

Quality reform: mission impossible?

Why is it so difficult to carry out reforms? Why, if structural reforms tend to improve the future prospects for the majority of the population, is it so difficult to adopt them? The difficulty lies precisely in two of the aforementioned words, future and majority. Reforms promise benefits in the future, but tend to generate costs today. They promise benefits for many, but not for all. In more formal terms, the costs and benefits are distributed asymmetrically among the population and over time. This is problematic, because if something diffusely benefits many but harms a few, the latter are highly incentivised to organise themselves in the form of a lobby. It is also problematic that the costs of reforms are concentrated in the short term while the benefits are spread out in the future. This means that the politicians who will have to push them through face the dilemma of suffering the political costs of their adoption without being able to capitalise on their benefits in the immediate electoral cycle.

Reforms, in Spain? Indeed

In this respect, it is no surprise that reforms are the eternally pending topic in many countries. However, there is no need to fall into a kind of historical pessimism. In particular, we must refrain from a defeatist vision of Spain's ability to implement reform. Contrary to what is sometimes believed, Spain has been active when it comes to structural reforms. The results have sometimes been somewhat irregular, such as in the case of labour reforms. On other occasions, however, the effects have been significant, such as with the 1959 Stabilisation Plan, the 1977 Moncloa Pacts, joining the EU in 1986, the European Single Market in 1993 and integration into the EMU in 1999.

What do these successful attempts tell us about the conditions in which reforms are most likely to be undertaken? The context in which all these reforms were launched shares some common traits. Firstly, the decision to reform was taken in difficult, or very difficult, economic times. These include the time when Franco's autocracy was on the verge of collapse due to a lack of foreign currency to pay for oil, when inflation threatened the transition to democracy, when Spain faced joining the EU with its industry undergoing a transformation and unemployment sky high, or when the public finances needed rebalancing and key sectors of the economy were being privatised in the midst of a post-Olympic recession.

A second element these reforms have in common is the fact that, at least in democratic times, the government has enjoyed a comfortable majority. This is the case with the Moncloa Pacts, EU membership and joining the euro. Finally, a third element is the presence of what we could generally refer to as an external benchmark or obligation. That was the role of the IMF in the 1959 Stabilisation Plan, of the examples of income policy set by Italy and Germany which inspired the Moncloa Pacts, and of commitment to the EU in joining and entering the euro area.

In short, successful structural reforms in Spain have been adopted when there has been external pressure, when there have been strong governments, and when the country has endured difficult times. Is this only the case in Spain? No, the fact is that there is abundant empirical literature confirming that these three determining factors tend to coincide in the launch of structural reforms in many other locations and eras, and it applies to different types of reform too.¹ After all, a key issue is that the reforms mentioned are those referred to in the economic literature as a change of framework, affecting elements that define how the economy functions (the typical liberalisation programmes, for example). But the truth is that reforms in specific areas, such as labour reforms or those in the product market, are also more likely to occur when the three above factors are combined.

Reforms are launched in difficult times because in this context the main groups affected often have less bargaining power, and the relative costs for the public decision-maker are often limited: if the current situation is bad, politicians may perceive that inaction is more costly in electoral terms than taking tough decisions, even if that means confronting organised lobbies. Similarly, if there is external pressure, for example in the form of international commitments, politicians are able to «shift» part of the cost of reform to that area. Finally, a strong government has what we could call greater «political capital». This is a conceptual metaphor that seeks to capture the fact that governments have a certain degree of popularity and support which they can devote to different policies: only when this capital is plentiful it is reasonable to consider investing in something politically costly as reforms.

1. See K. Masuch, R. Anderton, R. Setzer and N. Benalal (2018). «Structural policies in the euro area». ECB Occasional Paper, (210). And V. Galasso, T. Dang, J. Hoj and G. Nicoletti (2006). «The Political Economy Of Structural Reform: Empirical Evidence From Oecd Countries». OECD Economics Department Working Papers n° 501.

From the adoption of structural reforms to their effects

So far, we have established three factors that increase the likelihood of structural reforms being adopted. Let us now turn to a second key question, that of their effects. We began the article by stating that reforms tend to generate long-term benefits. However, there is one additional element that is critical in this outcome: the expected benefits will be different depending on the economic situation, at least with certain types of reforms. For instance, it is fairly well established that labour reforms tend to yield better results when they are adopted during good economic times. Here, an apparently unsolvable problem jumps into view. For example, adopting a reform that makes the labour market more flexible is more likely in the midst of a crisis, but if it is adopted, it can lead to greater job destruction in the short term.

Is it possible to reconcile this tension and not simply reform but manage to reform well, with effective results? This is not easy and not always possible, but the evidence points to a partial solution. Many reforms act on the supply side of the economy to generate their benefits, but their costs stem from the effects on short-term demand. The solution, in these cases, is to act by combining reforms with an expansive economic policy, usually through an increase in expenditure or investment, which helps to partly offset these negative short-term impacts on demand. Tempering the short-term costs can improve the situation and, to some extent, help to produce effects more in line with those expected from implementing the same reform in good times.

Other elements of good reform include three additional key aspects: credibility, institutional quality and compensation for those who lose out.² Let us firstly address credibility. It is difficult to identify an element in the implementation of good reforms that is both so critical and so elusive. Not in vain, credibility increases if reforms are genuine reforms. In other words, it is particularly harmful to announce a battery of small changes as though they were decisive actions. It has also been shown to be critical to provide as much technical evidence as possible. Doing so helps to distance reforms from overly politicised readings (the latter are associated with benefits for one party, not for all) and also provides transparency, another key attribute.

A second element, as we said, is institutional quality. States that function well from an institutional point of view implement better reforms. In particular, they are able to «protect» reforms from future political changes and ensure that the expected benefits end up materialising. In this regard, good reforms in certain areas sometimes involve prior political reforms, which ensure that the former can bear fruit.

The third element concerns the compensation of the groups which lose out due to the changes introduced by the reforms. There are many ways to approach this, from direct compensation to more strategic methods. History has shown that one of the most fruitful options is to make simultaneous and typically comprehensive reforms that allow acceptable exchanges to be offered. This would be the case, for example, in labour frameworks which act simultaneously both in the sphere of flexibility (e.g. making layoffs more adaptable) and in that of security (offering active policies, which boost employability, and incomes, to meet peoples' needs during the transition to their new job). This was the case, for instance, when designing Denmark's so-called *flexisecurity* policy.

We have reached the end, and you, the reader, may pose the big question: are European countries likely to adopt ambitious and effective reforms this time round, in the context of the window of opportunity offered by NGEU? We cannot provide a comprehensive answer, but there is reason for hope. The starting conditions are similar in two major respects in most countries: we are in difficult economic times, and there is an element imposing external discipline in the form of the conditions attached to the disbursement of NGEU funds. Moreover, – and this is a stark difference compared to many other attempts at reform – we are going through an almost unprecedented period of economic stimulus, which should help alleviate some of the short-term costs on the demand side. In conclusion, there is nothing stopping us from paying attention to credibility, from taking care to properly compensate the losers in the status quo, or from institutionally shielding the reforms. However, it must be recognised that political polarisation could prove to be a burden for reformist momentum. Nevertheless, if all the factors are taken into account, we are inclined to be optimistic and believe that, perhaps this time, we could witness a new case of successful reform in many EU countries – including Spain.

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2. See S. Khemani (2017). «Political economy of reform». World Bank Policy Research Working Paper 8224.