Structural reforms – easier said than done

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It is relatively easy to demand more investment, innovation, employment and competition in order to achieve more productivity and, ultimately, higher economic growth. That requires structural reforms. Their design and implementation is a complex matter in which a number of economic and political factors need to be considered. These include the design and, hence, the composition of reforms, the timing and sequence of changes, as well as the design of the policies through which they are implemented. What is crucial to the introduction of reforms and their subsequent implementation is not just the 'what' but also the 'who' and the 'how'. Ultimately, any structural reform must be tailored to the country's specific circumstances and this applies to design, implementation and impacts in equal measure. After all, neither are the elements of reforms and conditions identical nor do they have the same effects in all national economies.

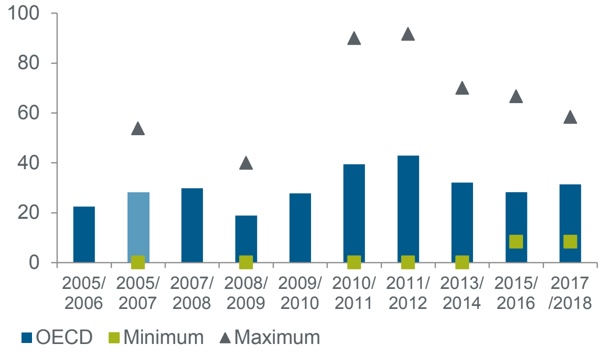
The demand for structural reforms is a popular one. Structural reforms are intended to strengthen and stabilise economic growth in the long term, as well as help prevent downturns and crises. If it is known which conditions promote growth in individual sectors or in the overall economy, these would 'simply' have to be created – through structural reforms. The task would therefore be to find the causes of too-low growth, propose appropriate structural reforms and retrospectively analyse how many of these proposals were implemented and to what degree of success. As structural reforms have a positive impact – by consensus at least in the long term,[1] national economies themselves should have an interest in implementing them. By that logic, structural reforms should be a sure-fire success.

Experience shows that this is not the case. Structural reforms are often implemented in phases, both for groups of countries and within countries. Thus, reform activity in OECD countries was quite high after the global recession but has since diminished (see Figure 1). A further example is the trade liberalisation in Latin American countries implemented within just a few years, especially at the end of the 1980s and the early 1990s.[2] Besides, structural reforms are not a one-way street; they can definitely be rolled back again. For example, unemployment support and other social benefits in Europe were expanded at the beginning of the global recession but scaled back again from 2010.[3]

International organisations such as the IMF, the World Bank and the OECD never tire of demanding and recommending structural reforms and supporting countries in their implementation. The OECD has the explicit mandate to formulate policy recommendations to its member states. It has been analysing reform progress in its Going for Growth reports since 2005. In the countries that are to receive financial support, the IMF and the World Bank make their programmes conditional on structural reforms, among other things.[4] The annual country reports of the IMF issued as part of the Article IV Consultations also analyse reform activity.

Figure 1: Implementation of OECD policy recommendations

Reform responsiveness rate (number of years in which significant policy changes are made in relation to the number of years available for implementing a proposal, in per cent)



Guide: On average, 28% of reform priorities were addressed with substantial action during the period of 2009/2010.

Source: OECD Going for Growth, various issues.

However, no one knows the right growth model for an economy.[5] The assumption is that more competition, fewer barriers to innovation, a flexible labour market and greater tax efficiency, among other factors, contribute to more employment and higher productivity. This would apply to all countries irrespective of their level of development and to all factors irrespective of their intensity.[6] Structural reforms in the meaning of specific policy changes and the choice of sectors to be reformed must then be derived from these general factors. Consequently, the reforms undertaken differ in accordance with the country-specific conditions.

Even if the demand for reform in a country involves not only general but detailed structural reforms, it must still be considered whether they are possible and what factors determine their implementation. After all, a significant aspect of the implementation of structural reforms is the policy applied with regard to interests and interest groups that are affected by their impacts. Structural reforms are therefore often hard to implement. Among other things, they require institutions that enable a balance of interests between various groups of society. In other words, there have to be rules for the changing of rules.[7]

Structural reforms come in all shapes and sizes

The term structural reform covers a broad range of changes. According to Duden, the "planned reorganisation, redesign and improvement of existing conditions" is associated with major changes to policies or institutional rules.[8] In the context of national economies, economic structural reforms change the architecture of an economy, the institutional and the regulatory framework. The primary objective is to promote (potential) growth. This can be achieved through higher productivity, more investment and more employment.[9] Other goals are improved shock absorption and more stable growth. The term structural reform often stands for deregulation, liberalisation and privatisation.[10]

The term structural reform is very difficult to operationalise, and the list of possible economic structural reforms is extensive. In addition, the focal areas of structural reforms differ according to a country's development level:

- For developing countries, four waves of structural reforms can be identified.[11] In the 1980s the priority was trade liberalisation, which was followed by an emphasis on financial market liberalisation and the liberalisation of financial accounts in the 1990s. They were followed by the market orientation of the agricultural and the deregulation of telecommunications and power generation.

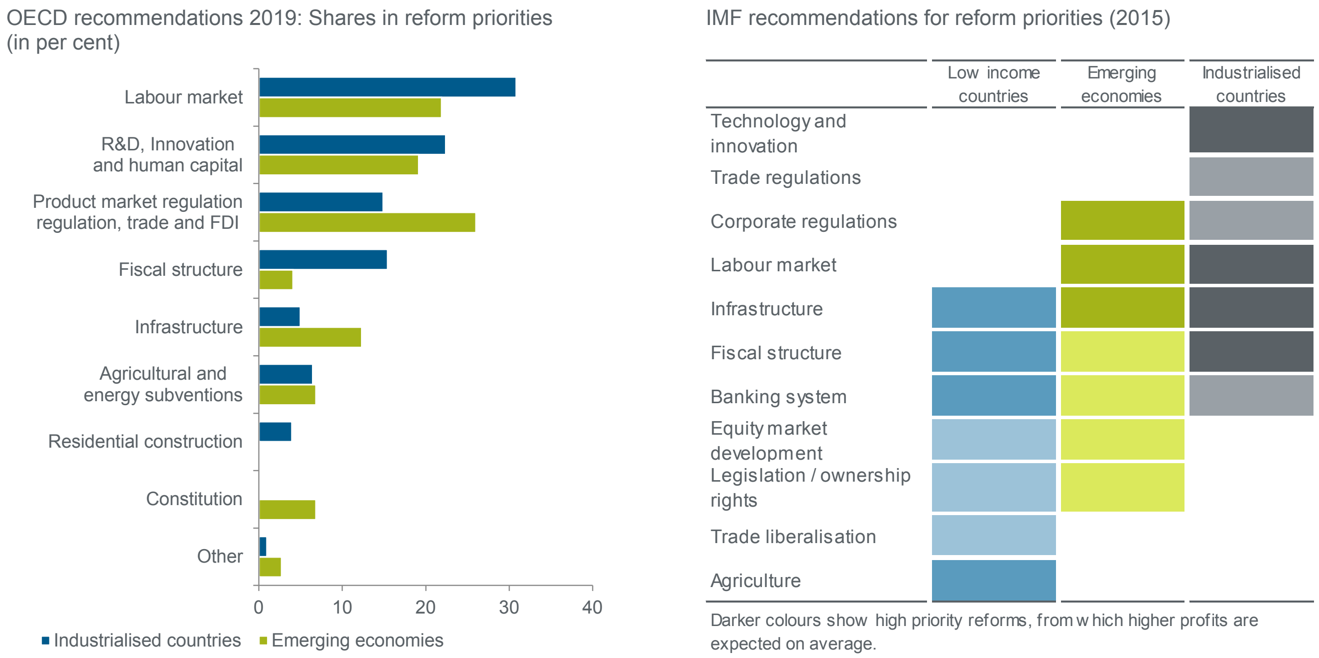
- For the transition countries, the task since 1989 was to change to a market economy. As there was no prior experience to draw on for such a conversion, they had to look to China and the reforms of the developing countries in the 1980s for guidance.

- In Europe, starting points for introducing structural reforms were the functioning of the labour markets, which had persistently high unemployment after crises starting in the 1970s,[12] the widening labour productivity gap to the US since the mid-1990s[13] and the formation and further development of the EU and EMU. But structural reforms remained a topic in Europe in recent times as well, for example within the framework of the Lisbon strategy starting in 2000, as a response to the euro crisis which peaked in 2011/2012, and for potential EU accession countries.

The IMF recently emphasised the benefit of structural reforms in agriculture, the banking system and infrastructure, as well as fiscal structural reforms for low-income countries (see Figure 2).[14] The IMF's recommendations for emerging economies are also directed at infrastructure (and fiscal structural reforms). Other reform priorities for this group of countries are the labour market and corporate regulation.[15]

For middle-income countries it is also relevant that they catch up with high-income countries and avoid a growth slowdown (see Box 1).

Figure 2: Areas of structural reform



Sources: Left figure: OECD (2019), Going for Growth; right figure: IMF (2015), Structural Reforms and Macroeconomic Performance: Initial Considerations for the Fund, IMF Staff Report.

Box 1: The middle-income trap

Middle-income countries stand out in their growth performance as they are more likely to face a growth slowdown.[16] This is already evident in the development of real GDP per capita (see Figures 1a and 1b). It is true that GDP per capita was higher in most countries on average in the years 2010–2014 than in 1970–1974. Taking the US as a benchmark, however, puts that progress into perspective. The picture hardly changes even if we look at the development since the years 2000–2004. This period was particularly favourable for developing countries because of the resources boom, the expansion of global value chains and the integration of China and the transition countries into the world economy. Still less than half of the transition countries are among the high-income countries (see Figures 1c and 1d).

The middle-income trap can be regarded as a reference framework for how policies and institutional change need to adapt to the structural circumstances of middle-income countries. Apart from that, it has been both empirically ascertained and identified through comparison with a benchmark. The reasons for a growth slowdown are diverse. They range from lack of infrastructure to exhausted production advantages to insufficient formation of human capital and limited access to education as a result of inequality.[17]

At least for productivity slumps there is no guarantee that countries can avoid them in any case, for example by investing heavily in education, avoiding excessive investment or developing relatively strong political systems. This is true even though insufficient education, excessive investment or weak political systems make productivity slumps more likely.[18] Similarly, it is probably too simplistic an idea to just eliminate the reasons for the growth trap in order to avoid it: more infrastructure, more human capital, more competition and entrepreneurship etc. Rather, the possible structural reforms must be selected and it must be clarified which reforms are to be initiated in which combination and sequence and scope and how they are to be implemented.

Systematic approaches to formulating policy recommend-ations are based on the growth theory which, however, falls short for middle-income countries, on the empirics of economic growth, which refer to average effects, or on international benchmarks.[19] As a rather more agnostic approach, a growth diagnosis is proposed with the aim of identifying the largest obstacles to growth.[20]

Figure 1a: Country comparison – real GDP per capita

In USD 1000, adjusted for interlocked purchasing power parities.

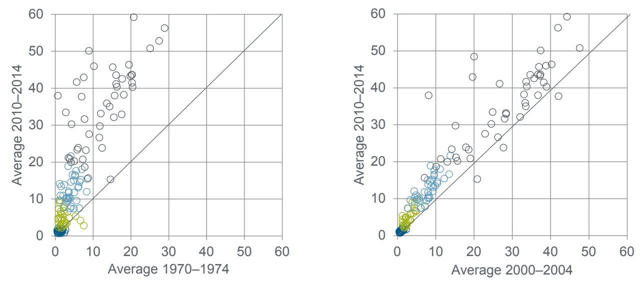


Figure 1c: Transition countries – real GDP per capita

In USD 1000, adjusted for interlocked purchasing power parities.

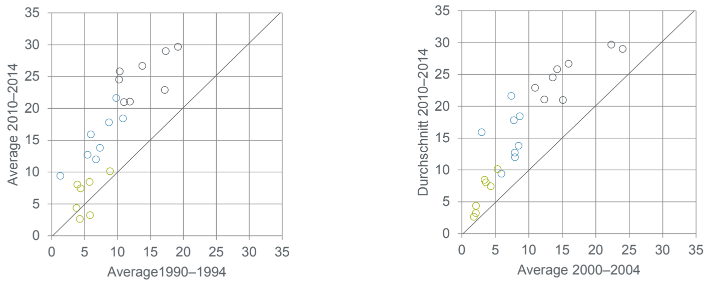
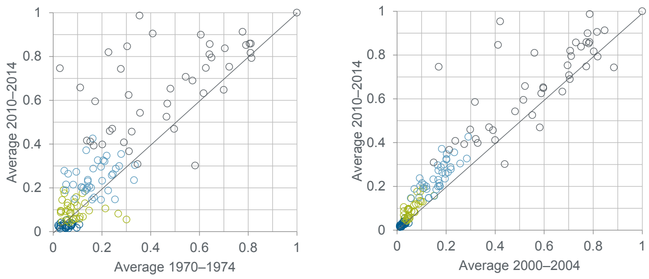


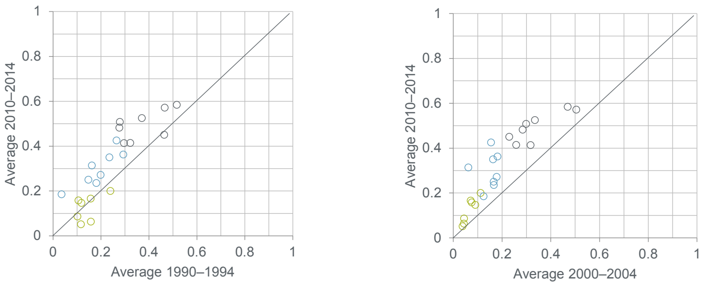
Figure 1b: Country comparison – real GDP in comparison with that of the US



○Low income countries ○Countries below average income
○Countries above average income ○High income countries

according to the World Bank classification for 2014, excluding transition countries

Figure 1d: Transition countries – real GDP in comparison with that of the US



Transition countries: Armenia, Azerbaijan, Bosnia and Herzegovina, Belarus, Czech Republic, Estonia, Georgia, Croatia, Kazakhstan, Kyrgyzstan, Lithuania, Latvia, Republic of Moldova, North Macedonia, Montenegro, Russian Federation, Serbia, Slovakia, Slovenia, Tajikistan, Turkmenistan, Ukraine, Uzbekistan.

Source: Feenstra, Robert C., Inklaar, R. and Timmer, Marcel P. (2015), "The Next Generation of the Penn World Table" American Economic Review, 105(10), 3150-3182, www.ggdc.net/pwt; own calculations.

According to the IMF's considerations, industrialised countries benefit particularly from the labour market, fiscal structural reforms, infrastructure and the promotion of technology and innovation.[21] The OECD sorts its recommendations according to the impacts on labour productivity and the degree of utilisation of labour as a production factor; the focus of its recommendations for reform lies on productivity growth and has intensified over time.[22]

Two global developments will crucially shape the design of structural reforms in the future. The first one is climate change, which demands that economic activity enables climate change adaptation but also combats climate change itself.[23] The second one is demographic change, which is still at different stages worldwide. But the ageing of the population will ultimately affect all countries so that structural reforms must be formulated that at least mitigate the negative effects on economic growth.

Structural reforms are held to high expectations

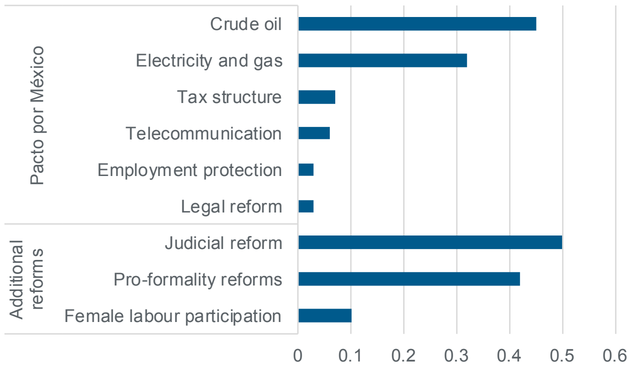
The debate on structural reforms is being conducted under the assumption that they help achieve sustained high growth. Whether this is actually the case is an empirical question.[24] The difficulty is that the diversity of possible structural reforms does not allow a general outcome to be expected at impact level. At the same time, the quantification of reforms is as much a challenge for the analysis as the fact that the effects are spread out over a longer period of time. In addition to structural reforms, many further factors influence a country's economic performance, which makes it difficult to separate the various influencing factors.[25]

In addition to the influence of structural reforms on the growth rate, volatility is another aspect that needs to be considered. Under certain circumstances, specific reforms such as financial market liberalisation may make an economy more susceptible to crisis.[26] Reforms in the labour and goods markets, on the other hand, tend to promote growth and may even make the economy less fragile.

It is therefore important to take a differentiated view of the impacts of structural reforms.[27] This is confirmed, for example, by the analysis of Mexico's comprehensive reform programme which was initiated in 2012/2013 (see Figure 2). The IMF has concluded that there are no signs of a growth boost yet as a result of the reforms, although they achieved successes such as greater competition in network industries.[28] This also applies to very specific reforms, as illustrated by the studies on the Hartz reform of the years 2003 to 2005, which aimed to reduce unemployment in Germany. The analyses have found effects of varying intensity on unemployment and wages. Even almost 15 years after the reform, a final verdict is still pending.[29]

Figure 3: Expected effects of structural reforms in Mexico when fully implemented

Additional GDP growth in five years in percentage points



Source: OECD.

A major point of contention is whether structural reforms have positive or negative effects in the short term.[30] After all, there is broad agreement on their long-term positive effects – even if not on their extent. Various analyses have come to the conclusion that structural reforms in the euro area can definitely have positive effects even in the short term and the European Commission at least has not found any negative effects.[31] In general, the negative effects of reforms on consumption can be more than offset in the short term by the positive effects on investment and the current account balance.[32] They do not even have to appear at all if the reforms are implemented quickly or promise income increases. What is ultimately crucial is the sequence and composition of reforms but access to credit for businesses and, hence, the development of the financial system are also essential for adapting to changed conditions.

The implementation of structural reforms is complex

Two areas collide when decisions on structural reforms are made:

- The identification of potential contents and the timing, sequence and composition of reform measures and
- The question of policy design in determining a particular reform with specific measures and their implementation.

Both political and economic reasons can hamper the decision for structural reforms and their implementation – even if the need for reform has been recognised and the corresponding measures have been identified.[33] This is because two distribution mechanisms clash here – the market and the state – and the persons affected by the reform are both citizens of the state and market participants.[34] Accordingly, a fraught area may build up between economic efficiency, social goals and distribution of power and income.[35] A wide range of influencing factors can therefore be identified that determine the political economy of structural reforms (see Figure 3 for a selection).[36]

Figure 4: Policy design in the implementation of structural reforms

General economic framework

- **Economic situation: Crises and economic uncertainty**
  Higher urgency of reform (+)
  Smaller advantages for groups of interest (+)
  Uncertainty about distribution of reform costs (+)
  Greater uncertainty about benefits of reform than about costs (-)
- **Fiscal and monetary policy: fiscal and monetary scope**
  Mitigation of distribution effects (+)
  Urgency amid lack of fiscal scope (+)
  Coverage of opportunity costs of lack of reforms from the budget (-)
  Fiscal consolidation in the package with further reforms (+)
- **Starting conditions in the reform areas**
  High need for reform (+), successful reform history (+)
- **Demographics: ageing society**
  Especially in reforms of social security:
  Uncertain future benefit (-)
  Higher proportion of population affected (-)
  Stronger interest in stability / financial viability of pension systems (+)
- **External influences**
  Integration into international financial and goods markets /
  membership in international organisations /
  Recourse to programmes of international organisations (+)
  Development cooperation (+)

Political conditions

- **Political regime and form of government**
  Protection of ownership rights (+)
  Support for investment as deferred consumption (+)
  Autonomy in decisions for growth (+)
  Political experimentation at subnational level (+)
  Power concentration and legitimacy of the president (+)
  Reforms at the central level in federal systems (-)
- **Political power of interest groups**
  Expected loss of advantages of interest groups (-)
  Institutions well adapted to distortions (-)
  Expectation of very unevenly distributed reform costs (-)
- **Government capacity:**
  Performance of state functions and control of the political system:
  Bureaucratic inefficiency, potential sabotage by groups of interest (-)
  Possibilities to negotiate with various interest groups (+)
  Unified stance of government institutions (+)
- **Quality of institutions**
  Rules for changing rules (+)
- **Political cycle: Interests for re-election**
  Structural reforms with short-term costs and costs for the voters (-)
  Reforms for more social benefits (+)

Agents of reform

- **Coalitions and political leadership**
  Transformative or growth coalitions (+), destructive or exploitative coalitions (-)
  Fragmentation from development process (-)
  Persons and groups with skills, means and convictions for reforms (+)

Overall social environment

- **Political norms and preferences for public goods**
  Political norms for cooperative behaviour (+)
  Preferences for public goods such as education, health and a state-run pension system (+)
  Creation of personal advantages as a function of the state (-)
- **Shaping of public opinion: efficient communication**
  Public support/reform consensus, especially on sweeping reforms (+)
  Changes to preferences and norms (+)
  Creation of confidence in future income growth (+)

Presumed direction of influence in brackets:+(-) positive (negative) effect on introduction of structural reforms.

Source: Own illustration.

After all, the political process ranges from problem identification and selection through the formulation of policies and decision-making to implementation.[37]

The literature comprises both theoretical models and empirical studies and arrives at very different results on the introduction of structural reforms. The effects depend not least on the type of structural reform and the countries examined.[38] Consequently, for almost all influencing factors, arguments can be found that they can promote or inhibit reform.

Outlook

There are calls for structural reforms for all economies irrespective of their level of development. The reasons may differ – whether it be to prevent the middle-income trap for developing countries or to combat productivity weakness in industrialised countries following the global recession. The ultimate goal is to strengthen and stabilise economic growth in the long term. The approaches to relevant measures are as diverse as the reasons for too-low growth.

However, the implementation of structural reforms is subject to a wide range of influencing factors – and often faces obstacles. First, the precise measures, their composition and sequence need to be defined. Second, they must be decided and implemented. The benefits in the form of higher long-term economic growth are not a sufficient motivation for the implementation of structural reforms. Rather, what needs to be taken into account are the political processes involved and the actors who ultimately implement the structural reforms. ■

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