Background paper for session on

The Sequencing of Structural Reforms

Examples from the euro area adjustment programme countries

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When and how should countries engage in structural reforms? What are the right framework conditions for implementing structural reforms? Which structural reforms should be prioritized in order to deliver more economic growth and new jobs? Given the emphasis that Europe has put on structural reforms in the last years, it is surprising, how little systematic analysis has been undertaken to address this issue. In this short background note, we want to record the most important changes in structural policies based on available indicators in 5 EU countries that have been under financial market stress and outside pressure and benchmark it with Germany. The main purpose is to detect common patterns across countries. A deeper analysis on effectiveness of reforms is beyond the scope of this short note.

Introduction

In a keynote address at the 2012 edition of the Brussels Economic Forum, Nemat Shafik, then Deputy Managing Director of the IMF, explained how even a few tenths of a percentage point gain in growth makes everything easier: fiscal consolidation, debt reduction, and poverty alleviation. “My German, mother-in-law once said: everything is better with butter. In economics, everything is better with growth”. The newly-appointed Deputy Governor of the Bank of England then went on by examining the measures needed to stimulate growth in both the short-term and medium-term. “Regaining competitiveness is a bit like running a marathon,” she said. “Many reforms, especially of the structural kind, take time to show results, and it is easy to hit a wall when vested interests resist change. To make it to the finish line, it is crucial that European policy-makers keep up momentum.”

In a nutshell, these messages encapsulate the challenges that national and European policy-makers have been facing since the euro area crisis erupted in 2010. Following the significant expansion of public deficits and debts associated with the Great Recession, European governments were left with few Keynesian policy levers to intervene in the economy. At the same time, financial markets were exerting significant pressures on bond markets, as confidence in the capacity of EU facilities to bail out failing sovereigns was weak. As austerity started to weigh on growth, the urgency to enact supply-side reforms and increase potential and, eventually, actual GDP growth was all the more felt.

Since then, there has probably not been a day without the magic "structural reforms" formula being pronounced in EU and national policy circles. The expression's vagueness however has lent itself to being interpreted differently across the board.

In this paper, we therefore analyse structural reforms in Europe and how and how quickly they have been implemented. In order to do so, we adopt the OECD's definition of structural reforms i.e. "*policy recommendations based on their ability to improve long-term material living standards through higher productivity and labour utilisation".*

Although few European countries are immune from the need to improve their economic performance, in this background note we will focus on six euro area countries: three under a Troika macroeconomic adjustment programme (Portugal, Ireland, and Greece), two that underwent significant market pressure (Italy and Spain), and Germany as an "early-reformer" comparison. Far from being comprehensive, this analysis can nonetheless indicate whether certain underlying trends can be identified. Has the crisis accelerated the pace of reforms? Has programme conditionality proved effective in boosting countries' competitiveness? Was financial market pressure sufficient to twist governments' arm into much-needed and long-procrastinated structural reforms? Were certain reforms implemented consistently at early stages of the adjustment process?

Given the current debt situation in the euro area and the resulting urgency to spur growth to reduce private and public debt overhang at a time of low inflation, we will focus on reform chapters that are likely to boost growth already in the medium-run. The OECD recognizes that "priority should be given to actions that can boost jobs in the context of ongoing fiscal consolidation". We thus look at measures that the literature, the OECD, and the Troika have broadly identified as growth-enhancing already in the medium-term (dropping education and innovation reforms). This is not to say that the latter are not important. To the contrary, Bruegel has been working extensively on the relationship between fiscal consolidation, macroeconomic adjustment programmes, and innovation/R&D spending (see Veugelers, 2014 – *mimeo*).

Shifting key policy recommendations from the OECD's Going For Growth report, on top of the EU's Country Specific Recommendations and Adjustment Programme documents (see Sapir *et al*., 2014), we identified the following as measures likely to lead to "higher productivity and labour utilization" already in the medium-term:

- Shifting tax burdens away from labour;
- Decreasing labour market regulation;
- Decreasing product market regulation;
- Reducing barriers to entrepreneurship (administrative burden);
- Reducing FDI barriers;
- Liberalising professional services;
- Reducing sectorial regulation (transport, energy, etc.).

Making use of OECD data and World Bank Doing Business Reports we tracked countries throughout time in their reform effort and hence in the sequencing of reforms. Clearly, the various countries analysed had different initial conditions, which call for tailored structural measures. We will partially take this into account when looking at the progress made under the various headings. As a final remark, we note that, when looking at competitiveness indicators, particular caution has to be

exercised at differentiating between measures that illustrate reform effort and reform outcomes. As an example, “length of trials” is often quoted as a key element influencing the business climate, FDI flows, and hence ultimately capital accumulation, labour market productivity and utilisation. However, reforms aiming at abridging this length are likely to have an impact only with a significant time lag. As such, it would not be appropriate to use this measure as an indicator of reform effort.

Analysis

As outlined in the introduction, in this section we aim to benchmark six different euro area countries across a battery of parameters, which suggest structural reform effort. In doing so, not only will we aim to describe, through the lenses of the data, the reform history of these countries, but also will we try to spot broader cross-country trends. Depending on data availability, the actual time span considered for analysis may vary from variable to variable. Caution will be necessary also as adjustment programmes kicked off at different points in time in Greece, Portugal, and Ireland.

Table 1 below shows how the **tax burden on labour** has been evolving in the selected six euro area countries. It must be immediately clarified that price competitiveness is only one side of the medal, with non-price competitiveness factors playing a key role. However, fixing the latter requires time and, when countries are under stress, fiscal devaluation can be a way to jump-start the economy and sustain employment.

Labour tends to have a fixed base relative to other factors (e.g. capital, particularly financial) and, as such, offers fewer possibilities for tax avoidance. In 2011, as countries came under pressure to put their budgets on a sustainable path, and fiscal consolidation reigned sovereign, most countries under analysis increased the tax burden on labour. However, in 2012, as unemployment levels were fast-rising, Greece and Portugal started shifting the tax burden away from labour. Ireland, the other programme country, did not go down the same path. It must be highlighted that the former “Celtic Tiger” enjoys very low labour taxes, by European standards. In 2012, Ireland’s average tax wedge was 26%, roughly half that of Germany (50%) and significantly lower that of Italy (48%), Greece (42%), and Spain (41%). As such, the tax burden can hardly be seen as significantly harming employment.

Table 1. Tax burden on labour

	Average rate of income tax and employees' social security contributions (%)							
y-o-y p.p. chg	2005	2006	2007	2008	2009	2010	2011	2012
Greece	-0.24	1.31	-0.60	-0.99	-0.49	-1.92	3.89	-0.60
Ireland	-0.65	-0.56	-0.83	0.08	2.71	1.20	-0.01	0.15
Portugal	-0.75	0.90	-0.25	-0.47	-0.51	0.73	1.08	-1.56
Spain	0.21	0.19	0.11	-1.30	0.50	1.93	0.31	1.84
Italy	-0.50	0.74	0.44	0.34	0.19	0.50	0.52	0.05
Germany	-0.06	0.30	-0.28	-0.24	-0.61	-1.98	0.46	0.05

Source: OECD, Bruegel calculations

Italy and Spain had failed to shift their tax burden away of labour by 2012, suggesting that market pressure has led to a prioritisation of fiscal consolidation needs with respect to growth friendly measures under this heading.

Another thorny issue that has received significant attention throughout the crisis has been **labour market flexibility**. Table 2 displays the OECD’s index of Employment Protection Legislation (EPL) for individual and collective dismissal for permanent (regular) contracts. As reform progress is assessed

on the 1 January 2013, values effectively refer to legislation enacted throughout the year before. It can thus be seen how Greece immediately tackled its stiff labour market legislation at the offset of its adjustment programme. The same thing took place in Portugal, where the programme commenced in June 2011. Portugal kept the reform momentum and further liberalised its labour market in the second year of the programme. Ireland, once again, stands out as a somewhat special programme country – increasing EPL in the first year of the programme. In this regard, we highlight that for the Irish programme the Troika broadly limited itself to setting hard targets and then allowed significant scope of action to the Irish government, increasing political ownership of the programme. Structural conditionality was, in a sense, limited with respect to the other programme countries (see Sapir *et al.*, 2014).

Table 2. Labour Market Regulation

Strictness of employment protection – individual and collective dismissals (regular contracts)					
y-o-y p.p. chg	2009	2010	2011	2012	2013
Greece	0.00	0.00	-0.41	0.00	-0.03
Ireland	0.00	0.00	0.00	0.09	0.00
Portugal	0.00	-0.20	0.00	-0.41	-0.21
Spain	0.00	0.00	-0.10	0.00	-0.27
Italy	0.00	0.00	0.00	0.00	-0.24
Germany	0.00	0.00	0.00	0.00	0.00

Source: OECD, Bruegel calculations

Interestingly, also countries under financial market stress significantly liberalised their labour markets in 2012, through the *Riforma Fornero* in Italy and la *Reforma Laboral* in Spain. Italy's labour market remains however one of the most rigid in the EU, following Germany, Belgium, the Netherlands, and France.

As detailed by the OECD, "a **competitive product market** environment that allows new firms to challenge incumbents, efficient firms to grow, and inefficient ones to exit, can help boost economic growth and living standards". The Paris-based organisation thus compiles an index of Product Market Regulation (PMR) which can be broken down in three main sub-components: state control, barriers to entrepreneurship, and barriers to trade and investment. Unfortunately, this data is only collected every 5 years. We will thus only be able to see whether the crisis broadly accelerated the reform process in selected euro area economies, but not with what exact timing the reforms were adopted.

Table 3. Product Market Environment

	Product market regulation		State control		Barriers to entrepreneurship		Barriers to trade and investment	
Δ	2003-08	2008-13	2003-08	2008-13	2003-08	2008-13	2003-08	2008-13
Greece	**-0.26**	**-0.51**	-0.42	-0.64	-0.34	-0.61	-0.03	-0.27
Ireland	**-0.20**	**0.06**	-0.56	0.15	-0.03	-0.01	0.00	0.04
Portugal	**-0.38**	**-0.40**	-0.41	-0.73	-0.19	-0.48	-0.55	0.00
Italy	**-0.33**	**-0.22**	-0.57	-0.44	-0.40	-0.08	-0.01	-0.16
Spain	**-0.20**	**-0.12**	-0.33	-0.21	-0.27	-0.10	0.00	-0.06
Germany	**-0.38**	**-0.12**	-0.12	-0.15	-0.51	-0.22	-0.50	0.02

Source: OECD, Bruegel calculations

As evidenced by the overall PMR score, the liberalisation process accelerated as a result of the crisis in Greece and Portugal. Ireland, once more, stands out as an outlier, where government policies

actually led to a worsening of competitiveness in the product market environment. In Italy and Spain, the crisis, and accompanying financial market pressure, did not prevent a slowdown in the rate of loosening of PMR. Howbeit these efforts, Greece remains one of the worst performers in the OECD with respect to this heading.

Moving beyond the aggregates, we notice that the trends observed for PMR are confirmed in the **state control** sub-component. Privatisations were significantly up-scaled with respect to the pre-crisis period in Greece and Portugal, while the involvement of the state in business operations was simultaneously decreasing.

Barriers to entrepreneurship, as captured by the OECD indicators, were sharply reduced in Greece as a result of the crisis. A somewhat smaller, but still significant, effort was made in Portugal to improve firm entry into the market. Under this heading, Spain performed better than Italy. Reform efforts were, however, weaker in both stressed countries.

The sub-component where fewer efforts seem to have taken place is **trade and investment**. Under this chapter, whereas Greece is still the top-reformer in our reduced sample, we notice different trends. Portugal made no progress since 2008: a significant slowdown with respect to the previous 5-year period, when barriers were significantly taken down. Germany, our comparison country, which was neither under an adjustment programme nor financial market stress, actually slightly increased its barriers to trade and investment throughout the crisis, following a period of strong liberalisations.

As part of the analysis of reforms fostering the business environment, we also looked at data produced by the World Bank under its yearly Doing Business Reports on the **administrative burden** imposed on firms. Although this data is somewhat more rudimentary than the one compiled by the OECD, its yearly frequency allows for a better analysis of the timing of reforms.

Table 4. Business Environment[1]

No. procedures to start a business							
	2008	2009	2010	2011	2012	2013	2014
Greece	15	15	15	15	11	11	5
Ireland	4	4	4	4	4	4	4
Portugal	6	5	5	5	4	4	3
Italy	9	6	6	6	6	6	6
Spain	10	10	10	10	10	10	10
Germany	9	9	9	9	9	9	9

Source: World Bank

As displayed in Table 4, Greece has been the top-reformer in terms of reducing the number of procedures to start a business. Bearing in mind the cutoff dates of the World Bank reports, we note that the Hellenic republic slashed by almost one third this parameter at the inception of the programme (2010-11) and then again there was a second push in the third year of the programme. As a result of structural reforms under this chapter, Greece is now aligned to the other selected

[1] Note that the timing of the World Bank Doing Business is such that 2014, for example, indicates the report released in November 2013. For the latter, the cutoff date is July 2013. As such, an improvement marked in 2012 indicated reforms carried out over the period 2010-11.

countries and performing better than Germany. The other selected countries, although admittedly less in need, have not carried out notable reforms under this headline.

Table 5. Business Environment

No. days to start a business							
	2008	2009	2010	2011	2012	2013	2014
Greece	38	19	19	19	11	12	14
Ireland	13	13	13	13	13	10	10
Portugal	6	4.5	4.5	4.5	3.5	3.5	2.5
Italy	13	10	10	6	6	6	6
Spain	47	47	47	47	28	28	23
Germany	18	17.5	17.5	14.5	14.5	14.5	14.5

Source: World Bank

The number of days required to start a business shows somewhat different trends with respect to the previously analysed indicator. In particular, Greece is found to have improved significantly in 2007-08, ahead of the crisis. Moreover, simplifications were enacted at the inception of the programme, when days to start a business were reduced from 19 to 11, in the period 2010-11. After that, it seems that reform momentum waned and implementation proved troublesome, as some of the progress made was lost. Somewhat similarly, Ireland improved its score under this heading at the beginning of its programme, from 13 to 10. Interestingly, Spain, which stands out as a (negative) outlier for number of days, enacted strong reforms at the eruption of the euro area crisis (2010-11), almost halving this indicator. Since then, further progress has been made in 2012-13.

Table 6. Business Environment

Cost of starting a business (% of income per capita)							
	2008	2009	2010	2011	2012	2013	2014
Greece	21.1	22.5	20.2	20.7	20.1	20.5	4.6
Ireland	0.3	0.3	0.3	0.4	0.4	0.3	0.3
Portugal	6.7	6.5	6.4	6.5	2.3	2.3	2.4
Italy	18.7	18.5	17.9	18.5	18.2	16.5	14.2
Spain	15.1	14.9	15	15.1	4.7	4.7	4.7
Germany	5.7	5.6	4.7	4.8	4.6	4.9	4.7

Source: World Bank

Administrative burdens can also significantly impact the cost of starting a business, to which we now turn. As evidenced in Table 6 above, these were not significantly altered throughout the time horizon analysed. Notable exceptions are represented by Greece, which over the period 2012-13 slashed this indicator by over 75%, and Spain which, as observed for the 'number of days' indicator, implemented significant reforms improving the business environment in the early stages of the euro crisis (2010-11).

Table 7. Business Environment

	Time spent paying taxes (hours per year)						
	2008	2009	2010	2011	2012	2013	2014
Greece	264	224	224	224	224	202	193
Ireland	76	76	76	76	76	80	80
Portugal	328	328	328	298	275	275	275
Italy	340	314	314	285	285	269	269
Spain	298	234	213	197	187	167	167
Germany	196	196	196	215	221	207	218

Source: World Bank

Finally, when assessing the reforms affecting the business environment, we looked at an indicator of the time spent by companies in filing tax declarations. Interestingly, progress under this heading is more heterogeneous, with few trends to be spotted. Under this chapter, Spain results as a clear out-performer: carrying out significant reforms before and throughout the crisis, the country managed to almost halve its indicator, now performing significantly better than Germany. The latter, on the other hand, experienced a slight worsening in this indicator, placing it in a worse position than Greece in the latest World Bank monitoring. Once again, Ireland results a top performer in terms of quality of the business environment.

Table 8. Liberalising Professional Services

	Accounting		Architects		Engineers		Legal	
Δ	2003-08	2008-13	2003-08	2008-13	2003-08	2008-13	2003-08	2008-13
Greece	-0.17	0.00	0.00	-0.63	0.00	-0.63	0.00	-0.63
Ireland	-0.79	0.00	-0.63	0.00	0.00	0.00	0.00	0.00
Portugal	:	0.00	0.69	0.00	0.00	-0.58	0.08	-0.04
Italy	-0.67	-0.79	-0.58	-0.88	-0.63	-0.88	-0.25	-1.15
Spain	0.27	0.00	-0.13	-0.46	0.00	0.04	-0.85	-0.83
Germany	-0.38	0.00	0.40	-0.69	-0.88	-0.13	0.00	0.02

Source: OECD, Bruegel calculations

The liberalisation of restricted professions is often mentioned in Troika documents as a priority to reduce undue rents in the economy and allow a more optimal redistribution of resources across sectors. Although each programme country was asked to draw a detailed list of closed professions and the regulation covering them, the OECD collects information on the level of competitive restrictions only in four key sectors: accounting, architecture, engineering, and legal services. Table 8 above shows how, with the exception of Italy, no further liberalisation of the accounting profession has taken place throughout the crisis. The other sectors analysed were instead significantly opened to competition throughout the crisis period, in both programme and stressed countries. Particularly noteworthy is Italy's effort across the board, which accelerated in the past 5 years. Ireland, a very market-based competitive economy, did not further liberalise professional services throughout the crisis.

Finally, we turn to **regulatory provisions in the network sector**: telecoms, electricity, gas, post, rail, air passenger transport, and road.

Table 9. Sector Regulation

	Greece		Portugal		Ireland	
Sector	2003-08	2008-13	2003-08	2008-13	2003-08	2008-13
Airlines	0.00	-4.00	0.00	0.00	-2.11	-1.00
Telecoms	-0.29	-0.35	-0.58	-0.12	-0.14	-0.13
Electricity	-0.51	-0.65	-0.58	-0.95	-0.96	-0.75
Gas	-1.20	-0.35	-1.41	-1.20	0.05	-0.80
Post	-0.47	0.00	-0.83	0.00	-0.83	0.00
Rail	-1.13	0.00	0.00	-0.38	-0.75	-0.38
Road	-2.75	0.00	0.00	0.00	0.00	0.00
	Spain		**Italy**		**Germany**	
Sector	2003-08	2008-13	2003-08	2008-13	2003-08	2008-13
Airlines	-0.15	-1.00	-0.37	-1.50	0.00	0.00
Telecoms	-0.10	-0.07	-0.07	-0.09	-0.27	0.04
Electricity	-0.05	-0.19	-1.52	-0.40	-0.39	0.00
Gas	-0.73	0.19	-0.38	-0.08	-0.39	-0.38
Post	0.00	-0.33	-0.33	-1.00	-0.75	-0.07
Rail	-1.25	-0.38	-1.38	0.00	-1.25	0.00
Road	0.00	0.00	-1.00	0.00	-0.75	0.00

Source: OECD, own calculations

In this realm, we note interesting country-specific trends: Greece made most of its network sector liberalisation before the crisis. It then sharply tackled regulation in the airlines industry over the past 5 years. Portugal furthered the reform momentum built before the crisis and further enacted measures for telecoms, electricity, and gas. Also Ireland further liberalised some of its network sectors during the crisis. Spain and Italy took some measures during the crisis, but less so than the programme countries. The latter was a strong(er) reformer in the pre-crisis period. Germany, our comparison country, made most of its reform effort in the 2003-08 period, and then intervened at the margin, especially in the gas sector.

Conclusions

In 2010, after having put in place significant Keynesian spending programmes and bank bail-outs in the aftermath of the financial crisis, many euro area countries found themselves in a problematic fiscal situation. As financial markets were losing confidence in the capacity of sovereigns to honour their debt obligations, significant austerity programmes were implemented. This, in turn, weighed on growth, leading to a vicious debt spiral. Boosting countries' growth prospects, by enacting supply side reforms, became all the more paramount.

In this short background note, we looked at whether reform efforts were truly up-scaled as a result of the euro area crisis, and with what sequencing. Notwithstanding the rough nature of this benchmarking exercise, several conclusions can be drawn:

1) The crisis significantly accelerated the pace of structural reforms in programme countries. To a smaller extent, and only under some headings, also countries under financial market stress up-scaled their reform momentum. After being a major reformer in the period 2003-08, Germany by and large stopped pushing further with reforms.

2) Faced with the need to urgently put public finances on a sustainable path, programme and stressed countries enacted harsh austerity measures which did not shift the tax burden away from labour. To use a popular term nowadays, 'smart' or 'growth-friendly' fiscal consolidation became a priority only at later stage.
3) Troika conditionality attached to macroeconomic adjustment programmes led to a front-loaded liberalisation of labour markets. At the peak of financial market stress, also Spain and Italy enacted significant reforms under this heading. Similarly, but to a smaller extent, also measures improving the business environment were enacted with a similar timing.
4) Notwithstanding being under a financial assistance programme, Ireland implemented relatively little structural reforms throughout the crisis, as the economy was already highly competitive. In some cases, it actually up-scaled regulation (e.g. in the product market sector), the role of the state in the economy, and workers protection legislation.

Although some of the findings might seem trivial at first sight, we believe them to warrant some reflection. One and foremost, the fact that structural reforms were implemented at a faster pace throughout a crisis period than during a time of relative economic bonanza. Although this is understandable from a political economy point of view, it highlights a problem: structural reforms are more likely to be effectively put in place when accompanied by appropriate funding and not in synchronous with fiscal retrenchment. Moreover, their effect is often negative in the short run (for example, labour market liberalisations) and positive only in the medium- to long run. Finally, better policies would most probably be devised when carefully planned out and thought through, rather than rammed through by decree and under time pressure.

Aside from this element, our analysis has no pretension to be normative in nature, but rather merely a positive description of the headlines of reforms on which governments chose to focus their efforts. We acknowledge that every country, even within the euro area, is different from the other, and the challenges to be faced are multi-fold. As such, no one size-fits-all prescriptions should be adopted. Consequently, many questions remain unanswered.

First, which reforms should be implemented with which timing? Assuming a trade-off, should labour market reforms precede business environment reforms? Should the liberalisation of closed professions anticipate progress under product market regulation? In other words, which policy mix is likely to have swifter positive impact on the economy?

Second, is it advisable for different reforms to be lumped together in large omnibus bills that are likely to increase the perception of fairness and that it is not few key sectors or categories that are being targeted? This may come with the cost of overwhelming the public administration and citizens, generate potential backlogs in courts, and reduce transparency of decision-making.

Third, as the Romans already acknowledged, '*quis custodiet ipsos custodes*'? In other words, reforms often were not implemented in non-crisis periods due to poor institutions and administrations. Can it be expected that, in moments of crisis, the political elite finds the necessary will to reform itself and the bureaucracy? Is it advisable to expend large political capital in institutional reforms in a moment of crisis, at the risk of being perceived as far from the problems of the citizens? And, if not, is the country not likely to return to 'bad habits' shortly after an adjustment programme or as market pressure wanes?

As a final caveat, we note that all our analysis (and the OECD's or World Bank's work) is based on *de jure* structural reforms. However, as the Greek programme has illustrated, implementation is just as crucial as drafting and getting approved a good bill in parliament. In this sense, a country's administrative capacity is likely to be key. Ensuring that reforms are actually seen through until the end is the only way to ensure they will have their planned impact on competitiveness and, eventually, on economic growth and living standards.