidation and structural economic policy reforms. However, reforms undertaken in times of financial market stress may not be politically viable in the long run if they lack the necessary social balance. This paper studies the distributional consequences of European fiscal consolidation and structural reforms and the scope for further reforms. Suggestions for the efficient bundling of reforms are made. The paper also makes suggestions regarding the strategy of international advice to countries which need structural reforms and it discusses the design of international incentives and a possible role for international mediation.

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Non Technical Summary

The recent and unprecedented efforts in several European countries to implement structural and fiscal policy reforms come along with a serious downside risk. Reforms undertaken during a debt crisis are not politically viable if they lack the necessary long run political support. Reforms that disappoint a large part of the population are unlikely to prevail, once the immediate threat of a government default has disappeared. In this context it is particularly relevant that Europe has meanwhile established new fiscal and monetary support instruments for states that are in financial difficulties. These new support instruments already reduce risk premia on southern Europe's bonds despite considerable political uncertainty in some countries. Consequently, missing reforms may no longer result in sharply increasing risk premia or the risk of losing market access.

In this new situation, voters may soon reconsider the recent policy reforms in several countries - just as they recently did in Italy. This is why it is particularly important to understand (i) how further efficiency-enhancing reforms can be complemented with other measures to increase overall political support and (ii) how the European Union as a whole can provide better incentives to member countries to undertake reforms that are efficiency enhancing and distributionally balanced. The present paper addresses these two problems. It studies the distributional consequences of Europe's fiscal and structural reforms and makes suggestions on how to combine different reforms in order to obtain more popular support in the long run. Moreover, it makes suggestions on how to structure positive and negative incentives for fiscal consolidation and structural reforms.

A good example for the political risks associated with unbalanced reforms is Germany's recent encompassing labor market reform. This reform has improved the efficiency of the labor market but it has failed to distribute the efficiency gains across different interest groups. Europe is so far following the German reform example and so it is taking a substantial political risk. Europe could instead follow the example of it's own 2005 agricultural reform. This reform included a compensation of reform-losers and it may therefore serve as a blueprint for other efficiency-enhancing reforms.

Several measures could become a part of reform packages that would be more likely to gain popular support. Most importantly, complementarities exist between labour and product market reforms. While labor market reforms tend to reduce real wages and increase profits, product market reforms tend to do the opposite. Combining them properly can make many citizens better off. This speaks in favor of the simultaneous implementation of both type of reforms. Other

options are a more effective competition policy, and an increase of the effective national tax rates on the gross return from capital. The latter policy need not reduce the net return on capital because capital owners benefit from an increase of the marginal productivity of capital.

Rents for owners of capital that arise from labor market liberalization arise in the entire European Union. National source taxation of capital income can only address this problem to some extend. The need to compensate losers of labor market reforms is another argument for more fiscal policy coordination.

Another way of compensating low income households is to improve the efficiency of regional public spending. Appropriate constitutional reforms and in particular steps towards more direct democratic participation can help to make public spending decisions more efficient.

Not all structural policy problems can be dealt with efficiently at the national level. Major structural reforms frequently create positive or negative cross country spillovers. This also holds for measures of fiscal consolidation. Therefore, one can make a case for policy coordination or international incentives.

External incentives for low deficits are one key ingredient for sustainable public finances. However, little is gained if fees for excessive deficits just result in even higher deficits. This is the most likely outcome when a weak government cannot convince major interest groups to bear the burden of stabilization. One way to address this problem is to grant the European Union the right to charge a limited supplement to the national VAT rate. The revenues from such a VAT supplement could be used to finance incentive payments for reforms or to insure countries against adverse outcomes of policy reforms with uncertain consequences.

Regarding positive incentives, the European Commission could act as an international market maker that efficiently deals with cross country externalities arising from national policy reforms. The paper also discusses simple mechanisms for the allocation of a given budget that have low information requirements and it makes concrete suggestions for the timing of offers, reforms, and financial transactions.

1 Introduction

Europe's governments are engaged in an unprecedented effort to make their public finances sustainable. They implemented wide-ranging reforms of their fiscal, labor market, social security and competition policies, and they revise their pension and financial systems. Many policy changes that would have seemed impossible a few years ago have recently been implemented with surprisingly little or ineffective political resistance. One likely reason for this is that several countries were under the immediate threat of losing their access to the capital market. This threat increased interest groups' willingness to accept measures which would have had little chance to be implemented under normal circumstances. A second factor that played a role is that there has been unprecedented international pressure on national governments to get reforms started. Facing the risk of a financial meltdown and the breakup of the currency union, Europe's policymakers have intervened in an unusual manner in other nations' fiscal policies. In this context, international help was made conditional on the progress of national reform efforts. The combination of an internal need for a policy turnaround and external incentives for reforms has made major policy changes in Greece, Italy, Portugal and Spain possible.

This unprecedented political success of reform initiatives comes along with a serious downside risk. Reforms undertaken during a debt crises may not be politically viable if they lack the necessary long run political support. Reforms that disappoint a large part of the population are unlikely to prevail once the immediate threat of a government default has disappeared.[1] In this context it is particularly relevant that Europe has meanwhile established new fiscal and monetary support instruments for states that are in financial difficulties. Various measures which are included in the treaty on the European Stability Mechanism (ESM) as well as the European Central Banks's (ECB) long term refinancing operations (LTROs) and open market transactions (OMTs) create a new safety net for the euro-zone countries. These new support instruments already reduce risk premia on southern Europe's bonds. Consequently, missing reforms may no longer result in sharply increasing risk premia or the risk of losing market access. In this new

[1] According to Fernandez and Rodrik (1990) some reforms that face initial resistance may be politically sustainable when the initial resistance was due to individual specific uncertainty about the outcome of the reform. However, in the context of a labor market reform that tends to reduce wages or a pension reform that tends to reduce pensions it is unlikely that this effect plays a substantial role, i.e. losers of the reform should know ex ante that they are going to lose.

situation, voters may soon reconsider the recent policy reforms in several countries - just as they recently did in Italy. Moreover, any new policy initiative will quite likely face tighter political constraints. This is why it is particularly important to understand (i) how further efficiency-enhancing reforms can be complemented with other measures that guarantee the required social balance and (ii) how the European Union as a whole can provide better incentives to countries to undertake reforms that are distributionally balanced.

The present paper addresses these two problems. It studies the distributional consequences of Europe's fiscal and structural reforms and makes suggestions on how to combine different reforms in order to obtain more popular support in the long run. Moreover, It makes suggestions on how to structure positive and negative incentives for fiscal consolidation and structural reforms.

The paper is organized a follows. Section 2 makes the case for balanced reform packages and discusses two prototype reforms: the German social security reform and the EU agricultural reform. The German labor market reform is unbalanced in the following sense. The reform has increased the size of the pie but it has failed to distribute the gains across different interest groups. Instead, I argue that the EU agricultural reform was particularly successful in compensating losers from the reform. Therefore, this reform may serve as a blueprint for other efficiency enhancing reforms.

Section 3 is an analysis of the reform progress that has so far been made in two countries which are of particular systemic relevance: Italy and Spain. I discuss the distributional consequences of the reforms that have been undertaken so far as well as of those reforms that have been recommended by the European Commission, the International Monetary Fund (IMF) and the OECD.[2] The main focus will be on the European Commission's country specific recommendations. I argue that several growth enhancing reforms that have been undertaken so far broadly redistribute from labor to capital. On the other hand, there are no compensatory growth enhancing reforms that redistribute as broadly from capital to labor. Another main result of the analysis of past reforms is that fiscal policy changes have had more balanced distributional consequences than the structural reforms. In both Italy and Spain, structural reforms so far create a substantial burden for insider

[2] The policy path that has been pursued so far is also important for the success of future policy measures. Voters who feel treated unfairly by the first set of policy reforms are less likely to accept additional steps into the same direction. Therefore, any possible compensation for reforms should not just concentrate on the status quo in 2013 but also on the situation before the beginning of the euro-zone crisis.

employees. To summarize: Europe is so far following the German reform example and therefore it is taking a substantial political risk.

In section 4 I discuss options for the design of reform packages that would be more likely to gain long term popular support. The objective of this part of the paper is to discuss how one can bundle reform measures in order to increase the chances of fiscal consolidation and structural reform. Ideally, the combination of two or more efficiency enhancing reforms would distribute the efficiency gains properly. In cases in which bundling of reforms can not yield a Pareto improvement or at least broad popular support, other distortionary and redistributive policy measures may have to be added in order to get enough political support.

The political success of a reform programme is not only determined by the actual reform outcome. Expectations regarding the consequences of reforms should play an equally important role. Therefore, it is key to understand what voters believe about the actual consequences of new policy measures. Systematic advice to national governments could be based on an empirical analysis of elicited beliefs regarding the consequences of reforms. However, in this context a problem of incentive compatibility arises. Simply asking voters about their preference intensity would not be enough. Section 5 makes a suggestion on how to gather data about individual beliefs and opinions and how to facilitate reforms through improved procedures for international advice.

Section 6 of the paper is devoted to Europe's attempts to improve the existing contractual arrangements (the fiscal compact and the six-pack) that are supposed to lead to fiscal sustainability. External incentives should be provided in a way that facilitates national reform making. Moreover, imposing reform incentives from outside create serious problems of democratic legitimacy both for the institution that recommends the reform and for the government that implements the reform. I study the interaction of external incentives and national reform making and I make several concrete suggestions on how to improve the structure of international incentives.

Section 7 summarizes the main results of the paper.

2 How to pay for reforms

2.1 Trade reforms or pay for them

A reform can simply be defined as a major policy change. However, the term "reform" is often used with a positive connotation. According to such a more narrow view, a major economic policy change deserves the label “reform” if it satisfies additional criteria. One may in particular demand that an economic policy change should – in some well defined sense - increase the size of the pie that can be distributed in an economy. This requirement may e.g. relate to the level of GDP in a specific year or to the long run GDP growth rate. A second criterion is that the policy change should make a substantial part of the population better off. Ideally, when the size of the pie is increased by the reform, it should be possible to make every citizen better off.

Many proposals for major policy changes that satisfy the first criterion (increase of the size of the pie) fail to satisfy the second one (make a majority better off). If a government does not properly design its policy proposals the country may stick to inefficient policies. Any successful policy proposal for fiscal consolidation and structural reforms in Europe must have sufficiently balanced distributional effects if it shall be politically successful in the long run.[3]

There are two options to create distributionally balanced reform packages. The first option - to trade reforms - is to bundle two or more efficiency enhancing reforms in a way that for each interest group losses from one reform are compensated for by gains arising in another area. An example would be the combination of market oriented reforms both on the labor market and on product markets. Labor market reforms reduce rents of insiders and increase profits of owners of capital. On the other hand, more competition on product markets reduces prices and profits and increases real wages. Taking for granted that both reforms increase the size of the pie, one may be able to find combinations of both reforms that make both workers and owners of capital better off.

In some situations it may be impossible to create a large enough compensation for losers of one reform using another reform. This is the case when only one sector works particularly inefficient. In such cases outright monetary transfers to the losers of one reform are a feasible alternative. This second approach may be more costly because transfers require some sort of distortionary taxation of reform-winners. Part of the efficiency gains are then eaten up by the transfer scheme.

[3] Buti et al. (2010) found that the re-election probability of reformist governments is not lower than that of non-reformist ones. This indicates that reforms may find enough support ex post. Buti et al. use changes of a market rigidity index as a measure of reform intensity. This measure does not distinguish between reforms that are costly for small parts of the population and reforms that adversely affect a large part. This might explain why they find that the size or reforms has little impact on the reelection probability. The labor market and social security reforms that have been undertaken so far and those that are in currently being considered are likely to belong to the category that is politically more risky.

The European Commission, the International Monetary Fund and the OECD regularly publish country specific policy recommendations. The measures included in those lists of recommendations are indeed likely to spur economic growth in the medium and long run and to reduce the debt/GDP ratio of any country that undertakes them. Many of the measures included are measures of deregulation. These measures concern barriers to entry into specific professions (notary profession, pharmacists, taxi drivers) the competition between firms, subsidies and the regulatory environment of firms. Considering these lists, it becomes obvious that there is considerable scope for balancing reform packages along the lines of the first approach.

However, one problem with this first approach is that it requires even more information than the second one. This information concerns all voters' preferences for all reforms whereas the second approach "only" requires information about preferences within one sector regarding sector specific reforms. The mechanism design literature has produced a number of interesting and abstract results regarding the implementation of ex post efficient social choice functions. However, very little has been achieved regarding mechanisms for concrete multidimensional policy problems. In sections 5 and 6 I will make some proposals on how to make progress in this respect. This is why it is an interesting option to directly compensate losers of a reform with monetary transfers. The EU agricultural reform is a good example for this approach.

2.2 Lessons from the EU agricultural reform

At first glance, designing a Pareto-improving reform based on a welfare enhancing policy measure may seem to be a simple thing. One only has to identify gains and losses that arise under a new policy, tax away some of the gains and use the tax return to compensate the losers of the reform. One major problem with this approach is that some reform losers and some reform winners are better informed about their willingness to pay or their willingness to accept than the government. This creates information rents for those who benefit a lot and for those who lose only very little. Any mechanism that is supposed to implement an appropriate compensation for losers of reforms has to deal with these political information rents. In some cases, information rents may be so large that a compensation of reform-losers cannot be financed (Grüner, 2002).

Grüner and Müller (2012) study the 2005 EU agricultural reform in order to estimate the information rent of reform-losers. The agricultural reform replaced previous distortionary quantity subsidies by a transfer that has been linked to the size of the area that is (minimally) cultivated by the farmer. Therefore, this reform is an excellent example for a policy measure that increases the size of the pie.

In their survey of farmers in Lower Saxony, Germany they found that about 50 percent of the farmers surveyed are satisfied with their transfer payment. This indicates that the European Union has managed to buy the support of a large enough fraction of the farmers in that region. The size of political information rents amounts to 10 -15 percent of the payments that are made. Taking into account that about 50 percent of the farmers receive less than their willingness to accept, it seems to be possible to buy the support of a majority of reform losers at a relatively low cost.

Today, there is basically no lobbying for a return to the old system of agricultural subsidies. One can therefore argue that the reform has been both efficiency-enhancing and politically successful. Europe's 2005 agricultural reform can be considered as a prototype example for how to reform other sectors of the economy. The success of this reform relies on the compensation payments. Currently, some politicians ask for a reduction of the compensatory payments to farmers. In deed, transfers which are not linked to any productive activity[4] are susceptible to be "unmerited". However, if Europe were to renegotiate the transfers to farmers, the credibility of further similar measures could be affected. This is why compensatory payments for reforms have to be reliable.

Whether or not a long run commitment to a compensatory payment is detrimental to economic efficiency depends on the relevant frame of reference. Such payments have to be financed through distortionary measures such as distortionary taxation. In this sense, their indefinite persistence hurts economic efficiency. However, one may argue that the alternative is not to reform the existing distortionary policies. In this sense, the persistent payment can be called efficiency-enhancing. Nevertheless, a phasing out mechanism may be useful because it may be more credible than any indefinite promise to compensate reform losers.

2.3 Lessons from the German labor market and pension reforms

Since the early 1980s German economic policy advisors asked for substantial labor market and pension reforms - with very little success. At the beginning of the new millennium, Germany's

[4] The subsidy is only paid if the farmer keeps the land in good shape which is not particularly costly.

unemployment rate increased above 10 percent and Germany's SPD-Grüne government rapidly implemented an impressive set of labor market and social security reforms. The reforms included several measures to increase labor supply of the unemployed, reduce the cost of social security, make the hiring process of workers more efficient, reduce firing costs and gradually increase the retirement age. Similar measures also figure prominently on the lists of today's country specific recommendations of the European Commission.

The main consequences of these reforms were twofold. On the one hand, the reform has created incentives for unemployed workers to seek a new job and so reduced unemployment (Walter, 2012). On the other hand increased labor supply was associated with stagnating real wages over a considerable period. The reform programme in Germany did not include any compensatory measure for this second aspect. Not surprisingly, the reformers faced fierce opposition which also manifested itself in a series of weekly demonstrations. The incumbent socio-democratic party lost several Länder-elections between 2004 and 2005 and it lost members many of which formed a new party together with the socialist PDS. In 2005, the German chancellor Gerhard Schröder decided to trigger an early election. The supposed motive for this was that Schröder had too little support left in his own party and in parliament. The sociodemocrats lost the election. The new CDU-SPD grand coalition government did not reverse the reforms after taking office in 2005. Measures to increase wealth creation of workers were discussed by the grand coalition. These measures could have been interpreted as a compensation for insider employees. However, ultimately, very little was achieved in this field. In 2009, the socio-democratic party gained disappointing 23 percent of the popular vote - compared to 38.5 percent in 2002.

The German experience shows that a left wing government may lose power when it implements a reform that is not in the interest of its main constituency - insider employees and pensioners. The German reforms have been successful only because - ironically - the new government was a more right wing one that did not want to reverse the reform. However, this initial political "success" of the 2005 reforms is now at risk. Some of the reforms have meanwhile partly been reversed while others are heavily contested. In 2010, 38 percent of respondents to a German survey stated that they are in favor of a retirement age of 65 years. Moreover, 21 percent were in favor of 62 years and 24 percent would pick 60 percent (Stern Magazine). Obviously, simple survey questions about the desired retirement age do not take into account the trade-off between retirement age and contributions to the public pension system that individuals face. Nevertheless, the above figures indicate, that the SPD government has enacted a pension reforms that is undesired by a majority of voters. This is why there is a considerable chance that Germans will choose to return to an earlier retirement age in the next elections.

Of course, the case of the German labor market reform is merely an example. To the best of my knowledge there is no systematic empirical evidence on the role of compensation packages or their absence. Nevertheless, the German example makes clear that any serious policy reform that does not include some compensation for the losers of the reform may be costly for the incumbent party. Moreover, even a more reform-oriented new government may find it difficult to stick to the predecessor's reform agenda. Consequently, national and international political advisors should consider options on how to compensate the losers of a reform.

2.4 Pay enough or not at all

From a rational choice perspective, compensation payments should always be useful to buy support for or reduce the resistance against a reform. However, a recent empirical literature which extensively studies potentially adverse effects of incentive and compensation payments on cooperative behavior (see Gneezy, Meier, and Rey-Biel, 2011, for a survey) raises some doubt on whether payments to losers of reforms are always the right solution. The view that compensatory measures may improve outcomes has been challenged by a number of papers that stress the existence of so called "motivational crowding out". According to this literature, monetary incentives to accept some collective action (such as the establishment of a facility for the disposal of nuclear waste in the neighborhood) may reduce the acceptance of the measure if more noble motives play a role (Frey and Oberholzer-Gee, 2006). Altruistic individuals who are in principle willing to give up something if there are substantial gains for society as a whole are less willing to do so if society offers a compensation in return for this favor.

Unfortunately, very little is known about possible adverse effects of compensation payments in a reform context. Many papers neither concentrate on policy reforms nor on collective action problems (voting, investing in costly opposition) which do play a role there. Nevertheless, one can already obtain some insights from this literature for the design of compensatory measures.

In a recent experimental paper, Winschel and Zahn (2012) find that compensation payments for an efficiency enhancing "reform" do not produce an adverse effect when the costs of the measure are fully known. Winschel and Zahn study a dictator game in which one player (the dictator) can give up resources (in their experiment 2 Euros) in order to increase the payoff of another player. The gains of the second player are higher than the losses of the dictator, ranging from 2.5 to 7 Euros. It turns out that about 20-30 percent of the players in the role of the "dictator" choose to give away the 2 Euros. Monetary rewards do not reduce the willingness to give up resources. This result is in some contrast to results of previous studies such as Frey and Oberholzer-Gee (2006) and Falk and Kosfeld (2006) who highlighted the disincentives which may be associated with a monetary compensation or incentive payments.[5][6] One possible explanation is that the result by Frey and Oberholzer-Gee (2006) might be based on a signaling effect, i.e. that the compensation signals that there is in deed a substantial cost for the losers of the policy measure. This effect is not relevant in the paper by Zahn and Winschel because losses of the dictator are perfectly known to him.

Another interesting insight can be drawn from a paper by Gneezy and Rusticini (2000) who study the effectiveness of incentive payments in a moral hazard context. They find that incentive payments may reduce effort when they are low, but that effort then increases in the size of the payment. This makes them to conclude that a principal should either pay enough or nothing at all. One interpretation of this finding is that a small payment just has an adverse motivational crowding out effect which makes this payment inferior to no payment at all. However, if the payment is large enough, the principal may be able to increase his welfare. In the context of a compensation for a reform this indicates that the government should either not use any explicit compensation strategy or choose a compensation which is sufficiently large to compensate a large enough fraction of the group which is adversely affected by the reform measure. Regarding the composition of reform packages, on can conclude that it may be counterproductive to accompany serious reforms of labor markets and the pension system with only cosmetic compensatory reforms

[5] Interestingly, Winschel and Zahn also find that subjects give up more money if they are less well informed about the gains that the second player realizes. In the treatment in which each value of the gain has an equal probability, about one third of the voters give up the 2 Euros. The value is lower for any known value of the individual gain.

[6] The experiment starts with a quite unequal distribution of resources in which the dictator starts with a higher endowment than the receiver. It remains open whether the role of information changes in a setup in which the receiver is endowed with more ressources than the dictator. This case would correspond better to the current European context in which most of the burden of major efficiency enhancing reforms would have to be borne by labor rather than capital. Moreover, one can not derive from this experiment how individuals react to information if it is uncertain whether there are welfare gains or whether the other group benefits at all.

in other areas.

Paying for growth enhancing reforms raises an additional problem in cases of excessive debt levels. Any up-front compensation payment for reforms may be in conflict with the objectives of fiscal consolidation or economic growth. On the other hand longer term transfer promises may be less credible. If the government chooses a front loaded compensation then fiscal consolidation is more difficult unless the government can raise additional revenue from reform winners to finance the compensation payment. One problematic aspect of this is that economic growth may be affected if the government uses distortionary taxation to finance an early compensation. A positive aspect of taxing reform winners over a longer time horizon is that there are cases where distortions that arise from taxation are more than offset by the positive effects that arise due to the reform. To understand why, consider a labor market reform that reduces wages and unemployment and increases profits. If the sum of wages and profits increases, taxing profits at a higher rate may still results in a higher net return on capital.

A different problem is that actors may be uncertain about the required size of a compensation. In this case, some outside insurance of the country against adverse consequences of a reform may actually be constrained efficient. In principle, such an insurance could be provided by a national or international insurance mechanism. This topic will be discussed in more detail in section 4.1.2.

3 Distributional consequences of policy reforms in Italy and Spain

The European debt crisis emerged in 2009 when it became clear that Greece has misreported its government financial data. Before that date several governments had launched spending programmes in order to avoid a more severe economic downturn. Following the bad news from Greece, Ireland, Portugal, Spain and Italy had to face increasing distrust on the bond markets and sharply rising borrowing rates. Since the beginning of the fiscal crisis, all six countries have undergone severe austerity programmes and most of them also undertook major structural reforms which are supposed to increase economic growth in the medium run. Understanding the distributional consequences of these first three years of fiscal austerity and structural reforms is quite important since some of these reforms have already lead to considerable disappointment in some groups of the population. This disappointment may make it more difficult to implement additional reforms and it may also lead to the reversal of some reforms which have already been implemented.

This section briefly discusses the distributional consequences of the reforms that have been approved during the first three years of the crisis in two of large European countries, Italy and Spain. I focus on these two countries because they are systemically relevant and I distinguish between reforms which directly try to reduce spending or increase revenue and other reforms that are supposed to increase the growth rate in the long run and so reduce the debt/GDP ratio. The selection of the reforms is based on a set of governmental, EU and IMF papers and on a recent paper by Callan, Leventi, Levy, Matsaganis, Paulus, and Sutherland (2011).

3.1 Italy's and Spains' fiscal policy reforms 2011-2012

According to the European Commission (2012, Box 2), the main budgetary measures adopted in Italy since 2010 are the ones that are listed in part 1 of the appendix of this paper.[7] These first measures in 2011 were followed by a longer list of additional measures in 2012. This second list contains more measures which are likely to reduce the payoff of capital-owners. Part 1 of the Appendix list ten measures that are likely to reduce the welfare of insider employees and fourteen measures that are likely to reduce the welfare of owners of capital. In this paper, I call a savings policy "broadly balanced" if the extra fiscal burden is roughly proportional to the income of a household. By adding up the fiscal effects listed in column 2 of the table that mainly either concern capital or labor one arrives at an extra revenue from the labor side of 0.8 percent of GDP and from the capital side of 1.95 percent of GDP. Overall, taking the capital income share of about 40 percent into account, this indicates that the fiscal policy measures undertaken so far in Italy are not biased against labor.

Regarding Spain, recent research by Callan, Leventi, Levy, Matsaganis, Paulus, and Sutherland (2011) indicates that fiscal policy reforms in this country have been distributionally balanced as

[7] According to the report the

> "budgetary impact in the table is the incremental annual impact reported in the programme, i.e. by the national authorities. A positive sign implies that revenue/ expenditure increases as a consequence of this measure. Permanent measures are not repeated in successive years, unless the budgetary impact changes significantly. The no-policy-change baseline excludes any wage contract renewals until 2015." The columns labor, capital and administration evaluate the distributional consequences of the corresponding measures. A "+" indicates that the respective group gains, a "-" that it loses and a "+-" an ambiguous effect. The value "0" indicates that there is no clear effect."

well. The authors have analyzed the distributional impact of the austerity measures implemented in six European countries including Spain before June 2011.[8] Figure 6 in their paper displays the percentage change of disposable household income in relation to the income deciles. It turns out that in Spain the extra fiscal burden is approximately proportional to income. It amounts to 2-3 percent of gross income. Hence, the fiscal policy burden so far has also been allocated in a fairly balanced manner in Spain. Concentrating alone on the fiscal side there is little reason to assume that the Italian or the Spanish government could be politically more successful using a different distribution of the burden than over the last three years.

3.2 Italy's and Spain's structural reforms 2011-2012

The Italian Ministry of Finance (2012) published a list of fiscal and structural reform measures that were initiated or implemented between November 2011 (the election of Mario Monti as prime minister) and September 2012. According to this document, the government's strategy is "based on three pillars: (1) fiscal consolidation, (2) structural reforms, (3) burden sharing and fairness." The paper lists substantial labor market and pension reform measures. Taken together, these measures are likely to increase labor supply. They include a reduction of the duration of unemployment benefit payments, an "increased flexibility on the firing side", an increase of the retirement age for normal and early retirement, and new calculation rules for pensions which provide incentives to work longer. These measures are also likely to make the insider employees worse off because they tend to reduce their wages. The paper also contains several measures that will most likely increase the welfare of insider employees. These concern the removal of several frictions on product markets. Most significant are the strengthening of the powers of the competition authority and the reforms regarding the energy sector. However, the set of reforms contains no element which redistributes as broadly from owners of capital to insider employees as some of the other items on the list redistribute from employed labor to capital.

The 2011 IMF report on Spain lists main policy reforms that have been announced in this country since May 2010. Part 2 of the appendix quotes the description of the reform from the report (left column) and then describes the most likely distributional consequences (right column). I mainly concentrate on insider employees in the description of distributional consequences because

[8] Unfortunately, the VAT increases are not included in their analysis.

insiders are politically particularly important. The table indicates that the reforms which have a predictable distributional outcome have a negative impact on the welfare of insider workers.

3.3 Italy and Spain: recommended reforms

Part 3 of the Appendix summarizes and evaluates the 2012 EU country specific recommendations for Italy[9]. The quote from the country specific recommendation can be found in the left column and the evaluation can be found in the right column. A majority of the measures that concern labor or capital and that have consequences that can be predicted easily is likely to reduce the welfare of workers - at least in the short run. However, several of the measures could be used to increase the burden share of capital. Part 4 of the appendix quotes and evaluates the actions which the European Commission has recommended to Spain should for the period 2012-2013 (source: European Commission, 2012a). The quote from the country specific recommendation can be found in the left column and the evaluation follows in the right column.

Overall, the reforms summarized in the appendix will most likely stimulate employment and reduce wages of employed insiders. It is difficult to evaluate the compensatory potential of other reforms that may reduce the rents of capital owners in various sectors of the economy. This can be a reason why further labor market and social security reforms may not find a sufficiently broad popular support.

4 Constructing reform packages

In the previous section I have argued that both Italy and Spain seem to have managed to spread the burden of the adjustment of government expenditures and revenues across income classes and income sources. However, the previous section also indicates that both countries were not equally successful in balancing the distributional consequences of their growth enhancing structural reforms. Similarly, the measures suggested by the European Commission in its country specific recommendations could only reduce the distributional bias of previous structural reform measures if both countries were to concentrate on a very small subset of the proposed policies or if the government uses additional measures. This is also problematic if one takes into account that, in

[9] Source: http://ec.europa.eu/europe2020/europe-2020-in-your-country/italia/index_en.htm

both Italy and Spain, the labor income share has declined substantially over the last 20 years[10].

According to the country specific recommendations Italy and Spain should continue to reform their labor markets. This section discusses different options to compensate insiders for the losses which are likely to arise from further labor market reforms. The first option is to adjust capital income taxes and to use the revenue to reduce the tax burden of low and middle incomes. The second option is to complement labor market and pension reforms by other reforms that are likely to be efficiency-enhancing and that would shift part of the burden of consolidation to the owners of capital. The third option is to engage in additional - constitutional - reforms which are likely to benefit most citizens. Adding these reforms to the list of country specific recommendations would help governments to continue on a more balanced distributional path. This could make the entire reform agenda politically more sustainable and it could also contribute to more sustainable public finances.

4.1 Compensation through the tax system

Many of the structural reforms proposed by the European Commission in its country specific recommendations would most likely increase the equilibrium employment level in the country that undertakes the reform. Some reforms (including an increase of the retirement age) increase labor supply, others would reduce insider bargaining power or lower wages in some firms or sectors. All these measures lower wages and increase employment and the return on capital. Hence, it must be possible to tax away part of the increased return on capital without providing any disincentives for investment relative to the status quo.

Of course, one has to take into account the distortions that arise from the corresponding tax increases. However, there are cases where distortions that arise from taxation are more than offset by the positive effects that arise due to the reform. To understand why, consider a labor market reform that consists of the removal of rigidities. Such a reform reduces wages and unemployment and simultaneously increases profits. If the sum of wages and profits increases, taxing profits at a

[10] To be precise: I do not evaluate the fairness of the past development or the planned policies in this paper. The point of this paper is a purely positive one. Further policy reforms will be less likely to get implemented if the distributional developments and the distributional predictions and expectations are not taken into account. It is also important to note that the topics mentioned in the CSRs actually belong there. Most of the items that are included in this list describe in deed efficiency enhancing reforms.

higher rate than before may still result in a higher net return on capital.

One should also take into account that some households which benefit when unemployment is reduced in one European country reside outside this country. Therefore, a change of a national income tax schedule which works under the residence principle would not be enough to collect a part of the rents of those who gain due to a structural reform. A more targeted way of financing a compensation payment is to increase the source based capital income tax.

4.1.1 Quantifying a fiscal compensation

In theory, a Pareto improving deal between insiders, outsiders and the owners of capital in the presence of labor market rigidities can be easily described. In practice however, it is notoriously difficult to estimate by how much one can increase the tax rate on returns from capital without lowering the net return. In what follows, I discuss different quantitative approaches to this problem.

One possible way of estimating the effect of labor market reform on wages and profits is to use estimates of the real wage elasticity of labor demand. From a given elasticity of labor demand one could in principle derive the wage reduction that is required if one wants to reduce the unemployment rate by a given number of percentage points. This exercise then directly yields the gross income losses of insider employees. This value also constitutes a lower bound for the gains of owners of capital because a firm can realize these gains when it does not change its labor demand.

Estimates of aggregate labor demand elasticities are available from various sources. Pierluigi and Roma (2008) estimate the long run labor demand elasticities for Italy of 0.24 and for Spain of 0.58. Other estimates for Italy are somewhat larger but below unity. This is why estimates of labor demand equations suggest that - in the current institutional environment - a reduction of the unemployment rate by one percentage point in both countries requires a wage reduction of more than one percent.

Another major difficulty that arises when one wants to quantify possible losses of insider workers that arise from the CSRs using elasticity estimates is that one has to predict the increase of employment in Italy and Spain if these countries implement all the relevant reforms listed in the country specific recommendations. This is difficult because the recommendations are not very specific about quantitative policy changes. To avoid this problem, one can base numerical predictions of wage effects on assumptions regarding the reduction of unemployment rate that shall be achieved by the reforms. In a country with a 10 percent long run structural unemployment rate, a reduction of the unemployment rate of 5 percentage points corresponds to an increase of the level of employment of about 5.5 percent. Using the estimated labor demand elasticity of 0.58 for Spain, an increase of labor demand of 5.5 percent would require a wage reduction of 9.8 percent. Taking into account a labor income share of approximately 60 percent, this would mean that capital income rises by 15 percent.

With a lower labor demand elasticity of 0.24 these numbers would differ significantly in the Italian case. The wage reduction in Italy would have to be much higher an gains of owners of capital would be larger as well. This amount still would have to be considered as a lower bound on the gains of owners of capital because firms can capture the corresponding rents by simply sticking to the old combination of inputs. Correspondingly, taxes on corporate profits could be raised substantially without reducing net profits and without inducing capital flight.

These numbers rely on the assumption that wages are reduced while the labor market institutions do not change. However, the reforms proposed in the country specific recommendations would significantly restructure the labor market and this would then endogenously reduce wages. A restructured labor market may also exhibit a different elasticity of labor demand. In particular, with lower labor turnover costs, it is likely that lower wages will result in more labor demand and less fluctuations of overtime work.[11] This is why structural labor market reforms that tend to lower wages may increase labor demand by more than what can be derived using the simple elasticity measures. In principle it may even be possible that equilibrium wages remain unchanged after a removal of rigidities and that employment nevertheless increases.

One option to deal with this problem is to proxy the new elasticity of labor demand by the ones of economies with more flexible labor markets. However, US and UK labor demand elasticity estimates are in the same order of magnitude of the above mentioned Spanish elasticity. Accordingly the losses of workers in Italy might be in the order of magnitude of up to 10 percent,

[11] Kugler and Pica (2008) analyze a natural experiment in Italy where the cost of a dismissal was increased for small size firms. They find that both hiring and firing rates in those firms decreased more than for the larger firms. Related to this, Schiwardi and Torrini (2004) indentify irregularities in the firm size distribution around the value of 15 employees. This is the number of workers above which Italy's unuasual article 18 of the labor code starts being applied.

even if the structure of the labor market is reformed.[12] However, these estimates still do not take into account that the mere institutional reform of some features of Italy's and Spain's labor market is likely to increase the level of employment even if wages remain the same. This is why the above numbers are likely to constitute an upper bound of the losses for insider employees.

An alternative approach to predict the increase of firms' labor demand in response to a reduction of the real wage, is to use estimates of production functions. This approach also makes it possible to calculate the interest rate effect of a reduction of the real wage. Estimates of national European CES production function are provided in Dimitz (2001). She finds that the elasticity of substitution in both Italy and Spain is close to zero. Assuming a Cobb-Douglas technology, $Y = aL^{\alpha}K^{1-\alpha}$, which describes the aggregate production technology of both countries (with obvious notation) the elasticities of demand of labor and capital are given by $\frac{1}{\alpha-1}$ and $\frac{1}{\alpha}$ respectively. To identify the changes of wages and profits, consider a reduction of the unemployment rate from 10 to 5 percent in an economy with a labor income share of 60 percent. In this case wages would have to decline by about 2 percent and profits would increase by about 3 percent. In an economy with an unemployment rate of 25 percent, the reduction to 10 percent would still only require a wage reduction of 7 percent. All these numbers are remarkably smaller than the corresponding ones derived from elasticity estimates.

To summarize, it is quite difficult to predict the gains for owners of capital from a labor market and pension reform. Predictions based on elasticities and those based on production functions can differ remarkably. Moreover, both approaches rely on the assumption that reforms do not change the way in which demand reacts to changes in wages. A robust method of compensating insiders has to deal with this uncertainty.

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[12] A second problem arises if there is an effect of product market deregulation on labor demand. Several theoretical and empirical papers have studied how product market and labor market deregulation jointly affect labor demand. According to Fiori,Nicoletti, Scarpetta, and Schiantarelli (2012) "deregulating the product market is more effective at the margin when the labour market is overall more regulated. In this sense, product and labour market deregulation can be seen as economic substitutes, which implies that in situations where labour market regulation is stringent and difficult to reform politically, deregulating the product market may be the best way to promote higher employment at the margin." This indicates that one should look at both the effect of product market deregulation and labor market deregulation on employment.

4.1.2 Insurance against aggregate uncertainty

There is considerable aggregate uncertainty about the distributional consequences of current reform proposals. This complicates any compensatory deal that could make both capital owners and insider employees better off. It is notoriously difficult to determine the gains of owners of capital and the losses of insider employees before a reform. The range of values that can be derived using various methods is far too large to design a compensatory tax adjustment that accompanies the structural reform. This problem arises even if there are aggregate gains in the country with certainty.

One way to address this problem is to link the compensatory adjustment of the tax system explicitly to specific macroeconomic outcomes. In principle, the state could promise both sides of the deal transfers that react to pre-specified distributional outcomes. However, if the resulting transfers do not always add to zero then the state takes a risk.

One simple way to make tax increases for owners of capital depend on the return is to let taxes increase by a predetermined amount as soon as the unemployment rate falls below a certain predetermined level. An alternative way to assure that workers accept the reform would be to commit to a certain value of a net labor income share. Taking into account that the absolute value of the labor demand elasticity in Europe is below unity, it is clear that a reduction of unemployment will result in a reduction of the labor income share. From an individual perspective, the wage will fall even more than the labor income share if employment increases. One option for the government is to publicly announce a target for the net income share of labor. If credible, such a political commitment makes sure that a reform that stimulates employment does not involve high losses for workers. However, in order to be credible, a broad consensus about the targeted values would be required. This would require an agreement with both representatives of owners of capital and insider workers regarding the compensatory deal. A problematic aspect of such a solution is that the labor income share is determined by numerous factors which affect both supply and demand (see Arpaia, Perez and Pichelmann, 2009, for a detailed analysis). The major weakness of targeting a specific net labor income share is that such a target may trigger tax shifts in response to factors that are not linked to structural reforms. These factors in particular include technological and demographic changes. A better indicator for the overall distributional impact of a reform may be workers' disposable real income in different skill groups. Still, one should keep in mind that similar problems regarding the impact of technological factors may arise and have to be taken into account.

The problem of uncertainty is more severe if the aggregate consequences of a reform for the entire country are uncertain. In principle, one could construct an international insurance mechanism for such a situation. Such an insurance would not have to be a full insurance against any macroeconomic risk. Instead, it could be made conditional on the reform being undertaken and it might be linked to very specific sectoral or labor market data.

4.2 Tax coordination and the closure of Europe's tax loopholes

Simultaneous labor market reforms in several European countries will lead to lower wages and higher profits all over Europe. This is why some of the resulting gains obtain for investors who neither reside nor invest in one of the reforming countries. Therefore, these investors could also be willing to pay for a more competitive European labor market. One option to include the owners of capital in Europe in such a deal would be to introduce stricter minimum standards regarding the taxation of profits, capital income and high individual income on the entire continent. In order to effectively coordinate capital taxation, the European Commission could be given a central role. Options include to (i) regularly provide a structured comparison of tax policies of all European countries,(ii) regularly identify uncooperative practices in national tax policies, and (iii) harmonize the tax base for capital income in Europe. Depending on the form of tax policy coordination at the EU level a new legal basis for tax harmonization may be required.

4.3 Centralizing Europe's competition policy

Market oriented reforms are not necessarily good for owners of capital and bad for insider employees. It is one of the most puzzling political observations that many trade unions are narrowly focused on nominal wage increases and seem to ignore the detrimental effect of missing product market competition on real wages.

One key design dimension of Europe's competition policy is the level on which decisions should be made. It is difficult to make a case for a national competition policy in the context of a common European market. After the 2004 reform of the EU competition policy system, Budzinski and Christiansen (2005) still saw a need for a reallocation of competencies:

"(1) The May 2004–reforms of the EU Competition Policy System did not significantly improve the allocation and delimitation of competencies between the Member State level and the EU level. This is true for the reforms of both cartel policy enforcement and merger control. The latter in particular has even been worsened in terms of becoming more complex and less clear-cut. The reason for the insufficient reform results lies in the interest-driven reform process – a pattern, which has dominated the evolution of competence allocation ever since the establishment of European competition policy.

(2) The heavy emphasis and high hopes that the participating agencies and actors put on the European Competition Network as a soft path towards a better competence allocation, thereby healing the deficiencies of the substantial reforms, further supports this result. Even the participating agents themselves seem to not have faith in the reform results and argue in favour of additional, informal correcting mechanisms instead. The first experiences with the network have confirmed this.

(3) Because of the insufficient reform results, we predict that competence allocation will remain a field of controversy within the EU Competition Policy System. Further reform pressure and discussions are imminent."

All this indicates that there is some scope for further centralization in this area that could broadly be in favor of workers.

Besides centralization, some rules regarding competition and subsidies to specific sectors or regions should be reconsidered. This includes e.g. Article107 2 of the TFEU which includes exemptions that leave the door open for non-competitive subsidization on the national level. Moreover, the European Commission's country specific recommendations already contain several specific measures to improve competition on the national level.

4.4 Use of complementarities

Synergies between different reforms should be exploited and properly communicated wherever they arise. One first important example is the interaction of pension reforms and reforms of the resilience of the financial system. Most proposals of economists for pension reforms consist of (i) an increase of the retirement age and (ii) a reduction of the contribution and benefit levels. The second measure creates incentives to buy more privately provided savings products. Therefore, a reduction of the contribution and benefit levels which comes along with a more privately funded pension system should find more political support if financial markets are better regulated. In this case, private investors can expect a higher level and a lower variance of the long run return to their investment.

More competitive financial markets reduce the generation of rents in financial institutions and increase the return on investment. Banks and insurance companies are powerful political actors. However, a pension reform that reduces public benefits increases demand for private financial intermediation and so increases rents. Therefore, a deal that makes investors better and the financial industry not much worse can be envisaged. Any attempt to further reform the pension reform should therefore be accompanied by clear objectives regarding the performance of the financial industry. Similarly to the previous point, the quality of corporate governance in all sectors of the European economy also affects the return on investment. Policies that improve investors' "say on pay" are good complements for a pension reform. To a certain extent the quality of the financial system and corporate governance issues can be addressed on the national level. However, a full solution to many of Europe's existing problems in both areas would benefit from a unified approach.

A second example for synergies is the combination of a pension reform with specific forms of labor market flexibility. Only workers who can expect to find an employment at the age of 60 will consider an extension of the retirement age a not that bad idea. Labor market reforms should be constructed with a particular focus on employment opportunities for older workers.

Most importantly, complementarities also exist between labour and product market reforms. While labor market reforms tend to reduce real wages and increase profits, product market reforms tend to do the opposite. Combining them properly can in principle make many citizens better off. This speaks for the simultaneous implementation of both type of reforms.

4.5 Citizen participation and quality improvement

To the extent that public and private spending are substitutes, austerity policies on the spending side are particularly costly for poorer households. Efficiency improvements in the provision of public goods can help to mitigate this problem. One way to improve the efficiency of public spending is to better tailor local public spending to individual needs. This means that regions spend less on public goods that are not really needed and more on those that are needed[13]. One way to achieve this is to introduce more elements of direct democracy into local or regional spending decisions.

Of course, a direct democracy also sometimes decides inefficiently on the provision of public goods (Noam, 1980). The reason is that voters who derive a small surplus from provision may constitute a majority while voters who derive a large negative surplus may be in a minority. In such cases the overall surplus from provision is negative but the majority decides to buy the good. Noam (1980) has derived a method[14] to estimate efficiency losses in direct democracy and he applied this method to data from votes in Switzerland. He finds that the share of welfare maximizing decisions is above 90%. Accordingly, direct democracy seems to produce results which are fairly close to the first best. In the same context, Feld and Kirchgässner (2000) note the following:

> "Compared to purely representative systems, direct democracy leads to a different type of communication among citizens and also between citizens and representatives. The opportunity of deciding for themselves on political issues provides citizens with incentives to collect more information. Because citizens are better informed, politicians have less leeway to pursue their personal interests. As a consequence, public expenditure and public debt are lower when citizens enjoy direct democratic rights. Citizens also feel more responsible for their community: tax evasion is lower in direct than in representative democratic systems."

In an indirect democracy, voters delegate the decision over the procurement of these public goods to elected politicians. This makes it less likely that spending decision efficiently address citizens' needs. One insight that one can draw from the literature on local direct democracy is that centralization is an answer to some but not to all of Europe's fiscal problems. More decentralization of spending decisions in the sense of more citizen participation may also effectively limit excesses in public spending.

[13] In a simple quasilinear setup with privately known willingness to pay for an indivisible public good, the good should be provided when the sum of all individuals' willingness to pay exceeds the cost. When the cost of the public good excees the sum, the good should not be provided.

[14] Noam assumes that voters with a low net willingness to pay abstain from a vote. This assumption and the assumed normality of the distribution make it possible to estimate mean and variance of the distribution of the net willingness from the number of "yes" votes, "no" votes and abstentions.

Other constitutional reforms may also contribute to a long term fiscal stabilization. Persson and Tabellini (2005) have shown that majoritarian parliamentary systems and presidential systems are associated with lower government spending. The result is fairly robust across estimation methods. Moreover, Funk and Gathmann (2008) provide evidence that referenda on local budgets reduce the size of the deficit. Schaal (2012) argues that these observations should not directly imply that one should adjust national constitutions in a way that minimizes spending. However, if two constitutions yield the same satisfactory results regarding preference aggregation, the effect on public finances should play a role. Country specific recommendations could therefore also address countries' constitutional design.

Existing empirical evidence suggests that the introduction of more elements of direct democracy on the regional level may improve the efficiency of public spending. It may also reduce overall spending. This can help to mitigate the adverse consequences of austerity policies for the poor.

A more ambitious approach than enhanced direct democratic participation is to use more sophisticated incentive mechanisms for the decision about the provision of local public goods. Such mechanisms include monetary incentives and monetary contributions. The objective of such mechanisms is to fully avoid the mistakes in public decision making that may arise under a direct vote. In this context, Grüner and Koriyama (2012) study the acceptance of a Vickrey Clarke Groves (VCG) mechanism when the status quo is choice via a referendum. They find that even when all voters already hold their private information, all voters may be better off with the VCG mechanism than with a referendum.[15],[16]

[15] Gailmard and Palfrey (2008) test three such mechanism in an experiment and arrive at a relatively high surplus extraction rates of more than 80 percent for the best mechanism - a voluntary contribution mechanism with proportional rebates. With the underlying distribution of subjects' willingness to accept, a direct democratic vote would perform even better. However, I would expect that the ranking would be different for other distribution of types that would lead to inefficient decisions more frequently in a direct vote.

[16] Related to the closer involvement of citizens in public decisions is the concept of citizen participation in procedural choices. It makes little or no difference for selfish and rational individuals whether they decided on the procedural stage or on a later stage. Someone who dislikes a reform proposal should always support a procedure that makes it more difficult to implement the corresponding proposal. Recent experimental research by Engelmann and Grüner (2012) instead indicates that efficiency concerns do play a particularly strong role on the procedural stage for part of the population. The authors consider a simple binary choice in a setup with random and privately known gains and losses. There are two stages - a procedural choice stage and a voting stage. On the procedural stage agents pick a more or less restrictive majority rule. Selfish individuals should choose their preferred option

Implementing decision procedures that lead to more efficient public spending can also be seen as a compensation for insider workers who obtain lower wages after structural reforms. Whereas Corneo (2006) emphasizes that an increase of the size of the public sector may be used as a compensatory measure, improving the quality of public spending is an option that is particularly attractive in times of excessive government deficits.

5 Improving procedures for international advice

5.1 The role of international institutions

According to the Treaty on the Functioning of the European Union (TFEU) all countries understand their economic policies as "a matter of common concern". In this context, the European Commission regularly prepares country specific policy recommendations. The TFEU does not give the European Commission or the Council a clear mandate to make recommendations regarding national distributive policies. Such a mandate could only be derived from the TFEU if national policies were to contradict fundamental fairness criteria. A more natural role of the country specific recommendations is to identify policy areas with significant scope for efficiency improvements. The Council and the Commission can then leave it to the national governments to decide how to sequence or combine reforms and how to allocate the extra returns from the reforms.[17]

The advantage of this efficiency oriented approach is that it respects the member countries' national sovereignty. However, a problem of the approach is that it gives the government very little external guidance on how to exactly proceed. It would be helpful if experienced external institutions could advise national governments on how to combine various policies in order to

on the voting stage. They should pick a restrictive rule on the rule choice stage if they are against a proposal and a permissive rule if they are in favor. However, our experimental results show that some subjects are willing to pick a biased rule on the procedural stage that yields higher expected welfare than a selfish voting rule. Accordingly, welfare gains seem to be possible if one offers voters the option to pick the voting rule before the vote. The authors also found that the voting rule reacts to the underlying distribution of information. This indicates that it may be useful to explain and highlight the aggregate consequences of reforms.

[17] The current approach of other international organizations such as the IMF or the OECD is similar to the one of the European Union. They list reforms that are likely to increase the size of the pie and to leave it to the national governments to decide whether to implement some subset of the reforms that have been recommended.

create the necessary support for the resulting reform package. In what follows, I will make some concrete suggestions on how international institutions could help national governments to compose balanced reform packages.

5.2 Quantification of reform consequences

There are three good reasons to have international organizations that give nations economic policy recommendations. A first reason is that there are spillovers of economic policies across borders. This requires some international coordination which can be substantially facilitated by a central agency. The second reason is that a central agency such as the European Commission can systematically collect and evaluate comparable data regarding different national policy experiences taking into account national preferences for information collection. The third reason is that an external agency is likely to be more impartial than any national advisor and therefore more credible in its recommendations.

Considering the second and third reasons, there is some scope for an improved design of the structure of country specific recommendations. These proposals could be complemented by a detailed description of the distributional and macroeconomic consequences of the proposed reform measures.[18] The experimental research that I surveyed in section 2.4 indicates that efficiency concerned voters have to be convinced that there are substantial gains involved for at least some citizens if they shall accept a policy change. Therefore, it may be useful to complement reform proposal by a description of the likely economic and distributional consequences.

5.3 Identification of voters' reform priorities

The design and composition of reform programmes both benefit from proper data regarding individuals perceptions of and preferences for reforms. Not only the actual consequences of reforms but also expectations regarding those consequences and individual preferences play a role. Ideally, data on perceptions of and preferences for reforms should be standardized internationally. This would permit to perform comparative research on the determinants of reform preferences and in particular on the interaction of reform making and preference formation. Therefore, the collection of the corresponding data should be located at the European level. Regarding the design of the

[18] The tables in the appendix are an attempt to give an example for such a description.

European Commission's country specific recommendations, a more ambitious approach would be to regularly complement the recommendations by a document that informs national policymakers about reform preferences in their own country.

Having more data on national reform preferences would be highly desirable. Collecting such data is not a simple task. A major problem of surveys which ask individuals about their policy preferences is that the survey questions are not incentive compatible. A respondent who expects his answers to have policy consequences, should selfishly overstate his expected gains or losses. Similarly, when asked about his willingness to accept a compensation payment or a compensatory measure, such a respondent should overstate this value as well. A reform-winner would instead understate his willingness to pay.

Signals in surveys have to be made costly in order to avoid the collection of such biased information. There are three possible ways to achieve this. The first is to give respondents a monetary reward that depends on the answer. This approach is straightforward in theory and difficult to implement in practice. It requires a lot of knowledge regarding individual preferences so that one can correct the bias.

A second approach is to explicitly link the probabilities of various policy outcomes to the set of replies. This is also difficult to implement in practice for legal reasons. Linking policy outcomes to the stated preferences of only a subset of individuals is at odds with the fundamental rule that voters should be treated equally.

A third, more realistic approach is to impose restrictions on the set of feasible answers. One way to do this is to let individuals rank alternatives. A strict ranking forces individuals to pick one best and one worst alternative. The Borda count is one such ranking method. In the context of reform preferences, a modified version of the Borda count can be used to collect and aggregate data on reform preferences. Under this modified mechanism, all respondents (indexed by i) are given a set of n reforms for an evaluation. In a first step, they identify reforms they like and reforms they dislike. In the second step, they have to rank all the reforms they dislike. The ranking shall represent the size of the expected losses from the reform. Similarly, they have to rank the alternatives they like. One way of aggregating the data is to allocate the value $n+1-k_i$ (k_i-n-1) to the k_i-th best (worst) alternative within the set of reforms with a positive (negative) individual evaluation. Adding up the numbers for winners and losers separately yields a value that represents aggregate gains and losses. These values satisfies a few desirable properties under truthtelling. One such property is monotonicity. The value $\sum k_i$ increases monotonously if the preference parameter k_i increases. Another property that is satisfied by this method is a Pareto-criterion: if all losers and all winner prefer measure x_1 to measure x_2 then measure x_2 yields higher aggregate gains and lower aggregate losses. If the aggregate consequences of one benchmark policy are relatively well known, then the aggregate rank numbers can help to assess the aggregate gains and losses. It may be helpful to complement country specific recommendations by data regarding individual preferences for reforms that is collected with similar methods.[19][20]

6 International incentives and national reforms

In the previous section I have discussed various ways to improve international policy advice to national governments. A more interventionist approach is that the European Union incentivises national actors to engage in reforms. There are two possible reasons to do this. The first is that reforms create positive externalities that are not fully internalized by the country that undertakes it. In this case a transfer from the beneficiaries of the reform to the country that undertakes

[19] A ranking method such as the modified Borda count can give us some indication regarding the aggregate gains and losses from specific reforms. A more ambitious approach is to try to elicit the individuals' exact willingness to pay for reforms or their willingness to accept. Again, in this context the problem of incentive compatibility arises. Respondents who expect that the stated losses will influence the size of the actual compensation payments will overstate their losses.

Grüner and Müller (2012) propose a method to recover the willingness to accept for specific reforms when individuals answers are biased. The authors ran a survey among farmers and asked them about their assessment of the 2005 agricultural reform. About half of the respondents stated that they are at least as well off with the compensation payment as before the reform. However, results looked different when the authors asked for the compensation payment that would have been necessary in order to make the farmers as well of as they had been before the 2005 reform. The non response rate to this question is much higher for reform losers than for reform winners. Moreover, reform winners who do give an answer choose a value that is close to the actual compensation they receive, i.e. they state that their information rent is rather small. The authors developed a structural econometric model that permits to deal with both biases. This method is applicable in other policy areas as well.

[20] So far, there is no comprehensive survey that produces comparable data on Europeans' willingness to accept various reforms. Similarly we lack cross country (and in many cases also single country) data on the perceived consequences of reforms. First attempts along these lines are currently made in the German Internet Panel (GIP) which is a project of SFB 884 at the University of Mannheim. I would expect the practice of international policy advice to benefit from the systematic use of such methods.

the reform makes both sides better off. A second possible reason for such transfers could be the benevolence of the entire union regarding its member states. When a welfare enhancing national reform is not undertaken because national actors cannot negotiate efficiently, a benevolent international agency may want to buy the reform from some of the national actors.[21] In what follows I will concentrate on transfers or fines as an instrument to deal with cross country externalities. I disregard the second motive because it is unlikely that transfers out of sheer benevolence will find the required political support amongst Europe's governments.

There are two ways to provide countries with monetary incentives to undertake reforms. The first is to use indirect incentives for reforms such as the EU's sanctions under the stability and growth pact (SGP). The SGP does not specify the policy measures that should be undertaken. It is left to the national government to decide how to avoid a sanction under the SGP. The decisions regarding these sanctions are tied to macroeconomic or financial outcomes and not so much to specific policy measures. However, the six pact gives the Commission some options to react to countries' economic policy choices in a discretionary manner. The second option is to enable the European Commission to reward specific structural reforms. This second approach has been suggested in the Van Rompuy plan for a central fiscal capacity of the European Union.

In this section I will first address ways to improve the general and negative incentives that are already specified in the SGP. I will then turn to possible specific positive incentives for reforms.

6.1 General negative incentives

The six pack and the fiscal compact include several measures that are supposed to incentivize national policymakers to keep fiscal deficits low. The basic idea of such incentive schemes is that market incentives for low deficits are replaced or complemented by regulatory ones. One advantage of regulatory incentives is that market incentives come along with a risk of multiple equilibria and self-fulfilling speculative attacks against nations. But can these regulatory incentives properly incentivize all national actors to undertake reforms? To answer this question, one needs to understand how deficits emerge and how external incentives interact with the underlying mechanisms.

[21] Another motive for reform related transfers is to insure countries against unfavorable reform outcomes. Such an insurance may also be efficiency enhancing because reform-related risk can be shared across countries. However, I would not label these transfers as incentive payments.

A first, very simple explanation for excessive deficits is that deficits emerge when voters do not care about them. According to this explanation, voters reelect governments that spend money on specific projects and ignore the financing side. If one favors this theoretical explanation then the SGP is a good instrument because sanctions may make voters more concerned about fiscal deficits. In this sense a sanction serves as a signal to national voters that may indirectly create incentives for national governments.

The second prominent theoretical explanation for excessive deficits, that I would like to consider is the war of attrition theory of fiscal stabilization (e.g. Alesina and Drazen, 1989). According to this theory, governments cannot reduce their deficit when one of several key interest groups opposes the proposed policy changes. This is why interest groups are involved in a war of attrition which only ends when one group gives in and accepts to pay a particularly large share of the cost of financial stabilization. One elementary version of the war of attrition game has a mixed strategies equilibrium in which it takes time until one interest group eventually gives in. A disturbing feature of such an equilibrium is that the expended future duration of the war of attrition does not depend on when the war started.

When one considers the war of attrition explanation of a delayed fiscal stabilization, it becomes clear that an external fine may produce a counterproductive effect. This is the case when the cost of a fine adds to the burden of the necessary fiscal consolidation. In an ongoing war of attrition among powerful interest groups the most likely outcome is that the government raises additional debt in order to finance a sanction payment imposed by the European Union. This sum would add to the overall stabilization bill. In this case, incentives to refuse reform proposals which shift the burden to one interest group would increase.

The European Union's incentives currently do not directly affect the interest groups which block specific reforms. Instead they affect the budget constraint and the popularity of the national government. National governments may not share a specific interest group's position. Such interest groups may refuse to cooperate in fiscal stabilization if they expect the resulting fine to make the incumbent government less popular. Therefore, if one considers the war of attrition explanation of excessive debt, an alternative to fines that have to be paid by the state are fines which have to be paid by the actual decision makers, i.e. by the members of the national interest groups which can block reforms. Direct fines on interest group organizations or their members are legally problematic. One way to circumvent this problem would be to tie a national policy instrument with very broad effects, such as the value added tax to the non-compliance with EU fiscal rules. This would indirectly affect national interest groups and so incentivize them to find an earlier agreement.

A third prominent explanation for excessive deficits is that the ruling party has an incentive to overspend on its preferred public good when there are frequent changes of government (Tabellini and Alesina, 1990). The motive for this policy is that the government can currently determine its preferred mix of public goods. By spending more it can also tie the hands of its successor. Moreover, if public goods are durable, an incumbent government may be able to determine the future mix of public goods as well. When one considers this third explanation for excessive deficits, a fine may have two countervailing effects. The first effect is that the fine costs the government some popularity. This reduces the probability of reelection and so incentivises the government properly. The second, countervailing effect is that, once it is know that the fine has to be paid, the reduced probability of reelection increases the incentives for current excessive spending. Taking this second effect into account, there is some risk of a vicious circle in which (i) a country runs an excessive deficit, (ii) a deficit procedure is initiated by the European Commission, (iii) facing a lower popularity, the government chooses not to cut the expenditure in its favorite areas and so fails to produce a balanced and encompassing consolidation programme, and (iv) the government is not reelected and the new government faces the same or even bigger structural problems.

In the light of the war of attrition argument it seems to be a superior alternative to let the European Union directly pick a national policy instrument in order to recover the fine. Such a mechanism would not perform worse than the current SGP in the context of the strategic deficit theory. One such option would be to grant the European Commission the right to charge a supplement to the national VAT rate of up to 1 percentage point. An increase of the VAT rate basically affects all voters. This provides interest groups with better incentives to accept an agreement on how to allocate the burden of stabilization.[22]

[22] One of the proposals included in the Van Rumpoy paper is that the EU uses automatic transfers between countries in order to enable them to flexibly react to nation specific shocks. This may at first glace seem appropriate because governments working under tighter fiscal constraints may be less able to react to a new economic situation. However, the six-pack still permits a national government to debt-finance some countercyclical spending – but only if the corresponding country has reached a low debt/GDP ratio and if it starts with a low structural deficit.

Along the transition path to these ideal conditions (hoping that we are on such a transition path) the Commission and the Council can make use of the exemption clauses and so leave governments some room even in case

6.2 Specific positive incentives

The renewed stability and growth pact so far only includes the possibility of negative financial incentives for reforms. Positive monetary incentives are an alternative to negative ones. For rational actors (governments and voters), the sign of such incentive payments (fine vs. reward) should not be particularly important. However, practically, the framing of incentives may be an important psychological and legal issue. One reason for this is that a fine is quite visible and can be easily exploited by the political opposition as a signal that the current government has failed. This is why even a marginal fine may be of some political importance. On the other hand, a reward for a specific policy measure may make the impression that policies are implemented in the interests of outsiders rather than citizens of a country. There are also important legal differences between fines and rewards. From a legal perspective a fine may be viewed as a much more direct external intervention which also requires a stronger enforcement capacity. Moreover, a fine that is tied to a specific policy measure would raise a serious problem of democratic legitimacy. This problem is smaller in case of a reward because the reward may or may not be accepted by the respective

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of considerable country-specific shocks. Moreover, a government may always choose to ignore the Commission's position and pay the corresponding fine if it disagrees with the Commission on the applicability of the exemption clauses. Hence, if we only consider the six-pack, automatic fiscal transfers do not seem to be necessary. This may be different if some countries choose national constitutional restrictions that go beyond the minimum requirements of the TSCG. In this case, international transfers can replace national anti-cyclical responses to country-specific shocks. One option is to only offer an international insurance to countries that make very limited use of exemption clauses in their national constitutions.

One could also consider centrally organized spending as a reaction to symmetric euro-area wide shocks. Since national deficit spending affects output in other European countries, there may in principle be a positive externality which national governments do not fully internalize. In a non-cooperative equilibrium this would yield a too small fiscal response to a symmetric shock. Hence, from an empirical perspective, a coordinated or centralized fiscal response may be useful if the multiplier of coordinated euro-area deficit spending exceeds the multiplier of national deficit spending. However, the ECB is another institution that can handle a euro-area wide shock. It internalizes the externalities that would arise under national monetary policy making and it can effectively substitute deficit spending programmes.

Automatic fiscal transfers create political moral hazard. They may reduce governments' incentives to undertake costly reforms. Moreover, the costs for non-cooperation of national interest groups are reduced. This is why any equilibrium of a war of attrition among interest groups should result in less cooperation if there is an international fiscal transfer scheme in place. Transfers that are intended to be temporary may therefore turn into permanent ones. Overall, such transfers seem to yield little extra benefits but they come along with significant risks.

country. Therefore, rewards for specific policies may be considered as a useful complement to fines for a country's failure to stick to the agreed upon targets for deficits.

Nevertheless, the institutionalization of rewards from the center for specific reforms also raises the issue of the democratic legitimacy. Most of the European Commission's country specific recommendations have distributional consequences. Even in the absence of transfers this can create a problem of democratic legitimacy. Linking fiscal transfers to selected country specific recommendations may aggravate this problem. One way to deal with this problem would be to involve the national government as much and as early as possible in the structuring of any such incentive contract. In such a setup, the European Commission would negotiate a country-specific transfer scheme with the corresponding government and the national government could make the first proposal in these negotiations. The European Council or the European Parliament could then approve the outcome of these negotiations.

Another serious problem that arises when one compensates countries for costly reforms is that the respective national government could ask for a compensation for a reform that it would undertake anyway because the actual cost of the reform for the country is relatively low. This kind of problem can only arise when the cost of the reform is private information of the national government. It is in deed reasonable to assume that national governments are better informed about the monetary transfer that is necessary to compensate citizens of a country for a particular reform. The following sections make suggestions how one can deal with the problem of overstated losses. It draws on the literature on Bayesian games and mechanism design.

6.2.1 A simple theoretical model

Consider a single country named i and assume for simplicity that this country has one single reform option. The country's decision variable x assumes a value of 1 if the reform is undertaken and it is zero otherwise. I assume that the reform may possibly - but not certainly - increase European welfare. The reform is costly for the country which undertakes it and it creates a benefit for the rest of Europe. There may be cases where a reform that is accompanied by an appropriate transfer is in the interest of both sides - the country that undertakes the reform and the rest of the Union. Both the cost c_i and the benefit b_i are randomly and independently drawn from some given distribution and both distributions are common knowledge.

For the purpose of a simple numerical illustration I will assume a uniform distribution on the unit interval for both random variables. The cost c_i is private information of the national government whereas the benefit is privately known by the European Commission. The cost c_i need not be a welfare loss that realizes in the country if the reform is undertaken. Instead it may represent the required compensation that enables the government to buy the reform from its voters. However, in most of what follows I will assume that the cost c_i is actually a welfare loss. In this case, an ex post efficient social choice requires that the reform is undertaken if $c_i < b_i$ and that it is not undertaken if $c_i > b_i$.[23] I also assume that, according to national legislation, the national government is entitled to communicate an ask price for the reform to the Commission.

Suppose that the national government maximizes expected national welfare $x \cdot (-c_i + t_i)$ where t_i denotes a possible compensatory transfer from the Commission to the country whereas the Commission maximizes Europe's welfare $x \cdot (b_i - c_i)$. The maximum expected value of European expected welfare in this example is 1/6, and the expected costs and benefits of an ex post efficient decision are 1/3 and 1/6 respectively.

Is there a mechanism that maximizes Europe's welfare that also respects national sovereignty? Sovereignty requires that a country can not be forced to participate in some international incentive mechanism. The voting population, the parliament, or the government may not want to participate in an incentive scheme. At some stage the relevant authority has to accept an international incentive mechanism. In a setup with private information, one has to distinguish three possible stages at which the consent of a national authority may be required. The first concept requires the country's consent only at the stage where the actors do not yet posses any private information about the cost c_i. This corresponds to a contractual stage before the reform option realizes. The corresponding constraint is called the ex ante participation constraint. It is weaker then the interim participation constraint, where the informed party already holds private information at the stage where he can opt out of the mechanism. The strongest concept is the ex post participation constraint that requires the informed party's consent at the stage where the mechanism has been played (ex post participation constraint).

Taking into account that the proposal of a possible reform should be made by the country concerned, it is clear that the interim participation constraint is the relevant one as far as the reforming country is concerned. This is different in the case of the decision of countries to contribute to the Commission's budget for such incentive payments. An agreement on the size of

[23] If c_i is not a welfare loss then ex post efficiency requires that the reform should always be undertaken.

this budget and on the various countries' contribution to the budget can in principle be achieved before the relevant private information has realized.

6.2.2 A direct revelation mechanism for a single country

Consider first the ex ante participation constraint. According to the revelation principle, we can restrict the analysis to direct revelation mechanisms. A direct revelation mechanism that implements an ex post efficient social choice yields an expected payoff for the country of $-(1-\hat{c}_i)\,c_i + t(\hat{c}_i)$ where $\hat{c}_i$ is the announced cost and $(1-\hat{c}_i)$ is the conditional probability that it is efficient to implement the reform. Incentive compatibility requires a transfer of the form $t(\hat{c}_i) = t(0) - \hat{c}_i^2/2$ from the Commission to the country where $t(0)$ denotes the transfer that is paid if the country announces a cost of zero. Ignoring $t(0)$, the overall expected payoff of the national government is $E\left[-(1-c_i)\,c_i - c_i^2/2\right] = -1/3$ and the Commission's expected revenue is $1/6$. The ex ante participation constraint is satisfied if $t(0) \geq 1/3$. This creates a minimum net expected cost of the transfer for the commission of $1/6$. The overall expected benefit of the rest of the Union is $Eb_i^2 = 1/3$. Therefore, efficient contracting at the ex ante stage is possible.[24]

Consider next the case where the mechanism has to satisfy the country's interim participation constraint. When $t(0) = 0$, the worst-off type $(c_i = 1)$ has a gross payoff of $-1/2$. Therefore the maximum transfer has to be at least $t(0) = 1/2$ in order to make all types participate. The overall transfer is $t(\hat{c}_i) = 1/2 - \hat{c}_i^2/2$ and the expected transfer is $1/3$. Hence, ex post efficiency and interim participation can be reconciled - provided that the Commission has the appropriate endowment to finance the fixed transfer component. However, one has to take into account that raising the funds that the Commission uses to subsidize reforms will also be subject to participation constraints. When only the ex-ante participation constraint has to hold on the revenue side then the overall expected benefit is just sufficient to finance the expected transfer.

6.2.3 A fixed price mechanism

A simple alternative to the previous direct revelation mechanism is the following two-stage mechanism. The Commission announces an offer $\bar{t}_i$ in stage 1. In stage 2 the respective country either accepts the transfer $\bar{t}_i$ and agrees to undertake the reform or in rejects the transfer and does not

[24] This result also holds for more general type spaces.

undertake the reform. If the Commission fixes $\bar{t}_i = b_i$ then the mechanism implements the ex post efficient outcome. Moreover, the mechanism satisfies the interim participation constraint because in equilibrium the transfer always exceeds the cost c_i.

In the case of a uniform distribution this mechanism creates a positive expected net surplus for the country of size $Eb_i^2/2 = 1/6$. Therefore, the Commission could in principle collect the corresponding sum at the ex ante stage from a liquid state. This mechanism has the advantage that it does not require as much information about the distribution of types as the direct revelation mechanism. However, this information is required at the stage where the ex ante transfer is determined.

Interim participation in this mechanism is only satisfied if the country does not pay any fixed amount to the Commission. The corresponding mechanism has an expected cost of $\int_0^1 b_i^2 db_i = \frac{1}{3}$. Again, this amounts to the expected benefit and efficient contracting is possible when only the ex ante participation constraint has to hold for the contributing countries.

6.2.4 Two sided private information

The analysis so far assumes (i) that the European Commission can raise the funds before the costs and benefits are known and (ii) that it is perfectly informed about the benefits that result from the reform. The first assumption is justified if the Commission already has a stable revenue source that it can make use of to finance such transfers. Therefore, interim participation is not required if the member countries agree on the mechanism before private information about specific reforms has realized. However, in the current pressing cases, interim participation would be a more natural requirement. The second assumption is quite heroic. The problem of incentivizing governments to undertake costly reforms becomes far more difficult if the Commission is uncertain about the international welfare gains that arise due to a reform and if it has to raise money on a case by case basis.

In the most simple two country case the problem turns into one of two sided private information. It is known from Myerson and Satterthwaite (1983) that there exists no balanced budget mechanism that satisfies both partys' interim participation constraints for all types and that ex post efficiently decides on the implementation of the reform. If interim participation is required then this means that either some third party would have to subsidize the mechanism or the mechanism does not achieve an efficient decision on the reform. One mechanism that does not require outside funding is a two sided auction in which both countries announce costs and benefits respectively and the reform is undertaken if the stated benefit is larger than the cost. The transfer in this case is a convex combination of both values. However, the mechanism does not always implement welfare enhancing reforms, i.e. it does not implement an ex post efficient social choice.

Another problem is that external benefits of a reform in one country may be dispersed across several other countries. In such cases, compensating the reforming country is a public good from the perspective of the other countries. It is known from Güth and Hellwig (1987) that there is no ex post efficient balanced budget mechanism in such a case, even if the cost is perfectly known. Moreover, efficiency losses may increase with the number of countries (Mailath and Postlewaite, 1990).

6.2.5 Multiple reform options in multiple countries: auctions

It is difficult to reconcile all interested parties' interim participation of and ex post efficiency when there are multiple beneficiaries of a reform. Having multiple reform options in multiple countries may instead be quite useful if one wants to reduce the cost of a support programme for a single reform. When there are multiple countries each of which has such a reform option, competitive mechanisms can be used to reduce the receiver countries' information rents.

A simple example for a mechanism that deals with several reform options is described in the following example. Consider a case where the Commission intends to financially support exactly one reform in one single country. Assume that there are two countries that differ in their privately known cost of their reform. Moreover, assume for simplicity that both reforms yield an identical known benefit $\bar{b} \in [0, 1]$ for the rest of the countries in the European Union. Again, I assume that any mechanism has to satisfy the interim participation constraints.

In an environment with only one country, the European Commission would have to pay an amount $\bar{b}$ with probability $\bar{b}$ in order to achieve an ex post efficient outcome. The expected cost of this mechanism is $\bar{b}^2 \leq \bar{b}$.

Consider instead a competitive environment in which two countries each have one reform option. The mechanism shall implement the lowest cost reform if the lowest cost is smaller than $\bar{b}$. A simple way to achieve this is to use a second price auction. This mechanism lets both countries simultaneously and independently announce their ask price $\hat{c}_i$. The mechanism then selects the appropriate country for the implementation of the reform. The country not selected pays a transfer to the Commission which is equal to the stated cost of the low cost country. This transfer can be viewed as the price for not having to undertake the reform. In analogy to a second price auction, it is a dominant strategy to announce the true cost value. Overstating the cost may lead to a loss if the second highest ask price is below the own price and above the true cost. Understating the cost may trigger a costly reform which then yields a loss for the country.

Under this mechanism, the expected transfer (conditional on paying a transfer) of the worst off type ($c_i = 1$) to the Commission is $\bar{b}/2$. Therefore, the mechanism requires a fixed transfer of $t(0) = \bar{b}^2/2$ to each country if it shall fulfill their interim participation constraints. The overall expected transfer to country i is

$$\frac{\bar{b}^2}{2} - \int_{\bar{b}}^{1} \int_{0}^{\bar{b}} x dx dc - \int_{0}^{\bar{b}} \int_{0}^{c} x dx dc = \frac{1}{3}\bar{b}^3.$$

The net expected cost of this mechanism is $\frac{2}{3}\bar{b}^3 < \bar{b}^2$. Therefore, efficiently implementing a single reform is less costly for the Commission than in the non-competitive case. However, the overall result is ex post inefficient because it may be the case that both reforms should be implemented but only the one that creates a higher surplus gets implemented. An ex post efficient mechanism would require a more complex transfer structure. Such an ex post efficient mechanism can also be designed for more complex (and realistic) environments with more than two countries and with known benefits b_i that may differ across countries. Any such mechanism asks the respective countries for an ask price $\hat{c}_i$.

Another practically relevant case is the one where the Commission has a given - say biannual - budget to finance incentive payments. In this case an externality arises across reform projects because financing one costly reform may imply that there is not enough money left to finance another large reform. In this case the mechanism should in principle give priority to the reforms that create a high surplus $b_i - c_i$. Exceptions may be made when it is better to use reforms that require a smaller transfer so that the budget is efficiently used.

There exists little theoretical research on simple or optimal mechanisms that could be applied directly in this context. One plausible option to address this design problem is that the European Commission collects ask prices from countries "offering" reforms. These prices should not be announced to the demand side of the "market for reforms". In a second step, governments which are on the demand side submit approval votes for various reforms. In principle, a government could cast more than one vote for a specific reform. One way of providing appropriate incentives would be to limit the number of votes that each government can cast. Both the votes and the values of the ask price could be used in a pre-specified procedure to allocate the funds that are available to the Commission.

6.2.6 Other practical design issues

Several other practical design issues regarding a formal negotiation mechanism for reform-related incentive payments need to be addresses. With regard to subsidiarity and national sovereignty, a mechanism should grant the participating national governments the right to make the first proposal regarding the set of possible reforms that could be part of a contractual arrangement. This is not yet a guarantee for voter support but it is better than leaving the first proposal to the European Commission. The right to make the first proposal may in principle also include the option not to submit a proposal at all.

In a competitive environment in which several countries make proposals, there should be one fixed date for the submission of the corresponding proposals. The submission should include an exact description of the intended legislative process for the implementation of the reform and of the details of the new laws that shall be implemented.

There should be enough time between two consecutive submission dates for the Commission to evaluate the proposals. In a next step, the Commission could allocate valuations (the b_i) to the various reforms. The third step is to let the participating governments simultaneously specify the amount required to finance the reform.

In principle, national governments could offer menus of different reforms in the first stage. However, this creates more delay on the evaluation stage. This is why it may be useful to leave it to the national governments to select a single proposal with a single ask price. Note that this does not exclude that the single proposal is composed of various components. Some of these components could in principle be used to internally compensate losers of single reforms.

Two other important issues are the verifiability of the implementation of the reform and the payment of the transfer. The transfer should be linked to the continued implementation of the programme. Therefore, ideally, it should be paid out over a period of several years. On the other hand, a too long period may result in inefficiently inflexible policies in the future. Taking this into account, a payment that is made over a period of 5-10 years seems reasonable. Table 1 summarizes and compares the different mechanisms that have been discussed in this section.

Table 1 Mechanisms

Name	Basic structure	Efficiency	Interim participation
Revelation mechanism	Government announces cost and pays transfer increasing in the announcement. Commission chooses afterwards.	Ex post efficient	Requires fixed central budget.
Fixed price announcement	Commission makes bid for reform. Government accepts or rejects.	Ex post efficient	Requires fixed central budget.
Two sided auction	Beneficiaries make bids for reform. Government announces cost. Payment is convex combination of bid and ask price.	not ex post efficient	Does not require fixed budget.
Second price auction	Several governments announce costs. Cheapest reform is implemented and others pay a transfer.	not ex post efficient	Requires smaller budget than single reform.
VCG mechanism for a given budget	Several governments announce costs. Reforms with highest surplus implemented. Other countries pay a transfer	Ex post efficient	Requires fixed central budget.

6.3 The European Commission as a mediator

The mechanisms that were discussed in the previous section reward nations for reforms by means of transfers to the national government. The role of the European Commission in this context is to broker a deal between the reforming country and other countries that may benefit from the reform. This requires that the national government is still in a strong enough position to enforce a new policy or to negotiate a national reform deal. In cases where the government is weak or in dissolution other options are needed. One option that is worth exploring is that the European Commission acts as a mediator between different national interest groups in the reforming country. In respect of national sovereignty, the use of this option would have to be limited to situations in which national governments themselves ask the Commission to assist in finding a solution to the country's economic problems.[25] Mediation can be seen as an alternative to external incentives such as fines or rewards for reforms. However, incentives provided by the European Union can also be complemented by a mediatory engagement.

According to Terris and Moav (2005) "35 percent of all militarized conflicts since World War II entailed some form of mediation". The political science literature on international mediation points out that in specific situations external mediation may play an efficiency enhancing role. Similarly, research in the field of law and economics has pointed out that mediation may create more efficient outcomes. Given the good experiences made in other policy areas, it should be considered seriously as an option for the dissolution of internal economic conflicts.

One option is that the mediator uses a formal mechanism that resembles a two-sided auction. In a two-sided auction the price is a convex combination (e.g. the mean) of a bid and ask price. Bidding takes place simultaneously and trade only occurs if the bid price exceeds the ask price. The risk of missing a trading opportunity limits misreporting. Similar mechanisms could in principle also be used by national governments to find out whether a deal among several interest groups is feasible. It is important to note that such mechanisms only work, if the no agreement option is sufficiently unattractive. This would be the case if no agreement leads to an automatic increment of taxes. Another option is that the mediator rewards an agreement. In the case where the EU acts as a mediator, such a reward would require that the EU has a fund for this activity.

In principle, a national government can also act as a mediator in an intra-national economic

[25] In principle this option is also available to a strong enough national government.

conflict. However, there are good reasons why an external mediator may be able to achieve a better result. The first is that the external mediator is more likely to be impartial. This is why communication should flow more freely in the case of international mediation (Ayres and Gerarda Brown, 1994). A second reason is that some national interest groups may try to sabotage an agreement, hoping that they can so get rid of the current government. A third reason is that an outside mediator may bring in a fresh view on the issue.

7 Conclusion

Further structural policy reforms would be most helpful to make Europe's government finances sustainable. Failure to undertake such reforms may either result in further risk taking by the ESM or the European Central Bank or in a return of market uncertainty and rising risk premia. Both developments could ultimately risk to lead to the dissolution of the currency union. Finding a balanced design of the next reform steps is of the essence. One key problem is to combine growth enhancing reforms with measures that redistribute some of the resulting rents for owners of capital to insider employees. The present paper has made a number of proposals on how one could proceed.

1. The structural reforms undertaken so far in Italy and Spain have created a significant burden for insider employees - relative to a scenario with no need for an adjustment. On the other hand, some of these reforms are likely to increase profits in the long run. The same holds for some of the reforms which are still underway. Efficiency-enhancing reforms that are costly for owners of capital or redistributive tax and transfer schemes could be compensatory measures.

2. Recent research indicates that the European Union has already made good experiences with a transfer scheme in the context of the 2005 agricultural reform. This reform has replaced distortionary quantity subsidies by payments that are linked to the size of the farm land. Such transfer schemes have to be given a long term credibility in order to make them politically acceptable. Failure to stick to a transfer scheme in one policy field reduces the credibility of future transfers in other policy fields.

3. The German labor market and pension reforms have been successful if one considers a higher

employment rate as a main objective. The reforms have been followed by an increase of labor supply, stagnating real wages and reduced unemployment rates. However, there has been no compensation for the losses of insider employees. The political success of the reform is mixed. The government that undertook the reform did not get re-elected. The reform was followed by the introduction of minimum wages which risk to undermine it's success. The increase of the retirement age is still politically debated.

4. An increase of the effective national tax rates on the gross return from capital that complements labor market and social security reforms need not reduce the net return on capital. This is why higher effective capital income taxes may be suited to balance the effects of such reforms.

5. Some reforms have highly uncertain macroeconomic and distributional outcomes. Uncertainty about wage and labor demand effects of reforms makes it difficult to calculate the necessary compensatory measures beforehand. Therefore, it may be impossible to find a compensation package in advance which is acceptable for both sides. In such a situation, governments can promise to adjust future policies and target one or several distributional indicators in order to ex post create the appropriate compensation.

6. It may be useful if all stakeholders who benefit from a reform contribute to the compensation of reform losers. Rents for owners of capital that arise from labor market liberalization arise in the entire European Union. National source taxation of capital income can address the problem to some extend. However, downward wage pressure in one economy also creates downward wage pressure in other economies. Therefore, there may be benefits from fiscal policy coordination when one wants to compensate insider employees for reforms.

7. Several policies can be undertaken on the union level to compensate insiders for reform losses. One such option is the closure of Europe's tax loopholes. This would help to make owners of mobile capital contribute to the consolidation efforts in many countries.

8. A more centralized European competition policy can help to overcome national regulatory capture and so contribute to an increase of insider employees' net incomes. In this context regional state aid rules could be reconsidered.

9. There is also a considerable scope for a better use of regional public funds. Appropriate constitutional reforms and in particular steps towards more direct democratic participation can help to make public spending decisions more efficient. The objective of such measures would be to implement more public projects that are actually needed and to reduce the waste of resources on projects that are not needed. A constitutional reform that makes reduced spending more efficient can be combined with lower income taxes for low income households. These households are likely to refuse spending cuts when public and private consumption are substitutes.

10. External financial incentives for low fiscal deficits may in principle be useful. However, both the war of attrition theory and the theory of strategic deficits point out that fines for excessive deficits or debt levels may be counterproductive. In a war of attrition amongst interest groups, a fine raises the difference of payoffs of winner and loser of the conflict. In the case of a strategic deficit, a fine may increase the incentives to spend money in the present legislative period if the government's probability of reelection is reduced. As an alternative to a fine, the European union could be given the right to directly change a national policy instrument in order to collect the fine. One such option would be to grant the European Commission the right to charge a supplement to the national VAT rate of up to 1 percentage point. This would yield better incentives for interest groups to cooperate on solutions.

11. A policy dependent VAT supplement could be used to finance subsidies or incentive payments for reforms. Thus, the option that the European Union may impose a supplement to the VAT rate creates a revenue source for a EU fiscal capacity.

12. The money raised for a common fiscal capacity could also be used to insure countries against an adverse outcome of a policy reform that has uncertain consequences.

13. The European Commission could take the lead in the collection of data regarding actual and perceived consequences of reforms and preferences for reforms. This data could complement the country specific recommendations.

14. The Commission can act as an international market maker that efficiently deals with cross country externalities arising from national policy reforms. The paper proposes a set of

simple mechanism that have low information requirements. The paper also makes concrete proposals for the sequencing of offers and transactions.

15. The European Commission can play an active role in mediating distributional conflicts within member states. However, it should only become active if asked by the national government and it should terminate its engagement as soon as one of the conflicting parties is not content with the mediation.

Appendix Part 1

Fiscal policy reform in Italy

According to the report the European Commission (2012, Box 2), the main budgetary measures adopted in Italy since 2010 are the ones that are listed below. The "budgetary impact in the table is the incremental annual impact reported in the programme, i.e. by the national authorities. A positive sign implies that revenue/ expenditure increases as a consequence of this measure. Permanent measures are not repeated in successive years, unless the budgetary impact changes significantly. The no-policy-change baseline excludes any wage contract renewals until 2015."

The columns labor, capital and administration evaluate the distributional consequences of the corresponding measures. A "+" indicates that the respective group gains, a "-" that it loses and a "+-" an ambiguous effect. The value "0" indicates that there is no clear effect.

	Policy measure 2011	**Budgetary impact (% of GDP)**	**Net labor income**	**Net capital income**
1.	Measures to improve tax compliance	0.1	unclear	unclear
	Increase in standard VAT rate	0.3	-	-
	Lower transfers to sub-national governments	-0.4	unclear	unclear
	Freeze of public sector wages and restrictions on recruitment	-0.1	-	0
	Cuts to non-obligatory ministerial spending	-0.1	0	0

	Policy measures 2012	**Budgetary impact**	**Net labor income**	**Net capital income**
	Re-introduction of owner-occupied dwelling taxation and rise in tax rates on other property	0.7	0	-
	Excise duties	0.5	0	0
	Stamp duties on financial assets	0.3	0	-
	VAT rates	0.2	-	-
	Harmonization of personal withholding tax rate on interests and dividends	0.1	0	-

	Regional surtax on personal incomes	0.1	-	-
	Tax compliance improvement and recovery of unpaid taxes	0.5	-	-
	ACE and deductibility of labour costs	-0.15	0	-
	Lower transfers to sub-national governments	-0.2	0	0
	Cuts to non-obligatory ministerial spending	-0.4	0	0
	Partial de-indexation of pensions	-0.1	-	0
	Other current expenditure (local authorities, military missions abroad	0.2	0	0

	Policy measures 2013	**Budgetary impact**	**Net labor income**	**Net capital income**
	VAT rates	0.6	-	-
	Stamp duties on financial assets	0.2	0	-
	Solidarity tax on high public wages	0.1	-	0
	Stamp duties on financial assets	0.1	0	-
	Higher social contributions on self-employed	0.1	0	-
	Tax compliance improvement and recovery of unpaid taxes	0.2	?	?
	Deductibility of labour costs	-0.2	0	-
	ACE and deductibility of labour costs	-0.15		
	Savings from higher retirement age, de-indexation of pensions and postponed endcareer payments	-0.4	-	0
	Smaller cuts to non-obligatory ministerial spending	0.2	0	0

	Policy measures 2014	Budgetary impact	Net labor income	Net capital income
	ACE and deductibility of labor costs	-0.1	0	-
	Savings from higher retirement age, de-indexation of pensions	-0.1	-	0

Appendix Part 2

Spain's structural reforms 2010-2012

The 2011 IMF report on Spain lists main policy reforms that have been announced in this country since May 2010. Part 2 of the appendix quotes the description of the reform from the report (left column) and then describes the most likely distributional consequences (right column). I mostly concentrate on insider employees in the description of distributional consequences because insiders are politically particularly important.

1.	New law on savings banks: (i) giving the savings banks 4 organizational options, including to spin off banking operations to a commercial bank and to become a foundation, (ii) improvements in corporate governance requirements.	This reform does not have a direct effect on the well-being of insider employees in general. There may be some minor positive indirect effects through enhanced financial stability. Moreover, rents of employees of savings banks may be reduced considerably. Owners of non-financial firms are not directly affected.
2.	Labor market reform: (i) reduction of severance pay (ii) financing of a portion of severance payments via a fund paid for by firms (iii) easing of the criteria for fair dismissals (iv) broadening the conditions under which firms can opt out of collective agreements.	The first, third and fourth measure clearly benefit owners of capital and tend to reduce wages. Measures (i) and (iii) lead to a reduction of firing costs which, according to the insider-outsider theory results in less bargaining power for insiders and in a reduction of their wages. Measure (iv) grants firms more flexibility to adjust wages. Wage setting in a more centralized setup should not take into account workers in marginal firms because they do not have a median position regarding the real wage objective. Therefore, flexibility is not in the interest of those insiders who are the last ones to be dismissed if a firm faces adverse conditions. The consequences on employees should be highest in sectors of the economy which have relatively high unit labor costs compared to other Eurozone countries.
3.	Comprehensive and transparent stress test as part of the EU-wide process.	This reform has no direct consequences for insider employees. However, it may improve overall financial stability. To this extent it may complement a pension reform which increases the share of the privately funded pension system (see also below).
4.	Reform of provisioning rules: (i) tightened allowances for repossessed real estate, (ii) unified and accelerated provisioning calendars, (iii) valuation	This reform has no direct consequences for insider employees.

	haircuts for collateral (accounted for as mitigating factor).	
5.	Pension reform: (i) increase in statutory retirement age from 65 to 67, (ii) gradual increase from 35 to 38.5 years of contribution for full pension rights, (iii) gradual increase in reference period from 15 to 25 years.	This reform increases labor supply of older workers in some sectors and it may lead to a reduction of the pensions that are effectively paid. The first effect will most likely result in reduced wages in sectors in which there is an elastic demand for older workers. In other sectors of the economy with rather unelastic labor demand for older workers – such as construction – the reform merely corresponds to a reduction of retirement benefits. The reform therefore benefits owners of capital and tends to reduce wages and pensions.
6.	Law to further strengthen the financial sector: (i) increase of core capital to 8 percent and to 10 percent for institutions reliant on wholesale funding and with limited private shareholding, (ii) individual recapitalization plans requested and approved by Bank of Spain, (iii) extended support of the FROB through the purchase of common equity.	This reform has no direct consequences for most insider employees with the exception of insiders working in the financial industry. However, it may improve overall financial stability. To this extent it may complement a pension reform which increases the share of the privately funded pension system
7.	Sustainable Economy Law: (i) improvement in the process of issuance of new regulations, (ii) simplification of business registration, (iii) strengthening of the public procurement process, (iv) greater independence and powers of network industry regulators, (v) enhanced linkages between vocational training, businesses and the general education system, (vi) incentives for the housing rental market.	Measure (i) is difficult to evaluate without knowledge of the new regulations. Measure (ii) benefits newcomers on markets, measure (iii) reduces rents of some producers and their employees, measure (iv) redistributes from the owners of the network industries and their employees to consumers. Measure (v) benefits both capital owners and young workers, it may reduce the welfare of older workers.
8.	Improved dissemination and transparency of regional budget execution.	This measure should not directly affect the well being of workers or capital-owners.
9.	Enhanced bank-by-bank disclosure of exposure to troubled assets.	This reform has no direct consequences for insider employees. It improves financial stability. To this extent it complements a pension reform.
10.	Reform of active labor market policies: (i) reform of the public employment agencies, (ii) greater follow up of the unemployed and expanded training, (iii)	All four measures aim at increasing the equilibrium employment level. This clearly redistributes from employed labor to the unemployed and to owners of capital.

	multi annual plans with quantitative targets on employment, (iv) lowering of social contributions for the part time employment of the young and the long term unemployed.	The consequences on employees should be larger in sectors of the economy which have relatively high unit labor costs compared to other Eurozone countries.
11.	Removal of tax incentives for housing investment (2011 budget).	
12.	Reform of the bankruptcy law: (i) introduction of alternatives to bankruptcy (such as refinancing agreements with preferred creditor status) and reduced reliance on judicial procedures, (ii) simplification of bankruptcy procedures in certain cases, (iii) increased powers for bankruptcy administrators, (iv) strengthened powers of judges on labour issues.	
13.	Privatization of the Lottery and the Airports authority (AENA) and increase in excise taxes.	
14.	Reform of collective bargaining: (i) increased prevalence of firm-level agreements, especially over provincial ones, (ii) reduction of the possibility of indefinite extension of previous agreements when social partners cannot agree on a new agreement, (iii) easing of opt-outs of collective agreements, (iv) options for firms to have greater internal flexibility.	Wage setting in a more centralized setup should not take into account workers in marginal firms because they do not have a median position regarding the real wage objective. Therefore, flexibility is not in the interest of those insiders who are the last ones to be dismissed if a firm faces adverse conditions.
15.	Front-loaded consolidation, including 5 percent public wage cut, 10% hiring replacement rate, 2 percentage point increase in VAT rate effective July 1 (per 2010 budget).	The 5 percent public wage cut directly affects those employees who are currently employed in the public sector. Moreover, in the long run it creates some downward pressure on wages in other sectors of the economy that compete on the demand side of the labor market with the public sector.

Appendix Part 3

Distributional effects of new reform proposals by EU commission: Italy

Note: Part 3 of the Appendix summarizes and evaluates the 2012 EU country specific recommendations for Italy. The quote from the country specific recommendation can be found in the left column and the evaluation follows in the right column.

1.	Implement the budgetary strategy as planned, and ensure that the excessive deficit is corrected in 2012. Ensure the planned structural primary surpluses so as to put the debt- to-GDP ratio on a declining path by 2013. Ensure adequate progress towards the MTO, while meeting the expenditure benchmark and making sufficient progress towards compliance with the debt reduction benchmark.	
2.	Ensure that the specification in the implementing legislation of the key features of the balanced budget rule set out in the Constitution, including appropriate coordination across levels of government, is consistent with the EU framework. Pursue a durable improvement of the efficiency and quality of public expenditure through the planned spending review and the implementation of the 2011 Cohesion Action Plan leading to improving the absorption and management of EU funds, in particular in the South of Italy.	The sectoral and individual consequences of this reform are highly uncertain because this is just a reform of the set of rules that govern public spending decisions.
3.	Take further action to address youth unemployment, including by improving the labour-market relevance of education and facilitating transition to work, also through incentives for business start-ups and for hiring employees. Enforce nation-wide recognition of skills and qualifications to promote labour mobility. Take measures to reduce tertiary education dropout rates and fight early school leaving.	This labor market reform may benefit capital owners and and it may reduce some regional wages. It benefits mobile unemployed workers.
4.	Adopt the labour market reform as a priority to tackle the segmentation of	

	the labour market and establish an integrated unemployment benefit scheme.	
5.	Take further action to incentivise labour market participation of women, in particular through the provision of childcare and elderly care.	The increase of labor supply benefits owners of capital and tends to reduce wages.
6.	Monitor and if needed reinforce the implementation of the new wage setting framework in order to contribute to the alignment of wage growth and productivity at sector and company level.	The distributional effect of this reform is unclear because it may differ across sectors and firms.
7.	Pursue the fight against tax evasion. Pursue the shadow economy and undeclared work, for instance by stepping up checks and controls.	It depends on the tax base on which the government focuses whether this reform benefits capital or labor or none of them.
8.	Take measures to reduce the scope of tax exemptions, allowances and reduced VAT rates and simplify the tax code.	It depends on the tax base on which the government focuses whether this reform benefits capital or labor or none of them.
9.	Take further action to shift the tax burden away from capital and labour to property and consumption as well as environment.	It depends on the exact choice of the tax base and on the tax rates whether this reform benefits capital or labor or none of them.
10.	Implement the adopted liberalization and simplification measures in the services sector. Take further measures to improve market access in network industries, as well as infrastructure capacity and interconnections.	This reform can redistribute from the owners of the networks to consumers.
11.	Simplify further the regulatory framework for businesses and enhance administrative capacity.	
12.	Improve access to financial instruments, in particular equity, to finance growing businesses and innovation.	
13.	Implement the planned reorganization of the civil justice system, and promote the use of alternative dispute settlement mechanisms.	

Appendix Part 4

Distributional effects of new reform proposals by EU commission: Spain

1.	Deliver an annual average structural fiscal effort of above 1.5% of GDP over the period 2010-13 as required by the EDP recommendation by implementing the measures adopted in the 2012 budget and adopting the announced multi-annual budget plan for 2013-14 by end July. Adopt and implement measures at regional level in line with the approved rebalancing plans and strictly apply the new provisions of the Budgetary Stability Law regarding transparency and control of budget execution. Establish an independent fiscal institution to provide analysis, advice and monitor fiscal policy, as well as to estimate the budgetary impact of proposed legislation.	
2.	Push up the increase in the statutory retirement age and the introduction of the sustainability factor foreseen in the recent pension reform.	This reform benefits owners of capital and it tends to reduce wages and pensions.
3.	Underpin the Global Employment Strategy for Older Workers with concrete measures to develop lifelong learning further, improve working conditions and foster the reincorporation of this group in the job market.	This measure complements the pension reform because it reduces the losses that arise due to an increase in the retirement age and it therefore benefits older insider workers. On the other hand, higher labor supply may lower wages for many insiders.
4.	Introduce a taxation system consistent with the fiscal consolidation efforts and more supportive to growth, including a shift away from labour towards consumption and environmental taxation. In particular, address the low VAT revenue ratio by broadening the tax base for VAT.	It depends on the exact choice of the tax base and on the chosen tax rates whether this reform benefits capital or labor or none of the two.
5.	Ensure less tax-induced bias towards indebtedness and home-ownership (as opposed to renting).	
6.	Implement the reform of the financial	This is a financial market reform which

	sector, in particular complement the on-going restructuring of the banking sector by addressing the situation of remaining weak institutions, put forward a comprehensive strategy to deal effectively with the legacy assets on the banks' balance sheets, and define a clear stance on the funding and use of backstop facilities.	complements the pension reform to the extent that a better functioning financial market may yield higher and less volatile returns for private investments.
7.	Implement the labour market reforms and take additional measures to increase the effectiveness of active labour market policies by improving their targeting, by increasing the use of training, advisory and job matching services, by strengthening their links with passive policies, and by strengthening coordination between the national and regional public employment services, including sharing information about job vacancies.	This reform reduces labor turnover costs. This benefits owners of capital and it tends to reduce wages.
8.	Review spending priorities and reallocate funds to support access to finance for SMEs, research, innovation and young people. Implement the Youth Action Plan, in particular as regards the quality and labour market relevance of vocational training and education, and reinforce efforts to reduce early school-leaving and increase in vocational education and training through prevention, intervention and compensation measures.	
9.	Take specific measures to counter poverty, by making child support more effective and improving the employability of vulnerable groups.	
10.	Take additional measures to open up professional services, including highly regulated professions, reduce delays in obtaining business licenses and eliminate barriers to doing business resulting from overlapping and multiple regulations by different levels of government. Complete the electricity	These measures broadly benefit consumers while some specific groups may realize losses.

	and gas interconnections with neighboring countries and address the electricity tariff deficit in a comprehensive way, in particular by improving the cost efficiency of the electricity supply chain.	

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